Chapter 3.1: The Banking Sector

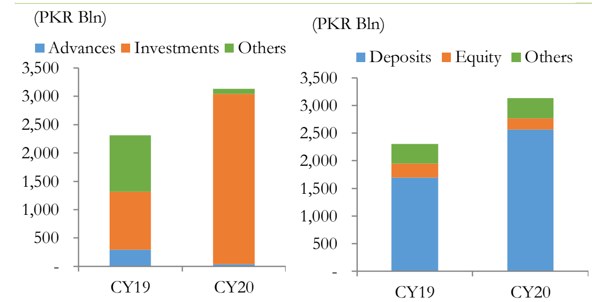
In CY20, banking sector has remained resilient despite pandemic induced vulnerabilities. The momentum of Advances — across various economic sectors — remained weak while banks' investments surged in the wake of higher government budgetary borrowing. Healthy flow of deposit provided the necessary funding to support the asset growth. Despite overall stresses in the macroeconomic environment, Non-Performing Loans observed a moderate rise partly supported by prudential relief measures. The earnings observed a marked improvement mainly attributed to lower interest and administrative expenses, and gains on sale of securities. The solvency continued to strengthen indicating elevated capacity of the banks to sustain stress from unexpected shocks. Given the uncertain environment, banks need to continuously assess the situation, particularly the repayment capacity of borrowers, and take necessary measures for ensuring institutional solvency.

Banking sector remained resilient during CY20…

Despite pandemic driven stress, banking sector's assets grew by 14.24 percent during CY20—higher than 11.73 percent growth observed in the previous year.

Growth in the asset base was almost entirely driven by investments which increased by 33.51 percent (**Chart 3.1.1**).[53] Marked rise in deposits—in a risk averse environment— enabled banks to finance investments of around PKR 3 trillion. Current accounts and saving deposits (**CASA**) contributed the lion's share in the growth of deposits, which mainly belonged to 'individuals' and 'businesses' categories of deposits. While advances recorded a paltry growth of 0.52 percent, this increase mainly resulted from SBP's policies to support the flow of credit. The credit decelerated across some economic sectors while made net retirements in others. Textile sector, however, availed highest financing during the reviewed year.

Chart 3.1.1: Assets and liabilities composition of the banking sector (flows)



Source: SBP

The credit risk of the banking sector, supported by SBP's macro-prudential interventions, moderately increased as Gross Non-Performing Loans Ratio (**GNPLR**) inched up to 9.19 percent by end Dec-20 (8.58 percent in Dec-19).

The after-tax earnings of the banking sector surged by 42.92 percent during CY20. Drastic cut in policy rate during March to June 2020 transmitted into lower funding costs on deposits due to immediate repricing of saving deposits.[54] On the other hand, interest earnings were supported by increase in the volume of investments in government securities as well as lag in the re-pricing of loans, which are repriced as per the frequency set in the loan agreement between the bank and the borrower.

The solvency of the banking sector remained robust, which further improved with, marked rise

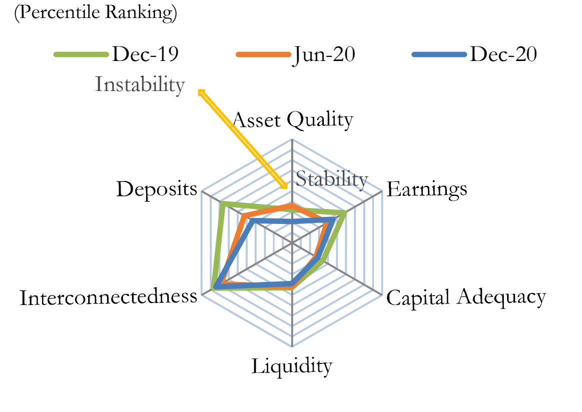
[53] Investments explain 96 percent rise in total assets flows during CY20.

[54] According to BPRD Circular No. 07 of 2013, in the wake of change in policy rate, re-pricing of saving deposits is applicable with effect from 1st day of the subsequent month. The circular can be accessed at: https://www.sbp.org.pk/bprd/2013/C7.htm

in earnings. The Capital Adequacy Ratio (**CAR**) increased to 18.56 percent by end Dec-20 from 17.0 percent in Dec-19. Similarly, the Basel liquidity ratio including Liquidity Coverage Ratio (**LCR**) and Net Stable Funding Ratio (**NFSR**) remained well above the required level during CY20.

Consolidated position of banks' stability along key risk dimensions has improved over the year as encompassed in Banking System Stability Map (**BSSM**) despite the elevated macroeconomic stress (**Chart 3.1.2**).

Chart 3.1.2: Banking Sector Stability Map



Source: SBP

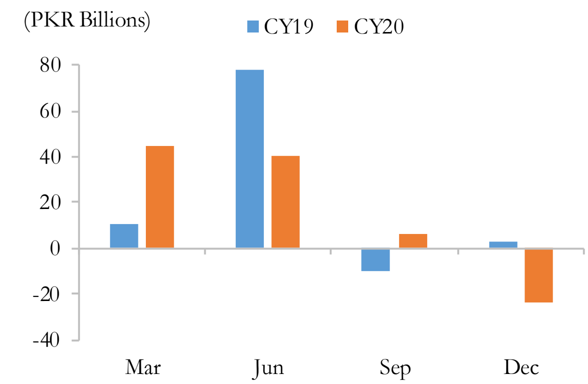
Credit risk increased somewhat …

The stock of banks' NPLs increased by 8.91 percent to PKR 829 billion during CY20. Positively, the current year growth in NPLs was lower than previous year's rise of 11.97 percent. However, GNLPR inched-up to 9.19 percent (8.58 percent in CY20) due to muted growth in loan portfolio. Importantly, the flow of NPLs increased by PKR 85 billion amid the height of uncertainties during H1CY20 which subsided to PKR 68 billion by the end of CY20.

…particularly in the first half, due to lockdown and other pandemic containment measures….

Rise in NPLs during H1CY20 manifested the impact of earlier macro-economic conditions especially higher interest rates which prevailed in Q1CY20 as well as lockdowns and social distancing measures enacted by the government during Q2CY20 (**Chart 3.1.3**).

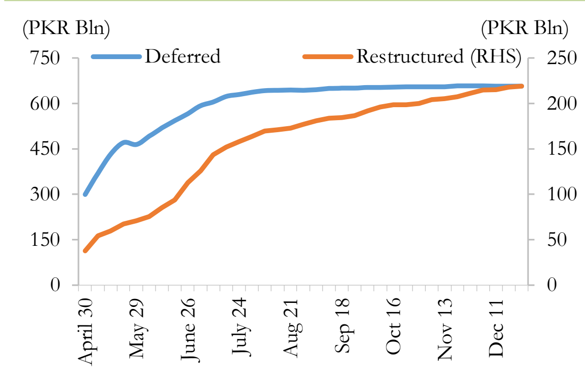
Chart 3.1.3: NPLs flows subsided in H2CY20



Source:SBP

With the impending cash flow constrains among economic agents due to pandemic containment measures, SBP acted proactively by providing relief through a host of measures, including 6.25 percent cut in policy rate between March to June 2020 and principal payment holidays and restructuring/ rescheduling of loans. From the start of the pandemic to end June 2020, loans worth of PKR 566 billion were deferred and PKR 113 billion allowed for restructuring/rescheduling (**Chart 3.1.4**).

Chart 3.1.4: Cumulative amount deferred and restructured/ rescheduled in CY20

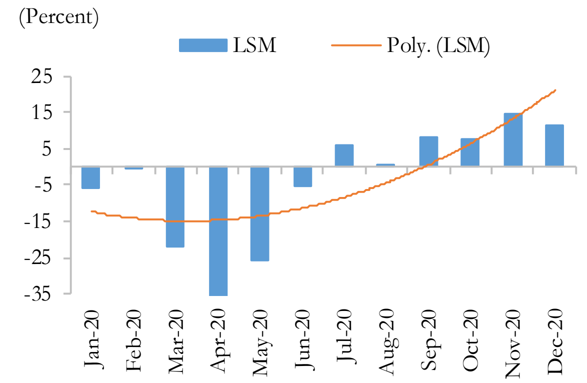


Source: SBP

… while credit risk subsided as support measures started to bear results

The contraction in NPLs during H2CY20 resulted from both the impact of SBP relief measures, gradual economic recovery, and increase in cash recoveries against NPLs. The support factors included upturn in manufacturing activity due to opening up of economic activity with SOPs, and combined impact of different policy measures, which were further augmented by government's package for the construction industry (**Chart 3.1.5**). Also, the lagged impact of monetary easing boosted re-payment capacity of the firms, which started to reflect in lower financial costs of borrowers **(see Chapter 6).**

Chart 3.1.5: YoY Growth in Large Scale Manufacturing Index



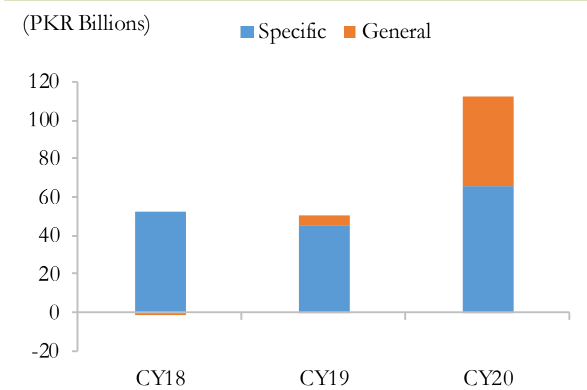
Source:SBP

Provisions increased substantially due to prudent approach of banks…

Provisions expense against NPLs grew by PKR 112 billion during CY20—considerably higher than previous year's rise of PKR 50 billion. Consequently, the stock of provisions reached to 88.33 percent of the value of outstanding NPLs by end CY20 (81.43 percent at end CY19). Higher level of provisioning translated into lower residual risk, with Net NPLR standing at 1.17 percent at the end of CY20 as compared to 1.71 percent a year ago. A proactively improved provisions coverage of credit risk suggests a lower risk to the solvency of banks.

It deserves emphasis that 41.96 percent of total provisioning made by the banks during CY20 were in the form of general provisioning which is kept as precautionary cushion under a forward-looking approach to address potential credit risks. This approach reflects banks prudent behavior in terms of both covering the anticipated risks post expiry of relief measures as well as a step to prepare for the implementation of IFRS 9[55] that was planned to be effective from January 1, 2021 (**Chart 3.1.6**).

Chart 3.1.6: Yearly provisions flows



Source:SBP

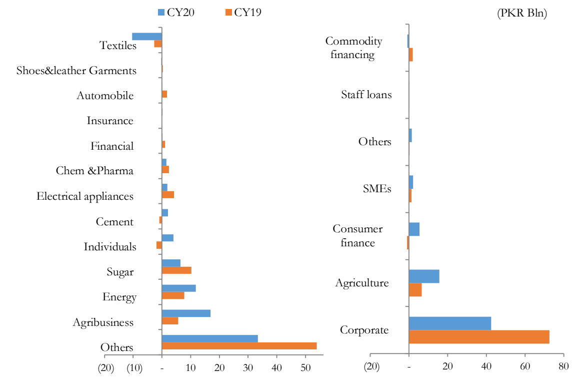
Rise in NPLs was concentrated in few economic sectors…

More than 50 percent rise in NPLs during CY20 was observed in Agribusiness, Energy, and Sugar sectors (**Chart 3.1.6**). The flow of NPLs in the Agribusiness amounted to PKR 17 billion against PKR 6 billion in CY19. Locust attacks on crops as well as pandemic driven problems (e.g., lack of public transportation and unavailability of labor

[55] IFRS 9 is an accounting standard published by the International Accounting Standards Board covering the measurement of financial instruments, asset impairment and hedge accounting.

The new standard introduces the concept of expected credit loss accounting, requiring banks to predict the future loss of all assets at the point of origination or purchase, and set aside provisions for these assets. Under the previous regime, IAS 39, banks provisioned for assets only at the point of impairment and other inputs) at the time of harvest drove-up NPLs of the sector.

Chart 3.1.7: Sector-wise and Segment-wise flow of NPLs



Source: SBP

Segment-wise analysis reveals that corporate witnessed deceleration in flow of NPLs during CY20 (**Chart 3.1.7**). Such a lower increase in quantum of NPLs despite pandemic stress demonstrates the effective role of SBP policies that facilitated banks to manage the credit risk as also risk averse approach in their lending strategies (**see Box 6.1 in Chapter 6**).

Among the sectors, Energy sector NPLs increased by PKR 12 billion during CY20—higher than PKR 8 billion recorded in previous year. The rise in NPLs was mainly driven by drop in international oil prices and softening domestic demand for petroleum products (owing to lockdowns) which translated into inventory losses[56] for Oil Marketing Companies (**OMCs**) and hence wakened their re-payment capacity. OMCs also experienced FX losses due to PKR depreciation at the onset of the pandemic. Besides, delay in receivables and non-finalization of Commercial Operations Date of certain energy firms resulted into delinquencies on their financial obligations during the reviewed year.

Sugar sector NPLs increased by PKR 6 billion during CY20 as compared to PKR 10 billion in previous year. Certain Sugar mills that experienced disruption in business operations in previous year—resumed operations in CY20 hence the sector was able to relatively better service the debt.

NPLs of the textile sector— one of the largest borrowers — contracted by PKR 10 billion in CY20. Quarterly analysis indicates that around 70 percent of the contraction in NPLs materialized during Q4CY20. Besides improved cash flows of textile sector due to export orders, improved cash recoveries by the banks contributed in the reduction of NPLs. Moreover, around 50 percent of the total NPLs during CY20 increased in "Others" category, a leading portion of which came from the overseas operations of some Pakistani banks.

Large and medium-sized banks' asset quality remained more or less stable …

Large and medium sized banks—holding more than 70 percent of the baking sector's NPLs—remained in a better shape during CY20 with contained infection ratio and an average provisioning coverage ratio (PCR) of 90.48 percent (**Table 3.1.1**). However, small and very small banks saw some increase in their infection ratio with average provisioning coverage of less than 70 percent at the end of CY20.

Table 3.1.1: Size-wise NPLs statistics

	Dec-19			Dec-20		
Bank-size	NPLs Ratio	PCR	% share in NPLs	NPLs Ratio	PCR	% share in NPLs
Large	6.11	102.82	51.57	6.85	115.54	52.46
Medium	6.40	69.62	21.83	6.67	73.92	20.48
Small	17.65	61.14	19.81	19.92	67.81	20.64
Very Small	21.50	65.56	6.79	23.59	67.80	6.43

Source: SBP

…though flow of private sector advances subsided...

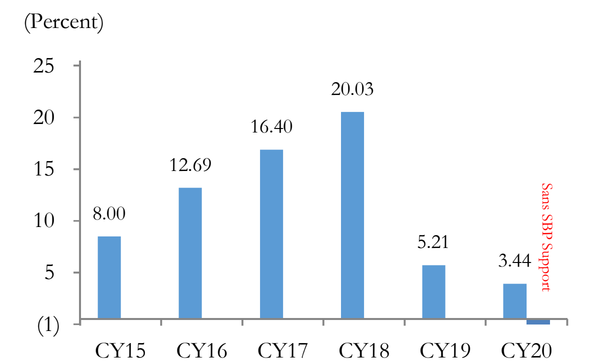
Total domestic advances increased by PKR 187 billion during CY20 against an increase of PKR 297 billion in the previous year. Advances to the private **sector** increased by PKR 217 billion while

[56] Inventory losses occur when OMCs buy crude oil at a particular price, which falls by the time the oil is shipped to refineries and processed.

public sector advances witnessed contraction of PKR 30 billion in the reviewed year.

Importantly, growth in private sector advances—at 3.44 percent—was the lowest during the last five years (**Chart 3.1.8**). The slowdown in financing manifested the impact of economic downturn triggered by the pandemic.

Chart 3.1.8: Domestic private sector advances growth



Source: SBP

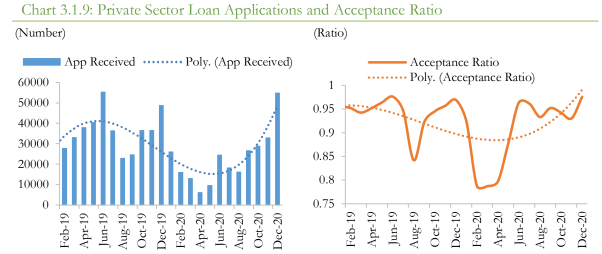
To mitigate the economic risks emanating from COVID-19, SBP enacted a number of concessionary refinance schemes to ensure easy access to liquidity including Rozgar Scheme[57], Temporary Economic Refinance Facility[58] (**TERF**), and Refinance Facility for Combating COVID-19 (**RFCC**).[59] Collectively under these schemes, banks disbursed PKR 247 billion during CY20, which kept the private sector advances growth positive during CY20.[60]

Weaker demand for advances mainly explains subdued growth of financing…

The analysis reveals that slowdown in private sector advances was primarily contributed by weaker demand conditions. In CY20, loan applications declined by 37.59 percent (273 thousand in CY20 vs. 437 thousand in CY19). From supply side perspective, banks accepted 92.76 percent application for financing in the reviewed year—slightly down from 94.97 percent in CY19, reflecting some degree of risk aversion on the part of banks in the wake of pandemic shock. Nonetheless, the mild impact of the pandemic, aggressive policy support by the SBP and the government and the subsequent early resumption of economic activities seem to explain revival in bank lending towards the end of the year.

Further, investigation shows that lowest loan applications were received during Q2CY20. Also in this period, banks' risk aversion peaked as acceptance ratio dipped to 88.01 percent (96.40 percent in Q2CY19)[61] (**Chart 3.1.9**). However, in subsequent quarters, loan applications consistently increased as well as the banks' willingness to lend improved.

Chart 3.1.9: Private Sector Loan Applications and Acceptance Ratio



Source: SBP

Except for textiles, other economic sectors availed moderate financing….

The **sector-wise** analysis indicates that textile sector availed highest level of financing among economic sectors (**Chart 3.1.10**). Most of the 11.75 percent growth in textile sector advances took place during the first and final quarter of CY20. Rise in financing during Q1CY20 was owing to

[57] The Scheme aimed to prevent layoff by financing wages and salaries of employees (permanent, contractual, daily wagers as well as outsourced) for six months (April 2020-Sep 2020) for all kind of businesses except for government entities, public sector enterprises, autonomous bodies and deposit taking financial institutions

[58] TERF is a concessionary refinance facility aimed at promoting investment both new and expansion and/or Balancing, Modernization and Replacement (**BMR**)

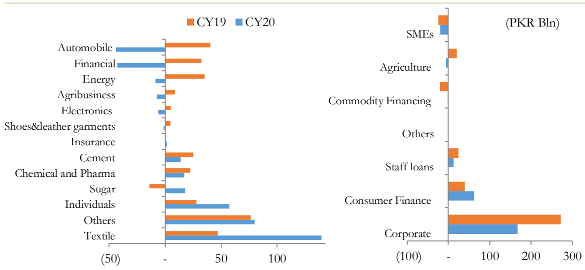
[59] RFCC aimed at enhancing the capacity of health sector of the country to deal with health emergency especially in the backdrop of COVID-19.

[60] The liquidity of PKR 213 billion, PKR 31 billion, and PKR 4 billion was provided to the private sector respectively under Rozgar Scheme, TERF, and RFCC.

[61] Monthly average of acceptance ratio during Q2CY20

enhancement of the aggregate limit for the Export Financing Scheme (**EFS**) by PKR 100 billion.[62,63] Increase in financing during Q4CY20 resulted from relatively early resumption of economic activity in Pakistan due to effective handling of the pandemic by the government that allowed textile sector to capture export orders ahead of its foreign competitors. Resultantly, textile sector demand for advances increased to scale-up exports.[64]

Chart 3.1.10: Sector-wise and Segment-wise flow of private sector advances



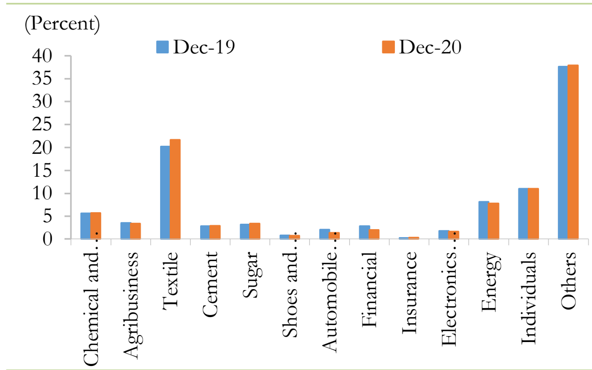
Source: SBP

Similarly, sugar sector advances grew by 8.11 percent in CY20. The growth in advances occurred during Q4CY20[65] due to an early start of sugarcane crushing. In the Cement sector, advances flows decelerated in CY20, due to improved cash flows of the cement sector on the back of higher sales[66] especially in H2CY20, when economic activities resumed and government announced a package for construction industry. Also, SBP's concessionary scheme for housing and construction finance also bode well for cement industry.[67] Similarly, higher sales of the Automobile sector during H2CY20[68] helped improve the liquidity of the sector, hence net retirement of 36.03 percent was observed during CY20 as compared to 49.84 percent growth in CY19. Financial sector made net retirement during CY20 as DFIs reduced borrowing from the banking sector.[69] Energy sector made net retirement as its cash flows improved owing to the issuance of energy Sukuk-II worth PKR 200 billion, which reduced the receivable of energy firms[70].

The composition of banks' loan portfolio remained unaltered …

The pandemic had no tangible effect on banks' distribution of advances to different sectors. The analysis indicates that sector-wise exposure of the banks remained almost stable during CY20 (**Chart 3.1.11**). This reflects that since the principal exposure of banks' advances was concentrated in manufacturing industry rather than high contact industries[71], loan structure of the banks remained unchanged despite pandemic shock.

Chart 3.1.11: Sector-wise percent share in private sector advances



Source: SBP

62 Press release related to EFS is available at http://www.sbp.org.pk/press/2020/Pr2-28-Jan-20.pdf
63 Higher financing coincided with higher exports of the textile sector, which stood at USD 3,378 million in Q1CY20 as compared to USD 3,327 million in Q1CY19.
64 In Q4CY20, textiles exports amounted to USD 3.5 billion as compared to USD 3.4 billion in Q4CY19.
65 Sugar advances showed higher contraction of PKR 20 billion during 9MCY20 against PKR 7 billion contraction in the comparable period of CY19.
66 In CY20, cement sales increased by 2.0 percent. However, in H2CY20, sales were higher by 15.7 percent as compared to H2CY19.
67 https://www.sbp.org.pk/smefd/circulars/2020/C10.htm
68 Though total cars' sales were 35.8 percent lower in CY20 as compared to previous year, however, sales were up by 13.4 percent in H2CY20 against H2CY19.
69 DFIs borrowings declined to just PKR 32 billion in CY20, from PKR 117 billion in CY19. As a result, investments during CY20 came down to PKR 47 billion from 117 billion in CY19.
70 These Sukuk were issued by Power Holding Limited during Q2CY20.
71 High contact-industries rely more on face-to-face interactions to conduct business operations e.g. hoteling, tourism, retail, etc.

Corporate segment significantly borrowed long-term advances…

The **segment-wise** analysis reveals that except for consumer segment, financing flows across segments were lower during CY20 as compared to CY19 (**Chart 3.1.10**). Further investigation indicates that a rise in financing of PKR 168 billion to **Corporate** segment during CY20 was almost entirely driven by fixed investment (**FI**) advances which increased by PKR 254 billion manifesting the impact of SBP refinance scheme including Rozgar Scheme and TERF.[72] The working capital (**WC**) advances, on the other hand, contracted by PKR 127 billion during CY20. In the final quarter of CY20, as the pace of economic momentum strengthened, financing demand for WC as well as trade financing (**TF**) also improved.

However, financing to SMEs subsided…

SMEs availed only a fraction of banks' lending portfolio, as their share in overall loans remained marginal. Unlike Corporate segment**, SMEs** made net retirement of 4.18 percent in CY20. Resultantly, the share of SMEs loans in total loans shrank to 5.32 percent from 5.68 percent in Dec-19. The historically lower share of SMEs in overall advances illustrates banks' abated risk appetite towards this segment.

…and the favorable lending rates triggered consumer financing

The **Consumer** segment grew by 11.13 percent during CY20, with most of this growth taking place in H2CY20. More than 60 percent contribution in consumer financing from auto loans and 33 percent from personal loans primarily indicating the impact of favorable lending rates due to significant monetary easing.

Public sector advances contracted by PKR 30 billion during CY20 (PKR -15 billion in CY19). Although there was an intake of PKR 35 billion for commodity financing, the retirements were driven by large public sector corporations in energy sector whose advances contracted by PKR 65 billion. This reflects maturity of long-term loans, issuance of Sukuk by a leading borrowing corporation, and improved cash flows of the public sector entities during CY20.

Unlike advances, banks investments in government securities surged during CY20…

Banks investments shot-up by 33.51 percent to PKR 12 trillion during the reviewed year (12.96 percent rise in CY19)-predominantly driven by investments in government securities. Weak financing demand, abundant liquidity, and high government budgetary borrowing needs accelerated banks' investments.

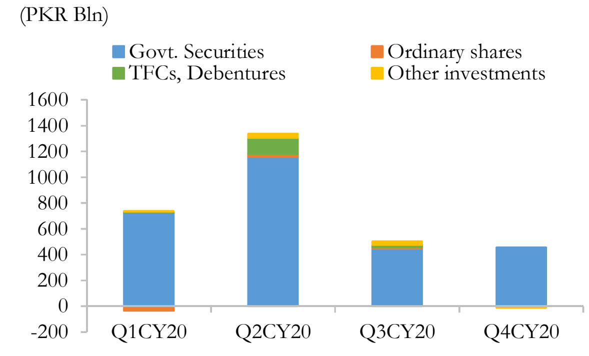
Further analysis indicates that most of the rise in investments occurred during second quarter of CY20 (**Chart 3.1.12**). In this period, domestic economy experienced economic shock driven by COVID-19, which not only weakened demand for financing (as business activity halted due to lockdowns and social distancing measures) but also pushed-up budgetary needs of the government to support the economy.[73] This combined with abundant liquidity due to healthy growth in deposits allowed banks to heavily invest in the risk-free government securities. Also during Q2CY20, banks investments in Term Finance Certificates (**TFCs**)/ Sukuk increased by PKR 124 billion, which primarily reflects Islamic Banking Institutions' (**IBIs**) investment in Energy Sukuk II (**see Chapter 3.2**).[74]

[72] Financing provided by SBP under Rozgar and TERF were of long-term nature that is why banks fixed investment advances accelerated.

[73] Budget deficit at -3.8 percent (of GDP) during Jul-Mar FY20 grossly widened to -8.1 percent during Jul-Jun FY20.

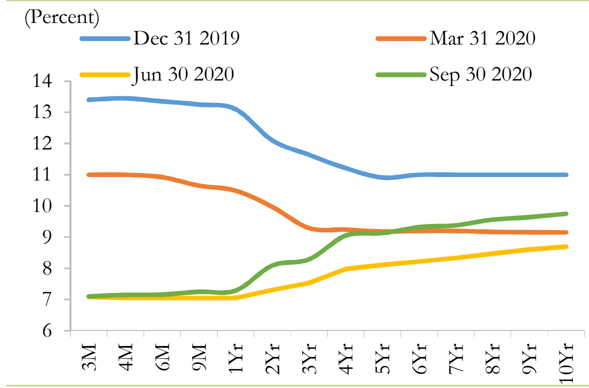
[74] These Sukuk—worth PKR 200 billion—were issued by Power Holding Limited during Q2CY20.

Chart 3.1.12: Break-up of Total Investments (Flows)



Source: SBP

Chart 3.1.13: Yield Curve



Source: SBP

In terms of composition, 91.86 percent of the investments in government securities were channeled into long-term bonds (PIBs). Consequently, share of PIBs in total government securities increased to 49.86 percent by end of CY20 (40.97 percent by end of CY19) while share of short-term securities (MTBs) declined to 42.07 percent (54.36 percent by end of CY19).

Interest rate dynamics as well as government debt strategy influenced investments composition…

The first half of CY20 observed a rise in both short-term as well as long-term investments by the banks. In the early months of CY20 (January and February) when there were no obvious expectations of decline in policy rate, banks preferred to invest in short-term i.e., 3 months treasury bills. However, as the expectations started to build for a cut in policy rate[75]during March-2020, banks bidding in 12M treasury bills auctions surged along with increased appetite for fixed rate PIBs in order to lock their funds at higher prevailing returns (**Chart 3.1.13**).

In Q2CY20, as policy rate moved down by 625 basis points to 7 percent, it became favorable for the government to improve its debt maturity profile and reduce its roll-over risk by increasing long-term debt. Accordingly, government reduced its target for MTBs to PKR 2.2 trillion in Q2CY20 from PKR 2.8 trillion in Q1CY20, while increased its auction target for PIBs to PKR 530 billion from PKR 450 billion. The government also introduced 3- and 5-years floating rate bonds during Q2CY20. Resultantly, long-tern borrowing of the government increased during Q2CY20.

In the second half of CY20, interest rate expectations (for 1 year to 10 years maturities) reversed owing to the anticipated rebound in aggregate demand pressures in the perspective of economic recovery. Interestingly, despite expectations that interest rates could rise in future, banks investments in MTBs declined during Q3CY20 while increased in PIBs, particularly in floating rate bonds.[76] Besides the change in government strategy on its debt profile, this increase was also supported by the reduced re-pricing risk[77] for banks in floating-rate PIBs.

75 Change in interest rate expectations was largely driven by fall in global oil prices and anticipated softening in domestic economic activity due to rising COVID-19 cases.

76 In Q3CY20, the government not only further reduced its target for MTBs to PKR 1.8 trillion but also retired its short-term debt (acceptance was less than maturing amount) leading to contraction in banks investments against MTBs. Contrarily, the government significantly raised its auction target for PIBs—particularly for floating rate PIBs —to PKR 1.3 trillion (auction target for PIBs fixed rate and floaters increased by 420 billion and PKR 830 billion, respectively). The banking sector also demonstrated increased interest in PIBs as banks bidding amount increased to PKR 2.4 trillion in Q3CY20 from PKR 1.0 trillion in Q2CY20.

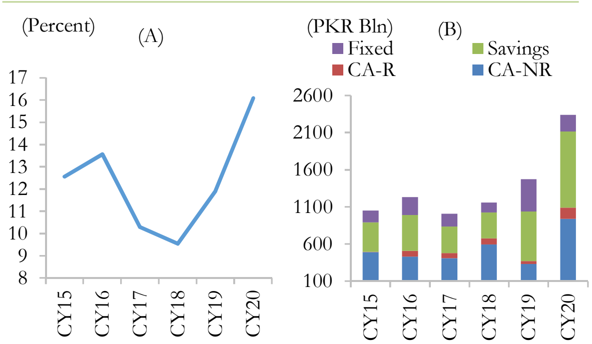
77 When interest rates rise, banks experience mark to market revaluation losses on their funds locked in long-term bonds at fixed coupon rate because value/prices of the bonds move down.

Similarly, during the last quarter of CY20 banks investments declined in MTBs (because government acceptance was less than maturity amount) while increased in PIBs[78]. However, investments in PIBs came down to PKR 388 billion from PKR 853 billion in previous quarter.

Surge in investments was supported by an abundant inflow of deposits….

Deposits of the banking sector increased by 16.08 percent to PKR 19 trillion during CY20 (11.92 percent in CY19)—highest growth in previous 5 years (**Chart 3.1.14A**). Savings and current account deposits together contributed 88.89 percent rise in total customers' deposits during the reviewed year (**Chart 3.1.14B**).[79] It deserves emphasis that fixed deposits contribution in total deposits flows during CY20 came down to just 9.32 percent from 29.54 percent in previous year. This seems to be on account of reduced incentive for depositors as deep cut in policy rate transmitted into lower return on deposits.[80]

Chart 3.1.14: YoY growth in deposits and customers' desposits flows



Source: SBP

Analysis reveals that deposits increased by PKR 1.5 trillion in the first half of CY20, with the entire rise taking place in Q2CY20. This is a period when economic stress peaked due to elevated infections, lockdowns and social distancing measures. The following factors may have played a role in the phenomenal rise in deposits:

1. First, pandemic played vital role in deposits accumulation. Slack in economic activity and lockdowns drove-up deposits due to constraints on spending avenues (e.g., closures of restaurants, shopping malls etc.), "forced savings" drove-up deposits.[81]

2. The pandemic also drove-up the deposits via economic uncertainty channel. People remained cautious to utilize their savings to ward against uncertain income flows during the pandemic. This is evident by phenomenal rise in savings and CA deposits.

3. Policy measure to promote the use of ADC in the pandemic, including SBP's instructions to waive off banks charges on online fund transfers, promoted the cash-less transactions and helped in keeping the funds in bank deposits.

4. Strong inflow of workers' remittances also supported the rise in deposits.[82] Besides, these remittances might not have been fully utilized for consumption due to the lockdown.

5. Other investment avenues were limited in the pandemic because of which people preferred to keep their savings in the banks.

However, in case of floating rate PIBs, return on bonds moves along the changes in the interest rates. Therefore, banks increased investments in floating rate PIBs during Q3CY20 were focusing on short-term interest rate horizon while parking their liquidity for the longer-term bonds

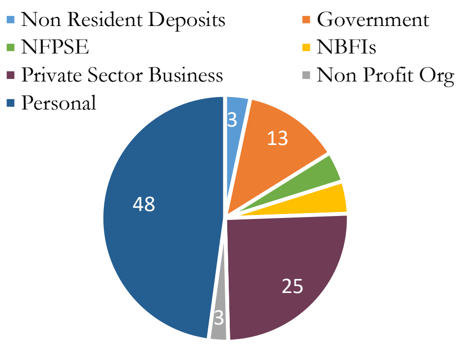
[78] The government further introduced quarterly floating rate PIBs with tenors of 2 years, 3 years, 5 years and 10 years during Q4CY20.
[79] Savings and CA-NR contributed by 43.08 percent and 39.47 percent, respectively.

[80] Weightage Average Deposit Rates (WADR) on fresh deposits averaged at 4.78 percent during CY20—down from 7.57 percent in CY19.
[81] Christine Lagarde (ECB President) explained the aspect of forced savings as one of the reasons behind rise in deposits in the euro area amid COVID-19. Her speech is available at BIS website (https://www.bis.org/review/r200615a.htm)
[82] In Q2CY20, workers' remittances amounted to USD 6.1 billion against USD 5.7 billion in Q2CY19.

In the second half, deposits observed a rise of PKR 1 trillion (PKR 726 billion increase in H2CY19). The liquidity support provided to the banks by SBP in the wake of COVID-19 notably increased during this period, supporting the expansion in banks' deposits. Banks could also have attracted deposits from institutional investors as the government imposed restrictions on these investors to invest in National Savings Schemes (NSS).[83]

The category-wise analysis of deposit holders indicate that most of the rise in deposits was contributed by individuals followed by private sector businesses (**Chart 3.1.15**).

Chart 3.1.15: Category-wise percent share in total deposits flows during CY20

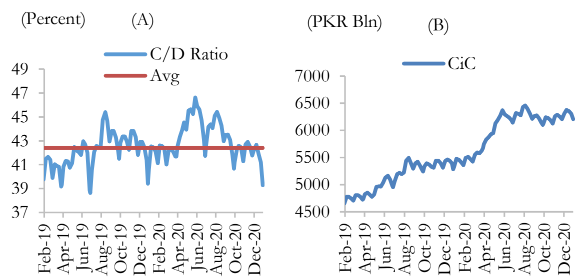


Source: SBP

Despite strong growth in deposits, currency to deposit ratio remained elevated in the economy…

Currency to deposit (**C/D**) ratio averaged at 42.98 percent in CY20—higher than the average of 41.84 percent recorded in previous year (**Chart 3.1.16A**). It was despite the fact that the banking sector received strong inflow of deposits during CY20 coupled with noticeable rise in mobile and internet transactions.[84] By looking at stock of currency in circulation (**CiC**), it can be observed that CiC sharply rose after March-2020 (**Chart 3.1.16B**).

Chart 3.1.16: Currency to deposit ratio and stock of currency in circulation



Source: SBP

One of the possible drivers of increase in CiC during this period seems to be Ehsaas Emergency Cash program launched by the government in order to mitigate the socioeconomic impacts of the outbreak.[85] Under this program, PKR 203 billion (USD 1.23 billion) were disbursed as one-time emergency cash assistance to 16.9 million families at risk of extreme poverty.[86,87] Moreover, wheat procurement by the government of PKR 190 billion during Q2CY20 may have led to higher currency in circulation on account of payments to farmers.[88]

Interconnectedness of the banking sector remained contained…

In the backdrop of ample flow of deposits and SBP refinancing schemes, banking sector interconnectedness, as exhibited in interbank borrowings, remained low during CY20. Moreover, persistent OMOs injections by SBP kept the market liquid reducing their dependence upon interbank money market for meeting the liquidity needs (**see Chapter 2**). Depending upon their business strategy and idiosyncratic dynamics, some medium banks engaged in significant

[83] http//savings.gov.pk/ban-institutional-investment/:

[84] Volume of internet banking and mobile banking transactions increased by 52.9 percent and 112.8 percent, respectively during 9MCY20 (on YoY basis).

[85] https://www.pass.gov.pk/Detailf90ce1f7-083a-4d85-b3e8-60f75ba0d788

[86] The program was launched on April 1, 2020.

[87] Government of Pakistan (July 2020). Ehsaas Emergency Cash: A digital solution to protect the vulnerable in Pakistan during the COVID-19 crisis.

[88] Enhanced wheat procurement target of 8.25 million tons in 2020 (6.25 million tons in 2019) and rise in wheat support price to PKR 1,400 per 40 kg from PKR 1,300 per kg explain higher financing for wheat.

interbank activity, however, overall unsecured interbank borrowings of the banking sector contracted by PKR 126 billion during CY20 as compared to a rise of PKR 42 billion in CY19. Moreover, stock of banks' borrowings as percent of total assets slightly declined to 12.80 percent by end Dec-20 from 13.33 percent a year ago.

…as well as the liquidity buffers remained high

The liquidity buffers of the banking sector improved during CY20 as a result of huge investments in government securities. Liquid assets to total assets ratio of the banks enhanced to 54.76 percent in CY20 from 49.65 percent in previous year (**Table 3.1.2**).

Table 3.1.2: Liquid Assets to total assets by bank ownership

	CY17	CY18	CY19	CY20
	Percent			
Public sector banks	55.20	50.71	53.93	56.55
Local private banks	52.67	47.07	47.29	53.33
Foreign banks	89.33	84.85	85.40	88.33
Specialized banks	34.27	19.39	24.44	31.72
All banks	**53.97**	**48.69**	**49.65**	**54.76**

Source: SBP

Accordingly, liquid assets to total deposits ratio of the banking sector increased to 74.29 percent in CY20 from 68.44 percent in CY19.

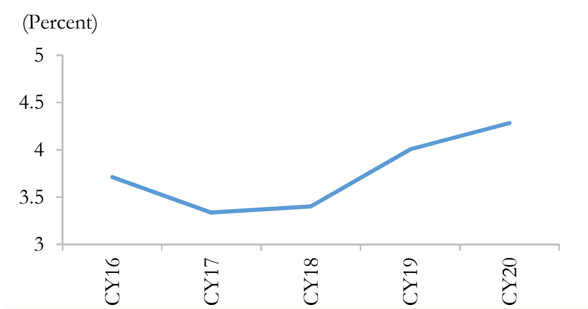
Similarly, banking sector continued to meet Basel III liquidity standards with wide margins. LCR improved to 226.0 percent (180 percent in CY19), while NFSR increased to 177.0 percent in CY20 (159.0 percent in CY19). [89]

Earnings of the banking sector accelerated during CY20…

Despite economic downturn and associated softening in advances, profit after tax (**PAT**) observed a healthy increase of 42.92 percent to PKR 244.04 billion in CY20 (14.34 percent growth in CY19). On the back of improved profitability, Return on Assets (**ROA**-after tax) and Return on Equity (**ROE**-after tax) rose to 1.05 percent (0.83 percent in CY19) and 13.78 percent (11.30 percent in CY19), respectively.

A number of factors drove-up banking sector's earnings. First, in the wake of pandemic, policy rate cut led to an immediate re-pricing of savings deposits due to Minimum Saving Rate policy.[90] This led to a decline in interest expenses by 7.28 percent during CY20 (90.05 percent rise in CY19). The impact of monetary easing also impacted the interest earnings which, however, managed to post an increase of 3.92 percent in CY20 as compared to robust rise of 60.55 percent in CY19. This growth in income was mainly attributable to sharp increase in volume of investment in relatively high-return longer-term government securities (**see Box 3.1**).[91] Resultantly, net interest income (NII) posted a healthy growth of 22.52 percent over the year, which led to increase in Net Interest Margin (**NIM**) to 4.28 percent in CY20 to 4.0 percent in CY19 (**Chart 3.1.17).**

Chart 3.1.17: Net Interest Margin



Source: SBP

[89] Banks are required to keep these ratios at least at 100 percent.
[90] According to BPRD Circular No. 07 of 2013, in the wake of change in policy rate, re-pricing of saving deposits is applicable with effect from 1st day of the subsequent month. The circular can be accessed at: https://www.sbp.org.pk/bprd/2013/C7.htm
[91] Quarterly interest earnings shot-up to PKR 516 billion in Q2CY20 then gradually declined to PKR 448 billion and PKR 417 billion, respectively, in subsequent quarters of CY20. This shows the lag impact of loans re-pricing in the wake of cut in policy rate, as the variable loans are repriced after a change in policy as per contractual frequencies, while minimum saving rate on saving deposits is immediately adjusted with effect from next month.

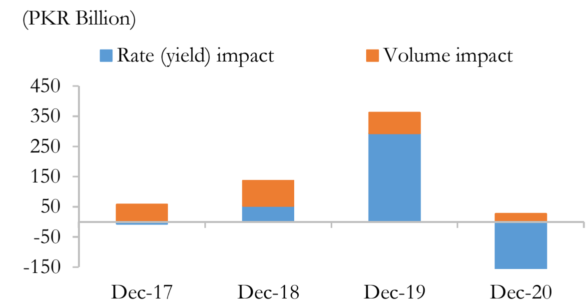
Second, non-interest income (**Non-II**) grew by 19.10 percent in CY20 as compared to marginal growth of 2.24 percent in previous year. Boost in non-interest income was entirely driven by gain on sale of government securities as the decline in interest rates generated revaluation surplus on securities, which was capitalized by banks during the year under review.[92] As interest rates moved down, banks capitalized this opportunity by selling their securities available for sale (**AFS**) to take advantage of higher bonds prices.[93] Banks' income from fee and commission, however, moderately declined by PKR 6 billion during CY20. This contraction reflects the impact of halt in economic activities and international trade during peak months of the pandemic besides SBP's policy to waive the charges of online Inter Bank Funds Transfer (**IBFT**).

Finally, banks' non-interest expenses (**Non-IE**) increased by just 5.82 percent in CY20—down from 16.10 percent growth observed in CY19. This was mainly due to the fact that the pandemic put a halt on banks' business expansion strategies and also accelerated the pace of digitization in their operations. This translated into lower branch expansion and allied expenses during CY20.[94] As a result, banks' administrative expense decelerated (5.30 percent growth in CY20 vs. 15.02 percent in CY19).

…Interest earnings were supported by volume effects of strong growth in investments, which made for huge cut in interest rates…

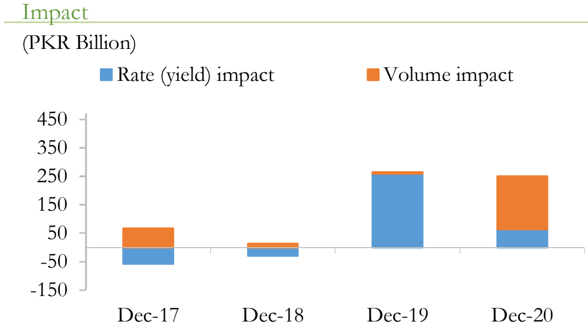
Unlike previous year[95], interest earnings from investments dominated banks total interest income during CY20. With considerable deceleration in advances and reduction in interest rates, share of income from advances declined to 41.16 percent during CY20 from 49.74 percent year earlier (**Chart 3.1.18A**).[96] On the other hand, rise in volume of investments in government securities drove the growth income as share of income from investment increased to 53.84 percent in CY20 from 42.42 percent in CY19. (**Chart 3.1.18B**). It deserves emphasis that as the banks have invested heavily in government securities over time, the income from increasing volume of risk-free securities mainly contributed towards total interest income **(See Box 3.1)**.

Chart 3.1.18 A: Earnings on advances - Rate vs. Volume Impact



Source: SBP

Chart 3.1.18 B: Earnings on investments - Rate vs. Volume Impact



Source: SBP

[92] Non-II rose by PKR 217 billion in CY20 as compared to PKR 182 billion in CY19. Out of the additional rise in Non II of PKR 34 billion, banks' earned PKR 42 billion from sale of government securities.

[93] When interest rates decline, bonds prices go up leading to capital gains for bond holders.

[94] 230 branches were opened in CY20 as compared to 549 in CY19.

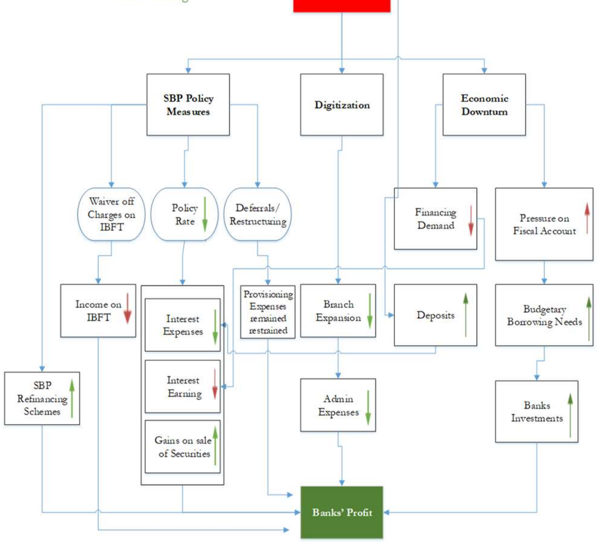
[95] In CY19, interest earnings from advances and investments amounted to PKR 931 billion and PKR 786 billion, respectively.

[96] The Charts 3.1.18A and 3.1.18B analyze the YoY changes in interest income and expense and trace these changes to two underlying factors i.e. changes in interest rate and the volume of earning assets and liabilities.

Interplay of different policy interventions and change in asset structure influenced banks' earnings …

Marked rise in banking sector earnings was supported by a robust growth in investments and different policy measures introduced to cope with the pandemic. An overall anatomy of the different pandemic related risks and policy measures and their impact on banking sector earnings is explained in the **Chart 3.1.19**.

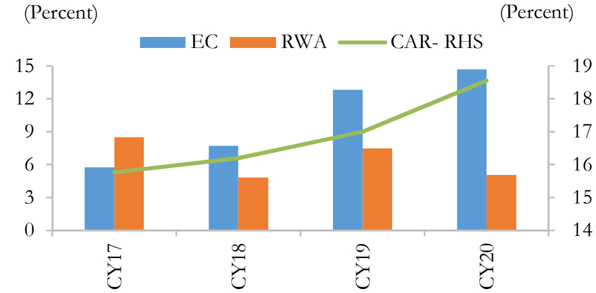
Chart 3.1.19: COVID-19 dynamics and banks earnings



Banking sector's solvency further improved during CY20…

Marked rise in earnings translated into improved eligible capital (**EC**) which strengthened by 14.67 percent (YoY) while banks' Risk Weighted Assets (**RWA**) increased at a relative lower pace of 5.06 percent. As a result, CAR increased to 18.56 percent by end Dec-20 from 17.0 percent a year earlier (**Chart 3.1.20**). The prevailing level of CAR was well above the minimum local requirement and global standard of 11.5 percent and 10.5 percent, respectively.

Chart 3.1.20: CAR level and yearly growth in eligible capital and risk weighted assets



Source: SBP

Improvement in EC of PKR 233 billion during CY20 was mainly contributed by Tier I capital which increased by PKR 148 billion reflecting 63.64 percent contribution in total EC. Further analysis reveals that the rise in Tier I capital was primarily driven by retained earnings, which contributed more than 80 percent in Tier I capital flows during the reviewed year. Remarkable increase in retained earnings largely came from healthy growth in profits, which were largely ploughed back, as the SBP imposed a suspension on dividend payouts for two quarters to conserve capital and enhance the lending and loss absorption capacity of the banks in the wake of uncertainties created by the pandemic.[97] Tier-II component of EC increased by PKR 85 billion during CY20. Around 50 percent rise in Tier II capital flows was contributed by revaluation reserves[98] followed by general provisions (38 percent contribution).

The RWA posted a muted growth of 5.06 percent in CY20 (7.46 percent rise in CY19). Slowdown in RWA was mainly driven by weak growth of Credit Risk Weighted Assets (**CRWA**) as banks mainly focused on investment in government securities while the growth in Market Risk Weighted Assets (**MRWA**) was also not that strong.

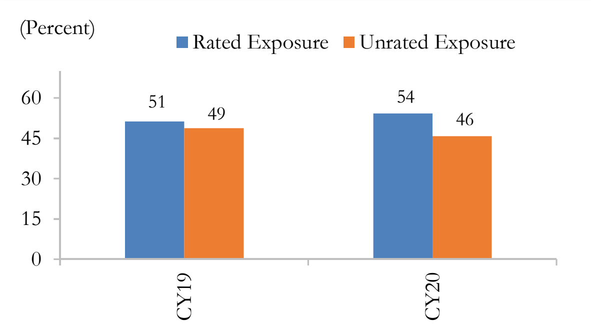
[97] https://www.sbp.org.pk/press/2020/Pr1-22-Apr-20.pdf

[98] Revaluation reserves increased by PKR 41 billion in CY20. Out of this, PKR 24 billion were contributed by unrealized gains on government securities held in Available for Sale (AFS).

MRWA grew by 8.56 percent in CY20 as compared to 33.76 percent expansion in previous year. Sharp deceleration in RWA despite huge investments in PIBs during CY20 (63.97 percent growth in PIBs stock in CY20 vs. 62.95 percent in CY19) manifests the increased investments in floating rate PIBs which carry low duration risk and lower capital charge. [99] Besides, equity and FX components of MRWA observed notable deceleration.

Similarly, expansion in CRWA remained muted during CY20 (2.62 percent growth in CY20 vs. 5.15 percent in CY19), as the banks' advances posted marginal growth. With most of this growth in advances to rated firms, the share of banks' lending exposure to rated corporate borrowers further increased (**Chart 3.1.21**). Incidentally, the banks have been following a conservative approach in their lending strategies. They focus more on large and better-rated firms as compared to unrated firms and SMEs, leading to lower capital charge over the period (**see Box 6.1 in Chapter 6**).

Chart 3.1.21: Banks' rated and unrated lending exposure



Source: SBP

On the contrary, banks' Operational Risk Weighted Assets (**ORWA**), accelerated by 16.87 percent in CY20 as compared to 10.9 percent in CY19. This was due to surge in gross income of the banks, which forms the basis of ORWA under Basic Indicator Approach of Basel rules.[100]

Pakistan's banking sector's soundness remained satisfactory in global perspective…

A cross-country analysis suggests that banks maintained higher level of CAR as compared to the average CAR of selective EMDEs while it was at par with some AEs (**Table 3.1.3**). In terms of domestic banks' asset quality, however, infection ratio was higher as compared to both groups of selective countries.

After-tax ROE of the Pakistan's banks was notably higher particularly in comparison to AEs. Also, domestic banks remained efficient in generating lower cost to income ratio as compared to EMDEs and AEs. In addition, the liquidity buffers maintained by domestic banking sector were significantly higher than the banks in EMDEs and AEs.

Table 3.1.3: Country-Wise Financial Soundness Indicators- As of September 2020

	CAR	Tier I CAR	Infection Ratio	ROA - after tax	ROE - after tax	Cost to Income Ratio	Liquid Asset Ratio	Liquid Assets to Short Term Liabilities
Pakistan	**19.5**	**15.5**	**9.9**	**1.1**	**14.8**	**47.1**	**54.6**	**110.6**
Argentina	23.7	21.8	4.5	3.6	24.6	49.4	48.9	69.3
Indonesia	23.4	21.7	2.9	1.7	11.3	46.5	20.1	29.0
Saudi Arabia	19.6	18.1	2.2	1.2	8.5	36.1	25.2	41.7
Turkey	19.4	16.1	3.9	1.5	13.7	34.1	45.6	60.6
Thailand	19.4	16.4	3.3	0.9	6.5	46.5	21.6	34.5
Malaysia	18.4	15.2	1.4	1.2	10.1	42.6	24.0	156.2
Brazil	16.7	14.3	2.4	1.3	13.0	58.6	17.5	274.5
Philippines	16.4	15.3	3.4	1.1	9.8	50.5	33.8	51.6
Peru	15.0	11.6	3.5	1.5	12.6	43.8	25.6	41.6
India	14.9	14.2	8.2	0.5	6.6	49.0	8.2	25.1
Chile	14.3	10.6	1.6	0.5	7.3	54.3	19.8	20.7
Russian Federation	12.7	10.4	9.3	2.0	17.2	96.3	22.3	119.7
China	14.2	11.6	1.9	0.8	10.3	26.9	24.4	58.2
Bangladesh	11.9	8.0	8.5	0.9	14.6	58.6	18.8	48.3
Average	**17.2**	**14.7**	**4.1**	**1.4**	**11.9**	**49.5**	**25.4**	**73.6**
Norway	23.1	20.2	0.8	0.7	7.5	43.9	12.5	25.7
Sweden	22.8	20.4	0.5	0.5	9.0	56.6	23.7	34.4
United Kingdom	21.0	17.6	1.0	0.4	6.5	63.8	23.5	50.0
Finland	20.1	17.6	1.5	0.4	5.6	62.0	20.3	39.2
Singapore	17.0	15.3	1.3	1.3	14.1	44.3	66.9	73.8
United States	16.2	14.4	1.0	0.3	2.7	61.2	16.7	157.1
Canada	15.7	13.5	0.6	0.7	14.8	67.5	15.7	75.2
Average	**19.4**	**17.0**	**1.0**	**0.6**	**8.6**	**57.1**	**25.6**	**65.1**

Source: IMF; SBP

[99] In case of increased investments in fixed rate PIBs, banks weighted average maturity rises leading to higher duration risk with respect to unfavorable changes in interest rates. However, since return on floating rate PIBs is tied to fresh weighted average yield recorded in MTBs auctions, there is a reduced risk of re-pricing.

[100] As per BIA, the gross income of the bank for each of the past three financial years as per annual audited accounts is used in determining the operational risk charge. See Q91: http://www.sbp.org.pk/bprd/Basel/FAQs-Basel-IIMCR.pdf