Box 7.1: Financial Performance and Soundness of Top Borrowing Groups of the Banking Sector

Introduction

Private sector corporate firms are a major user of banks credit in the Pakistan's economy. The corporate segment uses over 71 percent of banks' total loans and advances. Many of these firms are also part of business conglomerates thus adding to the credit concentration risk for banks. For this reason, SBP has set concentration limits on banks' exposure to single borrower, borrowing group, related party exposures, as well as aggregate limit on large exposures through its prudential regulations. Due to the large size of exposures and borrowing from multiple banks, any decline in financial standing and solvency of large corporate borrowers and borrowing groups may have systemic implications for the banking sector. Therefore, sound financial health and stable performance of large borrowers and borrowing groups is critical for the stability of the banking system. In the following paragraphs, repayment behavior and capacity as well as overall financial health of large borrowers and borrowing groups of the banking system have been analyzed based on following:

a. Banks' own assessment of credit worthiness of large borrowers and borrowing groups as captured through Obligor Risk Rating (ORR) which is assigned by banks to their corporate sector borrower.
b. Borrowers' repayment behavior in terms of any overdue payment of their loan obligations to banks.
c. Latest financial indicators of leading corporate borrowers as well as market-based indicators which show how investors value these firms[172].

For this purpose, 30 large borrowing groups and large borrowers (totaling 231 firms) have been identified based on SBP's internal exercise which used diversified sources of information on ownership of firms.

Assessment of Credit Worthiness

Credit worthiness has been assessed for the top 30 borrowing groups based on ORR assigned by banks. Identified firms of these groups hold around 21.3 percent of the corporate / commercial lending portfolio of banks and DFIs as of end Dec-22.

ORR framework: SBP requires banks /DFIs to compile both ORR (a kind of credit rating which is assessed by the lending institution itself) of corporate borrowers and Facility Rating of each financing facilities availed by them[173]. The ORR reflects the lending institution's assessment of the borrower's credit worthiness and one possible predictor of the borrower's default or satisfactory performance on his financial obligations. The rating continuum comprises 1 to 12, with 1 to 9 scales for performing categories and 10 to 12 for default categories.

Based on ORR of different borrowing entities of the groups, overall average rating (weighted by size of loans) of each group was compiled to assess the strength of these groups. Assessment indicates that around three-fourths of the top 30 groups have medium or good quality ratings. Even though CY22 was a relatively challenging year for businesses due to stressed macroeconomic conditions, banks' credit portfolio continued to show steady position of large 30 borrowing groups' credit worthiness and tendency on the part of a banks to prefer lending the better rated borrowers. The average internal credit rating profile of banks' loan portfolio has improved from CY21 to CY22 as reflected by the shift in the

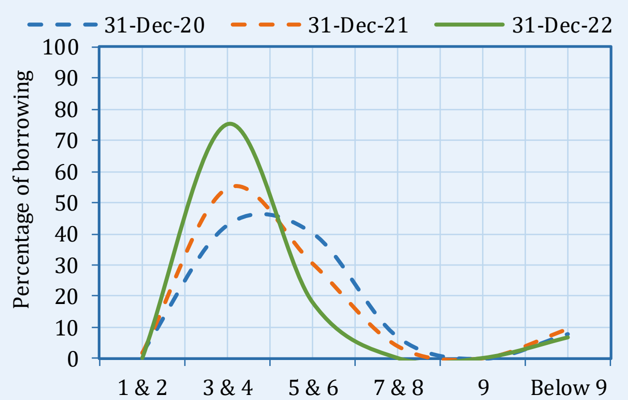
[172] Fetched from Bloomberg utility which captures and compiles indicators of listed firms.

[173] BSD Circular No. 08 of 2007.

quantum of credit to borrowers with stronger credit ratings. (**Chart 7.1.1**).

The shift in bank's credit portfolio towards better ORR also reflects a conservative approach on the part of banks to lend to better quality borrowers, as financial and market-based indicators show signs of weakening in the operating performance in CY22.

Chart 7.1.1: Internal Credit Rating of 30 Large Borrowing Groups



Source: SBP Staff estimates

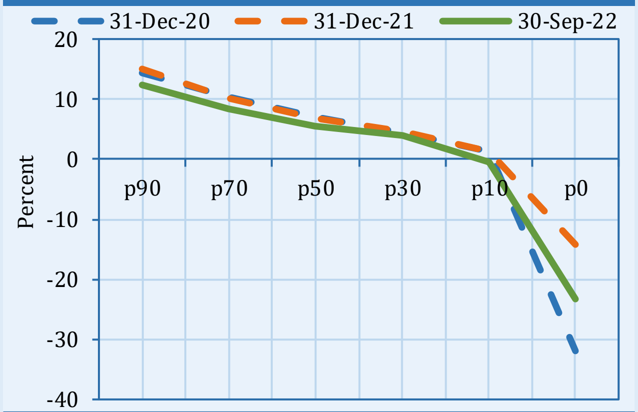
Financial Soundness and Market Performance of Listed Firms of Top 30 Borrowing Groups

Out of the identified firms of the top 30 borrowing groups of the banking sector, 77 firms, were listed on PSX. To analyze the financial soundness of these firms and assess how they are valued by the market and general investors, a detailed assessment of these 77 listed firms was made using the financial and market-based indicators. The following analysis evaluates various indicators of these firms, including ROA, ROE, current ratio (**CR**), interest coverage ratio (**ICR**), gross margin (**GM**), price-to-book (**P/B**) ratio, price-to-earnings (**P/E**) ratio based on the available data for the period ended Sep-22 vis-à-vis data of end Dec-21 and Dec-20.

Leading financial indicators of top borrowing firms for first three quarters of CY22 showed a general slackness in the wake of building macroeconomic challenges. However, these firms in general have shown resilient performance despite increased taxes, high inflation, and input costs, building uncertainty and slowdown in economic activities, and high finance cost.

Earnings of the selected firms generally showed sign of general weakening during CY22, as ROA across the entire sample declined in the first three quarters of CY22 as compared to last couple of years (**Chart 7.1.2**).

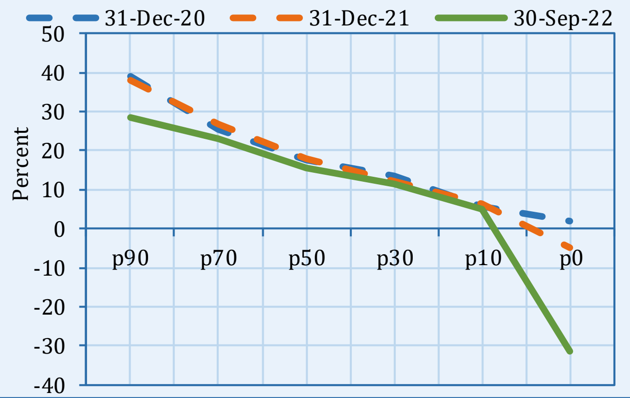
Chart 7.1.2: Percentile Distribution on ROA of Companies



Source: Bloomberg, SBP

Similarly, the ROE in the first three quarters of CY22 shows deterioration across the entire sample of these firms. The decline was more pronounced for the most profitable firms and loss-making firms due to high tax rate in FY22 and stressed economic conditions respectively while the remaining firms in the sample distribution only witnessed slight decline in CY22 (**Chart 7.1.3**).

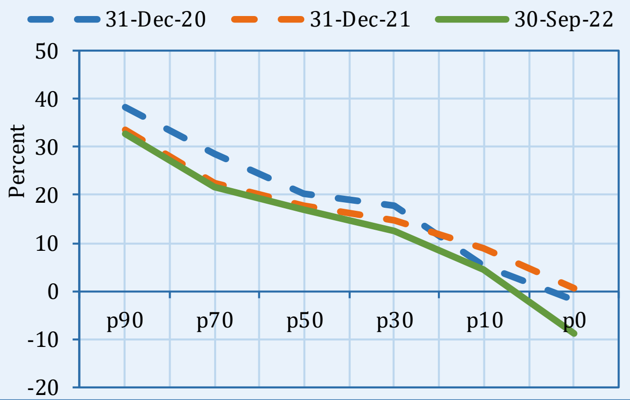
Chart 7.1.3:Percentile Distribution on ROE of Companies



Source: Bloomberg, SBP

Further analysis of earning shows that gross margin of firms deteriorated across the sample firms reiterating the fact that CY22 has been a difficult year for firms to conduct business in the wake of high inflation, economic stabilization measures, and rising cost of inputs (**Chart 7.1.4**).

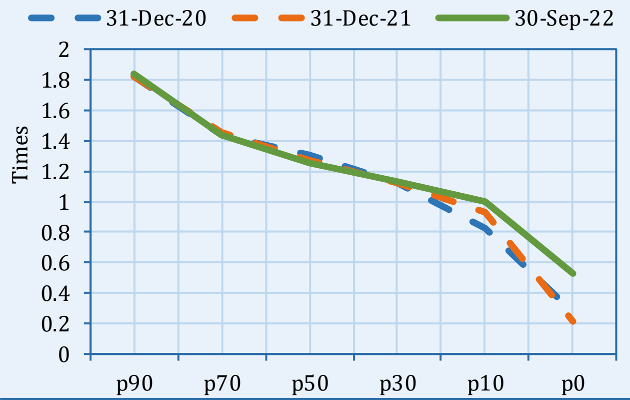
Chart 7.1.4: Percentile Distribution on Gross Margin of Companies



Source: Bloomberg, SBP

Despite the tough macroeconomic conditions in CY22, the liquidity profile of the selected firms remained almost steady and some firms also improved their current ratio. This steady performance may be because firms adopted cautious approach in managing their liquidity in the wake stressed economic conditions and slowdown in economic activities (**Chart 7.1.5**).

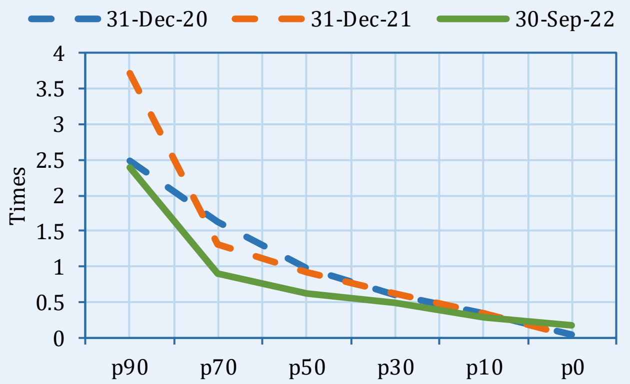
Chart 7.1.5: Percentile Distribution on Current Ratio of Companies



Source: Bloomberg, SBP

Detailed analysis of market and investors' sentiments shows that P/B ratio of the sample firms deteriorated during CY22 due to uncertain conditions and weak performance of equity markets that led to fall in the market prices of equity stocks (**Chart 7.1.6**).

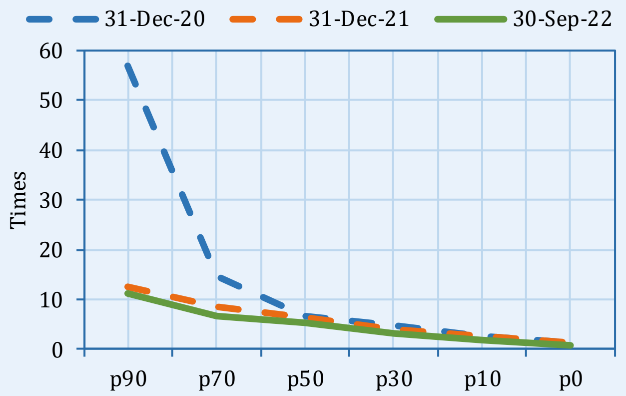
Chart 7.1.6: Percentile Distribution on P/B Ratio of Companies



Source: Bloomberg, SBP

Price-to-Earnings (P/E) ratio also follows the trend of other market indicators showing steep decline across the sample distribution of firms in CY22. In fact, the P/E Ratio has been suppressed since CY21. Although the sample firms' operating performance did not deteriorate significantly in CY22, the stressed economic conditions gave rise to risk-averse sentiments amongst investors who gave more importance to the (stressed) economic conditions than the resilient performance of the firms resulting in a general decline in P/E ratios for sample firms (**Chart 7.1.7**).

Chart 7.1.7: Percentile Distribution on P/E Ratio of Companies



Source: Bloomberg, SBP

Conclusion

The comparative position of ORR of the top 30 borrowing groups of the banking sector shows that these groups have generally improved their credit worthiness (i.e., ORR) in CY22 as compared to CY21. This improvement in credit ratings also reflects a prudent and risk-averse approach on the part of banks to have higher exposure to large well-established firms which have better credit worthiness. Despite stressed economic conditions and low confidence of investors in the equity market, top borrowing firms in general showed quite resilient financial performance and continued to serve their financial obligations during the year under review.