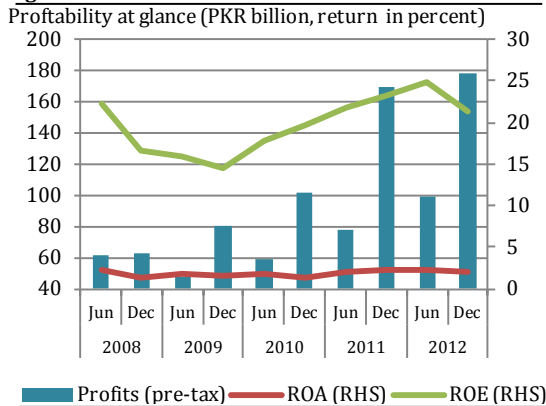


The banking sector posted an appreciable growth in earnings during the period under review, due to higher non-interest income and lower provisioning charge, though interest margins observed a deceleration. Despite growth in Risk Weighted Assets (RWAs), rising profitability added to the Capital Adequacy Ratio (CAR) which reached 15.35 percent—well above the local benchmark. With strong capital position, the banking sector is expected to remain resilient in various scenarios, though severe credit risk shock may bring a few banks under stress.

Figure 3.1

Profitability

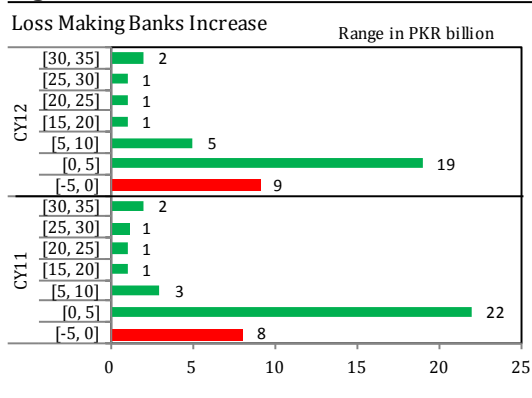
The profitability of the banking sector maintained the growth trend for consecutive third year and posted an unprecedented pre-tax profit of PKR 178 billion during CY12, though earnings for the second half remained lower than the corresponding period of CY11. This high level of income was mainly attributable to year on year (YoY) 27 percent growth in non-interest income and 21 percent decline in provisions charge. The net interest income from core activities, however, declined mainly due to increasing cost of deposits and borrowings, and low growth in interest income on account of policy rate cut during H2-CY12. Accordingly, net interest margins (NIM) narrowed while return indicators observed a decline (**Figure 3.1**).

Table 3.1: Concentration of Earnings (percent share)

Dec-2012	Share	ROA	ROE	AU	PM	NIM
Top 5	74.0	2.8	31.9	10.4	27.3	5.1
Top 6 to 10	15.7	1.4	22.8	10.3	13.9	3.9
Top 11 to 20	8.0	0.9	11.0	10.6	8.2	3.5
Top 21 to 30	2.1	0.6	5.0	10.5	5.9	4.5
Public Sector	15.5	1.6	18.8	9.9	16.4	3.6
Local Private	81.7	2.1	26.7	10.5	20.3	4.6
Foreign	0.5	0.4	2.2	10.0	3.6	5.3
Specialized	2.3	2.7	71.7	12.4	21.5	6.9
All Banks	100.0	2.0	24.1	10.4	19.2	4.5

Concentration of earnings tilted towards top banks

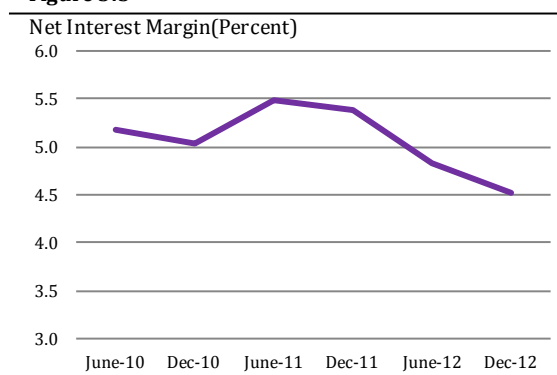
Over the last two years, profitability observed diversification from top to medium sized banks. The trend reversed during H2-CY12 as share of top 5 banks (by assets size) in earnings increased by 4 percentage points while that of smaller banks improved marginally by 0.3 percentage points (**Table 3.1**). Among various banking segments, performance of public sector banks (PSBs) improved which enhanced their share in earnings by 1.4 percentage points over the half year. Foreign banks' performance deteriorated due to consolidation of their business activities, which lowered earnings and share in the industry profits as well as increase in number of loss making banks (**Figure 3.2**).

Figure 3.2

Interest margins observed deceleration

Though overall profit surged, the NIM of banks dropped to 4.5 percent in CY12 from 5.4 percent in CY11 (**Figure 3.3**). The net interest income from core activities declined by 1 percent during CY12 due to cumulative 250 bps decline in interest rate over the 2nd half of CY12. This coupled with 100 bps increases in

Figure 3.3

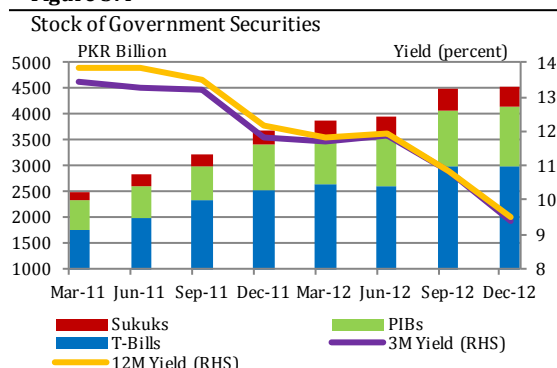


Minimum Saving Rate (MSR) on deposits, and increased money market borrowings further added to the decline in overall interest margins.

...as growth in net interest income slowed down...

With cut in policy rate, yield on government securities declined that translated into slowdown in overall return on investments. Against 31 percent growth in investments during H2-CY12, annualized interest income on investment grew by merely 13 percent (**Figure 3.4**). Similarly major portion of advances were benchmarked with KIBOR that dipped by around 2.5 percentage points for up to 1-year tenor, while Weighted Average Lending Rate (WALR) on fresh disbursements went down by 206 bps to 11.01 percent during H2-CY12. Resultantly, return on advances to customers dipped to 11.6 percent as of end CY12 down from 12.2 percent in Jun-12. Consequently, the return on earning assets declined by 1.2 percentage points to 10.6 percent in CY12 (**Figure 3.5**)

Figure 3.4



...while interest expense increased

The interest expense, on the other hand, surged by 11.3 percent during CY12, with major portion of increase took place in H2-CY12. However, declining interest scenario also affected the interest expense, as increase remained far below 19.4 percent growth in expense during CY11. A look at the components of interest expense highlighted that increase resulted from higher volume of deposits as Weighted Average Deposit Rate (WADR) on stock of deposit dipped by 162 bps to 5.43 during CY12. Increase in Minimum Saving Rate (MSR) in May CY12 also seemed to have contributed to higher expense on deposits. Further, due to consistently high level of repo borrowings, particularly in the second half of the CY12, led to substantial rise in borrowing cost. These transitory funds remained consistently high and reached PKR 1 trillion by end of CY12 (against PKR 675 billion in CY11 and PKR 508 billion in H2-CY12) while YoY cost of borrowing increased by 19.6 percent during CY12.

Figure 3.5

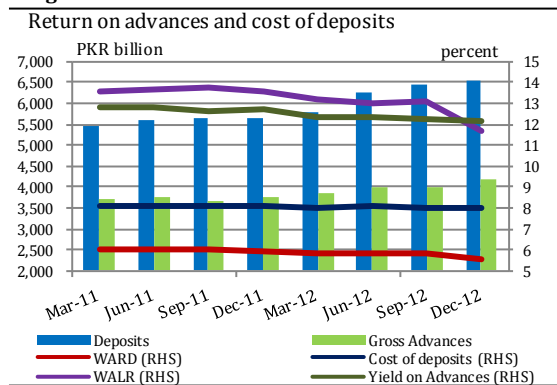
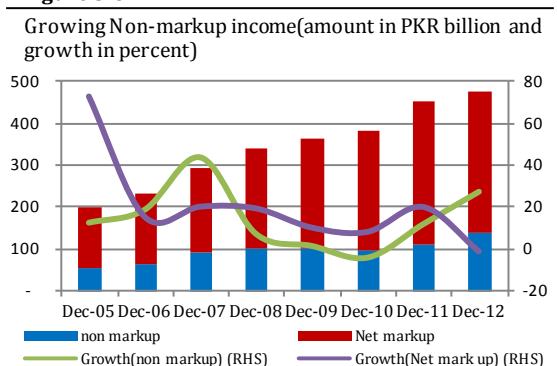


Figure 3.6



Healthy growth in non-markup income improved the overall profitability

The surge in non-mark-up income provided for overall growth in gross income mainly due to improvements in the equity market indices and gain on sale of securities. Non-interest based income increased YoY by 28 percent enhancing its share in gross income to 29 percent. The increase in investment in blue chips paid off banks, as they generated higher dividends and capital gains from

Figure 3.7

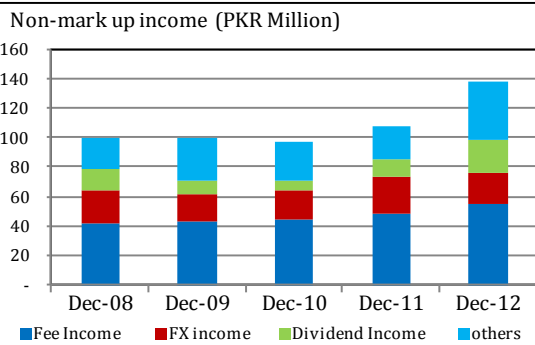


Figure 3.8

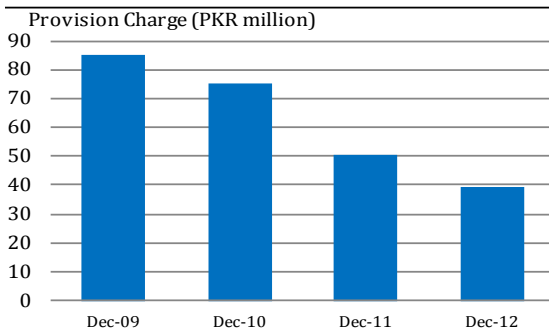


Figure 3.9

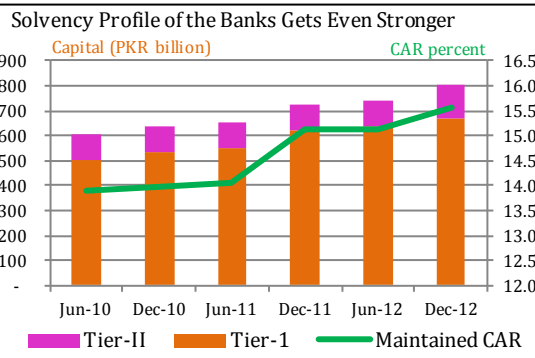
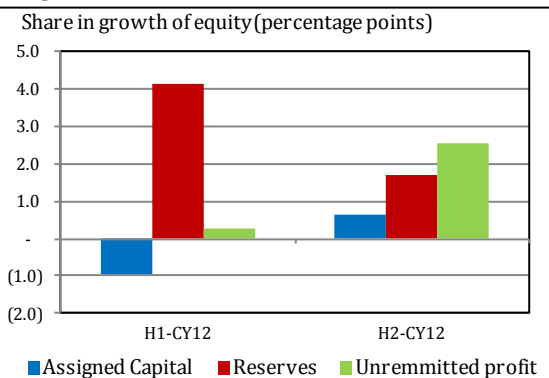


Figure 3.10



sale of some of these investments in listed shares over the period under review (**Figure 3.6**). Similarly, declining interest rate environment incentivized banks to book substantial gain on sale of government securities. Although fee income marginally improved, yet reliance on income from dealing in foreign exchange (FX) was pretty less in the period under review (**Figure 3.7**).

...while lower provisions charge limited the drag on earnings

Lower provisions charge on the back of improved asset quality and enhanced FSV benefit also boosted profitability of the banking system. During H2-CY12, NPLs declined while provisions saw a marginal increase of 4 percent (**Figure 3.8**). The subdued flow of provisions, among other things, resulted from enhanced FSV benefit⁴⁵ on collateral against NPLs. This benefit is expected to fade away due to gradual decline in benefit over the period of default, which can add to provisions even if assumed that NPLs have peaked out. Consequently, future profitability of the banking sector may be affected due to provisions on account of reversal of this benefit in coming years.

Solvency

The capitalization of the banking sector improved and remained well above the local benchmark⁴⁶. The Capital Adequacy Ratio (CAR) edged up by 32 bps to 15.4 percent over the H2-CY12, while corresponding Tier-I CAR, with a marginal increase, remained steady at 13.0 percent (**Figure 3.9**). The improved capital adequacy was primarily facilitated by higher retained earnings. The leverage ratio⁴⁷ also stood at a comfortable level well above the Basel-III standard of 3.0 percent. Though most banks meet the CAR, some banks continued to face challenge in achieving the prescribed Minimum Capital Requirement (MCR).

Improved profitability augmented the capital adequacy indicators

Pecking order theory⁴⁸ strongly holds in case of local financial sector as most banks widely utilized internal profits to increase capital positions. The healthy returns generated by the banking sector led to accumulation of un-appropriated profits. Accordingly, Tier-I capital increased by 5.6 percent, which

⁴⁵ Banking system availed additional FSV benefit of about PKR 20 billion during CY12

⁴⁶ Banks are required to maintain minimum CAR of 10 percent.

⁴⁷ The leverage ratio is measured as the ratio of adjusted tier-I capital to adjusted on-balance sheet and off-balance sheet assets

⁴⁸ In corporate finance, pecking order theory postulates that companies prioritize their sources of financing, first preferring internal financing, and then debt, lastly raising equity as a "last resort".

Figure 3.11

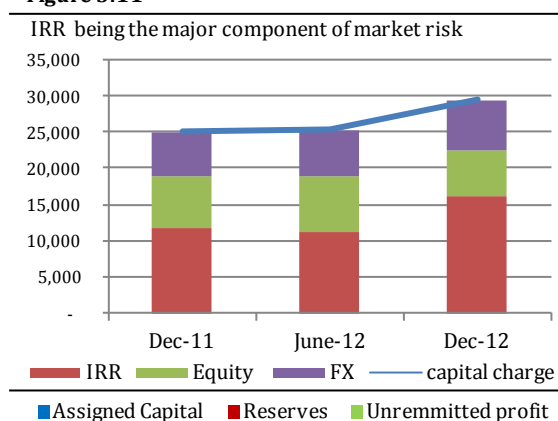


Table 3.2: Bank Category-Wise Solvency Ratios - CY12

	in percent					
	Capital to RWA		Tier 1 to RWA		Capital to Assets	
	H1	H2	H1	H2	H1	H2
Top 5	15.7	16.7	13.4	13.8	10.3	10.1
6 to 10	12.5	12.8	9.6	9.5	6.8	10.3
11 to 20	13.5	13.7	12.0	12.1	8.5	9.1
21 to 30	25.7	21.5	25.7	21.5	13.7	9.4
PSCB	14.4	16.7	12.3	13.9	10.1	10.3
LPB	14.9	14.9	12.7	12.4	8.9	8.6
FB	31.0	30.7	30.8	30.5	17.6	16.5
SB	10.9	12.3	5.4	6.8	7.6	8.3
Industry	15.1	15.6	13.0	13.0	9.3	9.1

Table: 3.3: RWAs to Original Exposure

Claims on	Jun-12			Dec-12		
	Original Exposure	Risk Adjusted Amount	RWA to Original Exposure	Original Exposure	Risk Adjusted Amount	RWA to Original Exposure
GoP	1,950	-	-	2,432	-	-
PSEs	574	69	12.0	630	60	9.6
Banks	196	72	36.7	237	90	37.8
Corporates (excluding equity exposures)	2,115	1,726	81.6	2,167	1,784	82.3
Categorized as retail portfolio	518	342	66.1	575	376	65.4
Past due loans	249	270	108.5	202	195	96.3
Total On Balance Sheet Exposures	7,106	3,303	46.5	7,763	3,390	43.7
Total Off Balance Sheet Exposures	3,918	556	14.2	3,885	604	15.5

enhanced its share in the regulatory capital to 83 percent in H2-CY12 (**Figure 3.10**). The stock dividends announced by banks also added to this increase. Further, a few merger and acquisition transactions allowed banks to enhance their capital base. As a result, paid capital of the banks increased by 1.1 percent over the second half of CY12, facilitating some banks in meeting the MCR and enhancing overall eligible capital.

Concentration analysis of solvency ratios showed CAR of top 5 banks further strengthened to 16.7 percent in addition to improvements in core capital that also enhanced the Tier-1 to RWA ratio. The capital adequacy of the smaller banks stood at 21.5 percent, down from 25.7 percent in H1-CY12, largely on account of relatively higher growth in risk weighted asset. Moreover, with improvement in credit disbursement, the leverage indicator of capital to assets ratio observed some decline in H2-CY12 across the banking sector (**Table 3.2**).

CRWAs increased with revival of private sector credit...

The risk-averse behavior of the banks continued its' gradual shift during H2-CY12, as all categories of risks, namely; credit, market and operational exhibited a rise in risk weighted assets. The CRWA, which formed 78 percent of the total RWA, carried over the trend of first half of the year and grew by 3.7 percent during the period under review; thanks to revival of private sector credit (**Table 3.3**). A further look at the composition of on-balance sheet exposures reveals that risk-adjusted assets were contributed by the corporate portfolio⁴⁹ followed by the retail loans.

Improved flows to private sector corporate and SMEs led to increase in share of risk-adjusted claims during H2-CY12. Similarly, lending to PSEs increased marginally in H2-CY12 and so did the share in corresponding risky claims⁵⁰. The credit risk adjusted off-balance sheet claims also inched up due to increase in trade related contingencies, commitments, and higher export refinance⁵¹ to private sector.

...while MRWA saw a pronounced increase

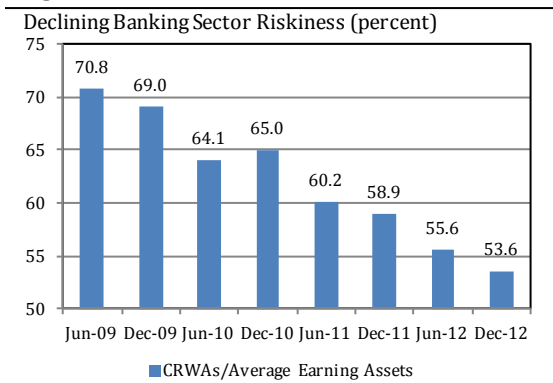
⁴⁹ This comes as no surprise as many corporate remained unrated and most of the collateral holdings do not qualify as eligible collateral under Basel II.

⁵⁰ PSEs are still unrated and thus attract higher risk weight leading to increase in risky claims on PSEs

⁵¹ In terms of Development Finance Review of December CY12, the linking of Overdue Export Proceeds with the Export Finance Scheme (EFS) Facility was introduced in July 2011 in order to limit EFS borrowers to keep their overdue export proceeds under 5 percent of their last year's exports. Initially, this step reduced the volume of EFS financing but subsequently the borrowers adjusted their overdue proceeds in line with the prescribed limit, which resulted in a boost in EFS portfolio in H1-CY12.

The MRWA witnessed a sizeable growth of 16.5 percent, bringing its share to 7.1 percent in total RWAs in H2-CY12 up from 6.45 percent in H1-CY12. Among the market risk components, interest rate risk (IRR) continued to hold the top seat as it witnessed a substantial growth of 43.4 percent in capital charge. Shift in tenor of securities from short term to medium and long term attracted higher risk weights in interest rate risk category; resulting in overall rise of market risk of banking sector. Increasing stock of investments in Government securities proved a mixed blessing; banks' earning potential sustained with low credit risk yet capital charge also took its toll in terms of higher market risk. Though capital charge on equity investments decelerated; however, foreign currency positions related capital charge showed a growth of 9 percent (Figure 3.10).

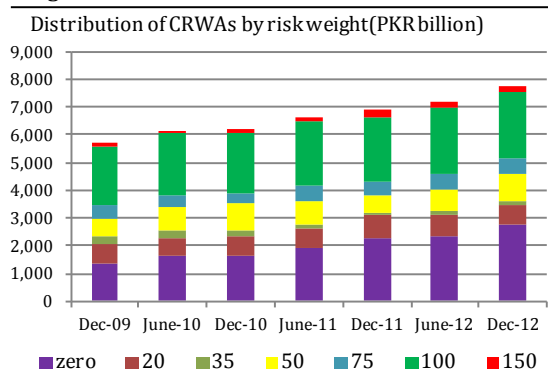
Figure 3.12



...whilst the riskiness of banking sector remained subdued...

Despite growth in CRWAs, the overall riskiness of the banking sector (CRWA assets to average earning assets) continued the subdued outlook. This comes as a no surprise as major part of the 14 percent expansion in earning assets during H2-CY12 carried low risk weights. With a slow pace growth, share of CRWAs as a percentage of average earning assets declined by 2 percentage points in H2-CY12. This trend though healthy in short run, may compromise risk management capacity of the banking sector in future (Figure 3.12).

Figure 3.13



Lower riskiness can be traced into rising level of lower risk weighted assets in the balance sheets of banks. In line with the large share of public sector investments, share of zero risk weighted asset reached its highest level of 36 percent during H2-CY12 after observing a marginal drop in first half of CY12. On the flip side, share of assets carrying 100 percent risk weight (usually assigned to the advances extended to unrated borrowers) continued southwards, an outcome of slow growth in private sector credit. Share of assets with risk weight of 50 percent reached to 12 percent of total CRWAs portfolio due to increase in exposure towards unrated public sector entities⁵² (Figure 3.13).

A higher capital base above the regulatory requirements provided banks with sufficient cushion against unexpected idiosyncratic shocks and severe macroeconomic conditions. As a part of its policy to strengthen common equity base of banks, the SBP over the period has enhanced the MCR requirement in a

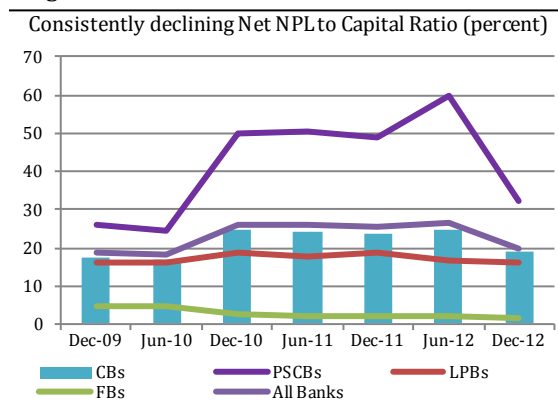
⁵² In case of public sector exposures, investments in Government securities is considered risk free and is assigned zero credit risk weight; moreover PSEs exposures carry low risk weights ranging from 0 to 50 percent. On the contrary, private sector exposures are assigned risk weights between 20 and 150 percent, while in practice majority of these falls under the 100 percent category.

	percent			
	less than 10	10 to 15	above 15	Total
H1-CY10	6	15	19	40
H2-CY10	5	13	20	38
H1-CY11	5	12	21	38
H2-CY11	5	10	23	38
H1-CY12	5	11	22	38
H2-CY12	5	9	24	38

gradual manner. The outcome of this approach is obvious in comfortable CAR of the majority banks. As of end December, 2012, only five banks lagged behind the required CAR of 10 percent, while CAR of 26 banks stood above 15 percent (**Table 3.4**). Banks falling short of CAR represent 6.1 percent of total asset and as such do not pose any serious concern to the solvency of the banking sector.

Improved credit quality provided a breathing space for overall solvency profile of banking system

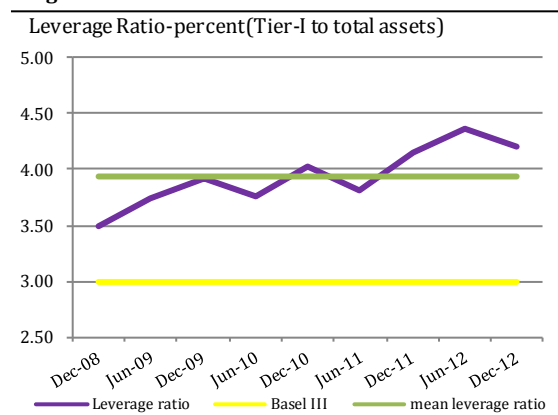
Figure 3.14



Solvency risk from changes in credit quality pacified during period under review, as most of the asset quality indicators observed improvement during H2-CY12. Net NPLs to Capital ratio-an indicator of fraction of banks' equity that could be impaired by loan losses, improved significantly during H2-CY12. Though this improvement was broad based and observed across all categories of banks, however most profound impact was observed in PSCBs category where ratio dropped from 60 to 32 percent (**Figure 3.14**).

Banking system leverage remained well within the prescribed band

Figure 3.15



The leverage ratio⁵³ for banking sector of Pakistan continued to rise at the back of rising equity levels and less securitized exposures. The ratio can be used as a countercyclical tool by setting dynamic limits during boom and downturns. During H2-CY12, the leverage ratio marginally dropped due to accelerated growth in on-balance sheet exposure relative to tier-I capital. On aggregate basis, leverage ratio stood at 4.1 percent in H2-CY12, much higher than the required minimum of 3 percent by the Basel Committee on Banking Supervision (**Figure 3.15**). With a comfortable level of this non-risk based indicator and potential of growth in the economy, banking industry enjoys enough buffer to further increase its leverage in the future times (**Table 3.5**).

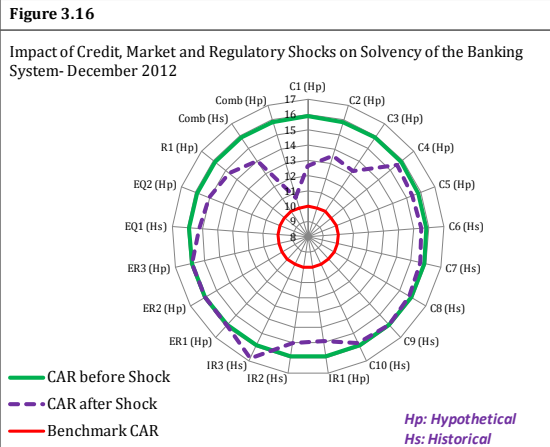
Resilience of the banking system:

The banking system continued to exhibit resilience to various stress shocks at the back of strong CAR at 15.6 percent. The stress shocks on the credit, market, liquidity and contagion risk on the banking sector reaffirms that with the exception of a few banks, the overall system is satisfactorily placed to withstand the

	amount in billion Rupees, ratio in percent		
	Existing	Simulated	Cushion
Capital	805	805	-
RWAs	5,246	8,052	2,806
CAR	15.4	10.0	

⁵³ Leverage ratio is defined as tier-I capital as proportion of total assets (adjusted both sides for intangible assets). The inverse of leverage ratio is call leverage multiples. This ratio is not yet applicable in Pakistan.

stress events⁵⁴. Importantly, all banks with before shock CAR of above 13 percent, including top 5 banks of the industry, would show resilience towards all the solvency tests.



Under the sensitivity analysis, the after-shock CAR of the system would stay strong, though certain shocks applied on the credit risk portfolio would have significant impact on the solvency profile of the banking system. The credit shocks including shock (C-1) assuming an increase in NPLs equivalent to 10 percent of performing loans and a shock of default of top three borrowers (C-3) would decrease the after-shock CAR of the banking system up to 320 bps (**Figure 3.16**). The latter shock indicates high concentration of top corporate and group exposure. Keeping in view of their systemic implication, banks need close monitoring of such exposures to avoid any institution specific and systemic implications.

As highlighted earlier, market risk of the banking system maintained subdued profile, due to various regulatory limits. Therefore, market risk related sensitivity shocks have minimal effect on the solvency profile of banks. Similarly, analysis of liquidity stress tests, which envisage significant withdrawals as of deposits and volatile funds, and dip in value of liquid securities, show that the ample fund based liquidity in the system would provide enough cushion to meet significant withdrawals of deposits and volatile funds. Similarly, haircut on value of government securities, would marginally decline the liquidity coverage ratio (LCR) as defined under Basel-III framework, would stay well above the minimum acceptable LCR value of 1.

⁵⁴ For details of stressed scenarios and the number of banks failing in each stress scenario, see Annexure 1.15