

The macroeconomic risks emanating from persistently high fiscal deficit, difficult security situation, and unresolved energy crisis continued to affect the real sector performance. The challenging conditions also reflected in a combination of low level of investments, increasing pressure on domestic financing due to inadequate external financial inflows and falling foreign exchange reserves due to lumpy payments to the IMF. Further, the current account surplus posted at the end of H2-CY12 on account of temporary external inflows; was not sufficient to address vulnerability on the external front. The persistently high budgetary needs and external financing shortfalls exerted pressure on both money and foreign exchange markets, which remained relatively volatile over the review period. However, with improvements in the inflation outlook and to address the subdued economic performance during the period, the central bank eased its policy rate to stimulate private sector borrowings and promote investment activities.

In contrast to the less than favorable developments on the macroeconomic front, the **financial sector** continued to increase in size. The asset base of the financial sector showed a healthy increase of 11.5 percent during H2-CY12. This strong growth during the half year enhanced the share of financial sector as a percentage of GDP after remaining on downhill for last five years (**Table 1**). This largely came at the back of strong assets growth in the banking system that enhanced its share in the financial sector. The improved demand for life insurance products provided for steady growth in the insurance sector and remained the second key contributor in the financial sector growth. The share of NBFIs dwindled pursuant to decline in net assets value of the mutual fund as the banks' interest in funds faded away due to gradual evaporation of tax advantage. The declining interest margins in the financial sector and deterioration in performance of the NBFIs affected the overall earnings as ROA of the system edged down by 18 basis points to 1.32 percent over the half year. The Payment systems continued efficient and reliable settlements of increasing interbank payments and securities transactions without any major disruptions.

Financial position of the **banking sector** relatively improved over the half year that largely reflected in strong assets growth and revival of private sector credit. This coupled with improved assets quality and record profits further strengthened the overall capital adequacy of the banks. Though the risk factors observed marginal improvements, the banking sector remained exposed to high credit risk, volatility in financial market, large government exposure on

**Table 1: Assets Composition of the Financial Sector**

|                          | CY06  | CY07  | CY08  | CY09  | CY10  | CY11   | Jun-12 | Dec-12 |
|--------------------------|-------|-------|-------|-------|-------|--------|--------|--------|
| Assets (Rs. Billion)     | 6,028 | 7,117 | 7,712 | 8,867 | 9,655 | 11,107 | 11,818 | 13,181 |
| Growth rate (percent)    | 14.5  | 19.4  | 8.4   | 15.0  | 8.9   | 15.0   | 6.5    | 11.5   |
| Percent of total assets  |       |       |       |       |       |        |        |        |
| MFIs                     | 0.2   | 0.2   | 0.2   | 0.2   | 0.2   | 0.2    | 0.3    | 0.3    |
| NBFIs                    | 7.8   | 8.0   | 7.6   | 5.3   | 4.4   | 4.7    | 5.2    | 4.2    |
| Insurance                | 4.1   | 4.6   | 4.4   | 4.4   | 4.4   | 4.3    | 4.3    | 4.3    |
| CDNS                     | 16.1  | 14.6  | 14.8  | 16.6  | 17.3  | 17.2   | 17.0   | 17.2   |
| Banks                    | 71.9  | 72.7  | 73.0  | 73.5  | 73.8  | 73.6   | 73.2   | 74.0   |
| Assets as percent of GDP |       |       |       |       |       |        |        |        |
| MFIs                     | 0.1   | 0.1   | 0.1   | 0.1   | 0.1   | 0.1    | 0.2    | 0.2    |
| NBFIs                    | 5.7   | 6.0   | 5.1   | 3.4   | 2.6   | 2.7    | 3.0    | 2.4    |
| Insurance                | 3.0   | 3.4   | 3.0   | 2.8   | 2.6   | 2.5    | 2.5    | 2.5    |
| CDNS                     | 11.8  | 11.0  | 9.9   | 10.7  | 10.2  | 9.9    | 9.7    | 9.9    |
| Banks                    | 53.4  | 54.7  | 49.0  | 47.3  | 43.3  | 42.2   | 41.9   | 42.6   |
| Overall assets           | 74.0  | 75.2  | 67.2  | 64.4  | 58.8  | 57.4   | 57.2   | 57.5   |

banks' balance sheets and narrow interest margins, in addition to continuing challenges on macroeconomic front.

The banking sector assets witnessed a strong double-digit surge of 12.2 percent during a half year- first time in the last five years, at the back of healthy deposits growth that facilitated relatively higher disbursement to private businesses and persistent government borrowing to meet revenue-expenditure gap<sup>1</sup>. Public sector demand for financing, however, decelerated mainly on account of net retirements against commodity operations.

The credit risk witnessed some improvements as flow of advances to private sector increased and banks managed to decrease infected portfolio. The growth in private sector advances was driven by a host of factors including improved Large Scale Manufacturing (LSM)<sup>2</sup>, downward movement in lending rates, improved liquidity position due to strong deposit growth, and lower returns on government papers. Unlike the last few years, growth was quite broad based as it was shared by both corporate sector and SMEs for meeting seasonal working capital needs with some demand for fixed capital finance as well. The textile sector remained the major user of credit due to seasonal peak in production process as well as for investments to overcome the energy shortages.

Meanwhile, demand for financing from Public sector observed some let up during H2-CY12, due to net retirements of commodity finance, though Public Sector Enterprises (PSEs)<sup>3</sup>, import of fertilizers and credit off-take for sugar continued utilization of banks' funding. The stock of public sector commodity finance, however, remained high<sup>4</sup> and represented major source of concentration on banks' balance sheet. During H2-CY12, commodity financing did observe net retirement, however, the level of financing remained 17 percent higher than the corresponding period of last year. As such concerns regarding piling up of this self-liquidating financing category continued, which can be considered quite alarming after taking into account the one off-settlement of PKR 78 billion towards unpaid subsidies during November, 2011. The pattern of increasing share of commodity financing is expected to continue in the coming year as demand for commodity finance will remain inelastic due to further rise in wheat support price<sup>5</sup> and import of fertilizer on account of underutilized capacity of local fertilizer companies owing to gas shortages. Keeping in view the critical nature of commodity procurement operations, the high level seasonal financing is necessary; however, its liquidation mechanism needs reconsideration to mitigate risks arising from its continuous growth and concentration on banks' balance sheets.

Over last few years and more specifically during CY12, financing needs of "Production & Transmission of Energy Sector (PTES)" remained high, which enhanced its share in advances from banks to about 12 percent as of end CY12. Though, an obvious outcome of looming energy crisis, the high concentration of these advances also raises concerns as most of the energy related structural issues remained unresolved. Over the last few years, accumulation of this circular debt ultimately led to conversion into direct government debt and a consequent rise in the public debt and its servicing cost while crowding out private sector credit. Despite similar conversion last year, PTES accumulated additional 33 percent during CY12 raising chances of similar conversion again. As such, concerted efforts are required to resolve the lingering energy sector issues.

The asset quality of the banking system improved over the half year due to drop in NPLs for the first time since CY08. The subdued activity in banks' advances over the last few years, rescheduling/ restructuring of lending portfolio of promising and viable corporate and amplified recoveries provided for major part of the decrease in infected portfolio.

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<sup>1</sup> The fiscal deficit during FY13 remained 8.0 percent of Gross Domestic Product (GDP) as against the target of 4.7 percent (Monetary Policy Statement, State Bank of Pakistan, September 2013).

<sup>2</sup> Large Scale Manufacturing (LSM) Index grew by 2.13 percent during Jul-Dec 2012 against 0.83 percent during the same period in CY11.

<sup>3</sup>The expansion was largely driven by: (1) a bailout package for the Pakistan Steel Mills Limited; (2) lending to power sector holding company; and (3) borrowing by Pakistan International Airline Company to repay its long-term loans.

<sup>4</sup> In FSR for H2CY11 and H1CY12, it was highlighted that the demand for commodity finance would reach record new highs due to increase in the support price for agriculture produce.

<sup>5</sup> The post review statistics show that fresh lending for public sector commodity operations in fact surpassed the previous levels.

This coupled with expansion in private sector loans during H2-CY12 led to a reduction in infection ratio to 14.5 percent down from 15.9 percent as of end H1-CY12.

Improvements in the asset quality provided some comfort; however, concentration of credit to corporate segment remained another key risk area for the banks. This coupled with subdued flows to other economic sectors, drifted up the share of large exposures in the total lending portfolio. Though, stress analysis showed low level of concerns for the banking system on aggregate basis due to high capital adequacy ratio, banks need close monitoring of these exposures to avoid any adverse impact on their solvency.

On the funding side, healthy growth in deposits supported the surge in assets. The growth in deposits came from consistent rise in current account-saving account (CASA) deposits. The saving deposits seemed to have responded well to the SBP move of raising minimum floor on saving deposit rate<sup>6</sup>, while current deposits increased together with higher seasonal disbursements. However, pursuant to deceleration in fixed deposits, the maturity profile of deposits turned towards shorter maturities of up to 1 year. The deposits growth was partially attributable to continued growing worker remittances and rise in FCY deposits on account of depreciation in domestic currency<sup>7</sup>.

Despite a reasonable growth in deposits, the trend of the constrained market liquidity continued due to higher flow of credit to private sector and persistent demand for financing from the public sector during the second half of CY12. The shortfall in budgeted external resources increased budgetary borrowings, which enhanced reliance of the Government on bank borrowings. As increase in deposits failed to match enhanced liquidity needs, banks resorted to heavy secured borrowing from the money market, which kept short-term overnight rates volatile throughout H2-CY12. The SBP therefore made significant injections through OMOs to ease out the market liquidity. These banks' borrowings channelized mostly into Government papers for the rollover of existing government debt and funding its additional requirements, which remained the second best to monetization in the prevailing circumstances.

With continued flow of funds into Government securities, the fund based liquidity indicators improved further during H2-CY12. The surplus liquidity kept the liquid assets as a percentage of total assets and deposits and statutory reserves to their highest level. As a result of deposits growth, Advances to Deposits ratio (ADR) further decreased by 36 basis points to 52.16 percent. The share of Government securities in total investments increased substantially with majority of the investment concentrated in short term instruments. While such a high concentration of investment in Government securities provides surplus liquidity to the system, it posed re-investment risk that materialized with the decline in market interest rates and interest margin over the second half of CY12. In addition, this lower risk portfolio while allowing banks to manage risk on their balance sheets in the prevailing difficult environment, also limited asset diversification and financial intermediation between private savers and borrowers.

Banks posted strong profits during CY12 at the back of healthy growth in non-interest income and decline in provisions charge against the NPLs. The banking sector recorded 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. The net interest income from core activities, declined mainly due to higher 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 some decline. The increase in cost-to-income ratio; a measure of bank efficiency, also affected income growth mainly because of substantial rise in salary expenses and continuous expansion of branch network. However, decline in provisions charge due to slow down in NPLs and enhanced FSV benefit, supported growth in overall profitability.

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<sup>6</sup> Minimum rate on saving deposits was increased from 5 percent to 6 percent w.e.f. May 01, 2012.

<sup>7</sup> Depreciation of rupee by 2.7 percent against USD during the quarter

The capital of the banking sector remained strong and well above the domestic<sup>8</sup> and international benchmarks, thanks to higher earnings. The Capital Adequacy Ratio (CAR) edged up by 32 bps to 15.6 percent over the H2-CY12. Despite improvement in private sector credit disbursement over the half-year, higher accumulation of un-appropriated profits and a few merger and acquisition transactions allowed banks to strengthen their capital base. The leverage ratio<sup>9</sup> also stood at a comfortable level and well above the Basel-III standard of 3 percent. Further, solvency risk<sup>10</sup> from changes in credit quality pacified as most of the asset quality indicators observed improvement<sup>11</sup>. Though most banks met the CAR requirements, some banks continued to face challenge in achieving the prescribed Minimum Capital Requirements (MCR). With strong capital position, banks generally exhibit resilience towards various stress shocks<sup>12</sup>, with large banks strongly buoyant towards all the solvency tests.

In continuum with the decade long growth trend, assets and deposits of **Islamic Banking** Institutions grew by 17.6 percent and 17.3 percent respectively far exceeding the conventional bank growth during H2-CY12. As a result, share of Islamic banking in total assets of the banking sector edged up by 40 bps to 8.6 percent. Islamic financing, however, remained confined to non-participatory financing modes for meeting working capital needs. In sharp contrast to banking sector, flow of funds was equally distributed among investment and financing activities, with most of the funding provided by healthy deposits growth. To bring uniformity in industry practices related to profit and loss distribution on deposits as well as to boost the confidence of general public in Islamic Banking, the SBP issued instructions for “Profit & Loss Distribution and Pool Management for Islamic Banking Institutions<sup>13</sup>” during H2-CY12.

The improved asset quality indicators of Islamic Banking kept the credit risk subdued. Liquidity parameters also presented comfortable profile, due to substantial flow of funds into Ijarah Sukuks during H2-CY12. However, financing to deposit ratio remained dismally low at 32.43 percent indicating substantial room for enhancing the leverage. The operating performance of IBIs somewhat deteriorated due to high operating expenses largely due to robust increase in branch network and related resources. Deceleration in earning also affected the accumulation of retained earnings that led to dip in Capital Adequacy Ratio of Islamic Banks<sup>14</sup>. Like commercial banks, some Islamic banks continued to face challenges in meeting the MCR.

**NBFIs** after remaining on growth trajectory for last two years, observed a contraction in H2-CY12 due to 22 percent decrease in the Net Asset Value (NAV) of mutual funds, particularly the money market and income funds. The decline took place due to waning interest of banks in mutual fund investment due to gradual evaporation of tax advantage<sup>15</sup> and declining interest rate scenario. As highlighted in earlier FSRs, mutual funds industry was exposed to a high concentration in money market mutual funds. Banks also made substantial investment in these funds directly and indirectly, which exposed mutual funds industry to both reinvestment as well as regulatory risks. The expected launch of Basel-III<sup>16</sup> and changes in tax regime made some banks to pull off their investments from mutual funds.

Other NBFIs observed contraction in assets by 4.3 percent mainly due to reduction in assets of Investment Finance Companies and Development Finance Institutions respectively. The performance of both these sub-segments deteriorated, while IFCs continued to struggle for survival due to persistent short fall in meeting Minimum Equity

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<sup>8</sup> Banks are required to maintain minimum CAR of 10 percent.

<sup>9</sup> The leverage ratio is measured as the ratio of adjusted tier-I capital to adjusted on-balance sheet and off-balance sheet assets

<sup>10</sup> Net-NPLs to Capital ratio

<sup>11</sup> With improvements in asset quality indicators, particularly the provisions coverage, capital at risk also observed considerable decline of 6.5 percentage points to 20 percent over the half year.

<sup>12</sup> For number of banks failing stress scenarios, see Annexure 1.15

<sup>13</sup> IBD Circular No. 3 dated November 19, 2012

<sup>14</sup> Represent CAR of Islamic banks only.

<sup>15</sup> The income of banks is presently taxed as per the corporate tax rates i.e. @35 percent of income before tax. However, the income generated by banks from investment in mutual funds was taxed at 10 percent. As per Finance Act 2013, dividend received from Money Market Funds and Income Funds has been fixed at 25 percent.

<sup>16</sup> Basel Capital accord under look through approach for collective investment schemes, require banks to calculated capital charge on their mutual fund investments as if the underlying exposure/asset class is held by the banks themselves.

Requirements (MER). The performance of Modarabas and leasing companies observed some improvement as they retired borrowings and enhanced reliance on deposits growth, while shifting their focus on core activity, which changed the structure of assets from investing activities to advances and lease business. Most of the NBFIs' after tax profit of PKR 402 million came from earnings posted by Modarabas and leasing companies. However, solvency concerns continued to haunt most of the leasing companies.

The risks associated with the **insurance sector** lessened barring few exceptions just as the coverage and size of the sector surged by 10.6 percent during H2-CY12 largely contributed by a robust 33.4 percent growth in life sector business. Though technical risk on motor coverage remained high, both life and nonlife providers benefited from lower claims ratio and improved earnings on investments in government securities as well as increased returns from the equity market. As a result, the insurance sector witnessed substantially higher profits during H2-CY12.

The continued focus of the SBP for bringing improvements in automated **payment and settlement system** resulted in increase in transactions settled in terms of value and numbers during H2-CY12. The Pakistan Real Time Interbank Settlement Mechanism (PRISM) effectively managed the efficient settlement of increased large value<sup>17</sup> and quantum of transactions even in the times of stress in the liquidity market. The financial sector's investments in information technology (IT) infrastructure also facilitated improvements in payment system infrastructure particularly, the deployment of core banking solutions that helped to achieve the higher degree of operational efficiency, better provisions of services and higher reliability of systems. Similarly, in line with past trend, value and volume of transactions in retail banking grew due to growing usage of Real Time Online Banking (RTOB) resulting into gradual but persistently increasing volume of e-banking transactions.

### Post period Performance Highlights of Banking Sector H1-CY13

During H1-CY13, the **asset base** of the banking system observed modest increase duly supported by robust deposits growth. The net advances declined marginally on the back of partial settlement of circular debt while investments in government securities moderated on account of lesser fiscal reliance on commercial banks. The banking sector continued to post reasonable profits; though at a decelerated pace, due to higher provisions charge and lower interest margins. The solvency of the system remained in conformable zone; capital adequacy Ratio stood well above the minimum benchmark, however, some banks found it challenging to comply with capital requirements. The asset quality deteriorated marginally, yet coverage ratio improved due to high provisioning.

The advances marginally declined by 0.9 percent primarily due to partial adjustment of inter-corporate circular debt of PKR 324 billion (by incumbent government) enabling corporate (especially PSEs of energy sector) to off-load their outstanding debt<sup>18</sup> obligations. In addition, the seasonal retirement in

**Table 02: Highlights of the Banking Industry**

| Indicators                   | CY10  | CY11  | Jun-12 | CY12  | Jun-13 |
|------------------------------|-------|-------|--------|-------|--------|
| Key variables in PKR Billion |       |       |        |       |        |
| Total Assets                 | 7,117 | 8,171 | 8,653  | 9,711 | 10,090 |
| Investments (net)            | 2,157 | 3,055 | 3,275  | 4,013 | 4,253  |
| Advances (net)               | 3,358 | 3,349 | 3,573  | 3,804 | 3,727  |
| Deposits                     | 5,451 | 6,244 | 6,803  | 7,294 | 7,756  |
| Borrowing                    | 538   | 675   | 508    | 1,027 | 835    |
| Equity                       | 695   | 784   | 808    | 882   | 901    |
| Profit Before Tax (ytd)      | 105   | 170   | 99     | 178   | 82     |
| Profit After Tax (ytd)       | 65    | 112   | 64     | 118   | 55     |
| Non-Performing Loans         | 556   | 592   | 635    | 615   | 616    |
| Provisioning Charges         | 75    | 50    | 11     | 40    | 18     |
| Non-Performing Loans (net)   | 185   | 182   | 214    | 176   | 165    |
| Key FSIs (percent)           |       |       |        |       |        |
| NPLs to Loans (Gross)        | 14.9  | 15.7  | 15.9   | 14.5  | 14.8   |
| Net NPLs to Net Loans        | 5.5   | 5.4   | 6.0    | 4.6   | 4.4    |
| Net NPL to Capital           | 26.7  | 23.1  | 26.5   | 19.9  | 18.3   |
| Provision to NPL             | 66.7  | 69.3  | 66.3   | 71.5  | 73.2   |
| ROA (Before Tax)             | 1.5   | 2.2   | 2.4    | 2.0   | 1.7    |
| CAR                          | 13.9  | 15.1  | 15.1   | 15.6  | 15.5   |
| Advances to Deposit Ratio    | 61.6  | 53.6  | 52.5   | 52.2  | 48.1   |

Note: Statistics of profits are on year-to-date (ytd) basis.

<sup>17</sup> PRISM transactions are classified as high value transactions due to higher average size per transactions although there is no lower limit on such transactions.

<sup>18</sup> The gross advances in "Production and Transmission of Energy" declined by Rs 50 billion during H1-CY13 in sharp contrast to continuous accumulation during last few years (PKR 113 billion in H1-CY12 and PKR 29 billion in H1-CY11).

textile sector and deceleration in credit demand in sugar sector (due to government support<sup>19</sup> and high export volume) superseded the positive credit flows in commodity finance (PKR 58 billion). The segment-wise credit analysis showed decline in credit for working capital and fixed investment needs. Due to high credit risk and banks' cautious approach, the declining trend in credit outlay to SME sector continued with another reduction of PKR 32 billion in outstanding stock. The consumer finance continued gradual uptick in "personal loans" and "auto finance" segments.

The **asset quality** of the banking system marginally deteriorated in H1-CY13 with an increase in NPLs by PKR 9.2 billion (1.5 percent) cumulating to PKR 616.5 billion. The flow of fresh NPLs led to overall rise in NPLs. This, combined with marginal dip in advances, slightly increased "NPLs to advances" ratio by 29 bps to 14.76 percent in H1-CY13. However, improved recoveries against NPLs and declassification of rescheduled/restructured NPLs kept the growth in NPLs in check. On the positive side, the NPLs coverage further improved due to additional provisioning charge on the back of phasing out of FSV benefits and downgrade in existing NPLs portfolio. The net infection ratio and provisioning coverage ratio improved to 4.4 percent and 73.2 percent in Jun-13.

The liquidity profile of banking sector further improved in H1-CY13, due to steady growth in deposits, partial settlement of circular debt in June CY13, decline in net credit disbursements, and moderation in Federal Government reliance on bank borrowings. Fund based liquidity further strengthened as banks continued to accumulate Government securities, though the trend somewhat moderated with 6.3 percent growth in H1-CY13 as against 29 percent growth in H2-CY12. Unlike last year, most of the increase was funded by 6.23 percent increase in deposits. The deceleration in government borrowings allowed banks to utilize deposits growth to make net retirement of secured borrowings from the central bank. With more than 87 percent of banks' investments placed in risk-free Government securities (with a share of 36.8 percent in total assets) and stagnancy in financing, ADR further reduced to 48 percent during the period.

The banking industry posted a reasonable **pre-tax profit** of PKR 82.1 billion during H1-CY13, although 17 percent lower compared to H1-CY12. This dip was observed mainly due to decline in net markup income. In addition, higher provisions contributed to lower profitability of banking system. Improved non-markup income on the back of fee based income and gain on sale of shares and Government securities supported overall earnings of the system. The decline in net markup income led to decline in Net Interest Margin (NIM) by 90 bps to 3.9 percent in H1-CY13. As a result, the Return on Assets (ROA) and Return on Equity (ROE) slipped down to 1.7 percent and 18.6 percent respectively (2.3 percent and 24.8 percent in June-12).

The Capital Adequacy position of the banking system marginally improved over the half year, at the back of improved capital position of the banking sector. The materialization of stock dividends announced by the banks in the annual announcements, and build up of statutory reserves on earnings provided for enhancement in the capital base. Overall industry remained well capitalized though some banks kept on facing challenges in meeting MCR of PKR 9 billion.

Going forward, time honored pattern of seasonal pickup in demand for bank credit toward the end of second half of the year is expected to expand the earnings assets. Given the sufficient amount of liquid assets in the form of government papers, banks' liquidity profile will continue to remain in comfort zone. However, with fiscal discipline as envisaged in IMF commitments, the government borrowings for budgetary needs from the banks are expected to remain moderate. Such a scenario may create some funding space, though ability of banks to lend to private sector will largely depend upon the mobilization of fresh deposits and retirement of public sector commodity finance; stock of which persistently remained high and increasing. The flows to private sector will also be contingent upon extent of demand from the sector and extent of government borrowings. The banking sector is expected to post reasonable earnings for the full year, however, factors like increase in minimum deposit rate and prevailing overall interest rate

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<sup>19</sup> The government's support through purchasing 4.8 million tons of sugar and exceptional growth in sugar export

scenario, may keep profit growth under check. The reasonable earnings and capital injection by some banks to MCR have helped strengthen their capital positions, which placed them in comfortable position to comply with the Basel III capital requirements to be effective on banks from CY14. However, persistent macroeconomic issues will make it challenging for few capital deficient banks in meeting the capital adequacy requirements.