Chapter 1 Financial Intermediation

The asset base of the banking system observed modest increase of 3.9 percent in the wake of challenging economic environment, partial settlement of circular debt and moderating reliance on banking sector for funding fiscal deficit. A decent growth in customer deposits provided for funding needs. Despite decrease in the Government borrowing from the banking sector, investment in Government papers surged partially due to settlement of circular debt. The flow of advances subsided due to dampening private sector credit, though public sector enterprises enhanced borrowing to finance commodity procurement operations in line with established seasonal pattern.

Figure 1.1

Changes in Banking Sector Assets

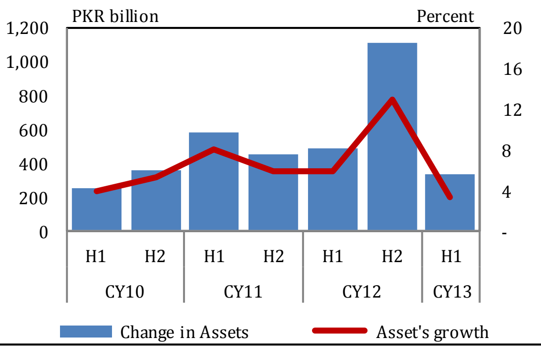


Figure 1.2

Flows in Asset Components (PKR billion)

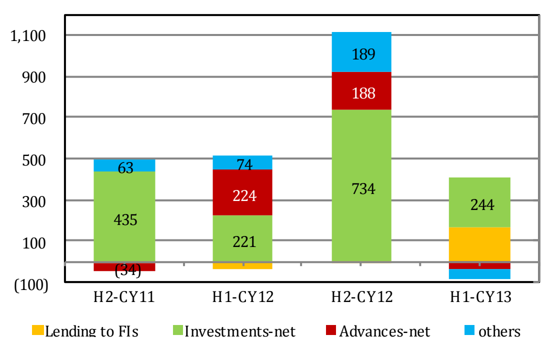
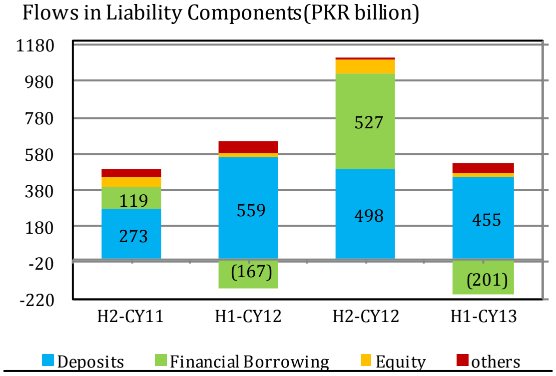


Figure 1.3

Flows in Liability Components(PKR billion)



Challenging economic and business conditions and relatively lower reliance of the Federal Government on the banking sector during the period under review decelerated the banking sector growth. The asset base observed a modest growth of 3.9 percent during H1-CY13 as advances declined while investments in government securities decelerated (**Figure 1.1 and 1.2**). Deposits of the system kept a steady growth pace with composition somewhat tilted towards Current Account Saving Account (CASA) deposits (**Figure 1.3**).

Private sector credit flows subsided….

Advances portfolio declined marginally due to net retirements by private sector. This decline was contributed by host of factors, amid, partial settlement of circular debt enabling corporate to fulfill banks' obligations, seasonal net retirement in textile credit, and lower credit off-take in sugar sector. The credit to Small and Medium Enterprises (SME) remained on the downhill due to banks' cautious approach while consumer finance observed some recovery in some of its segments. Among others, the energy shortfall and security concerns continued to play dampening effect on credit demand.

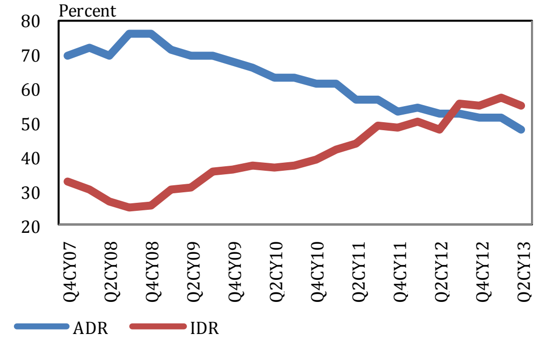
….while banks' exposure on public sector increased

The public sector exposure continued to gain weight on the banks' balance sheet largely for financing the funding needs of the public sector enterprises and fiscal deficit. During H1-CY13, banking sector extended 7.2 percent advances for public sector commodity procurement operations. Moreover, banks also increased their investments in Government securities by 6.3 percent. As a result, share of public sector credit increased to 44.5 percent of the banking sector assets.

The funding needs were largely financed through 6.2 percent increase in deposit. Most of this increase took place in customer

Figure 1.4

Shift in Asset Mix



deposits under CASA category, while fixed deposits declined by 1.26 percent. This sluggish trend in fixed deposits seems to be the result of adjustments made in minimum saving rate[8] over the last year[9]. The growth in foreign currency deposits remained very much in line with depreciation in domestic currency, while remaining within the regulatory limit[10]. Among other liability components, borrowings from financial institutions dipped as banks retired secured borrowings from the central bank, while equity of the system grew by 2.3 percent due to accumulation of retained earnings.

ADR is on continuous fall…

Banks' continued investment in government securities with slowdown in lending to private sector reshaped the banking assets in last few years. The tilt of banks' balance sheet to less risky assets, given consistent growth in deposit base, well reflected in declining Advances to Deposit Ratio (ADR) against almost a parallel rise in Investment to Deposit Ratio (IDR). This contrasting pattern of ADR and IDR advocates limiting financial intermediation in the banking system and crowding out of the private sector credit. Importantly, during H1-CY13, ADR declined from 50 percent to 48.1 percent **(Figure 1.4).**

Table 1.1: Sector-wise Credit Flows in H1-CY13

PKR billion

	Public Sector	Private Sector	Total
PTES	1.3	(50.9)	(49.5)
Sugar	0.6	27.3	27.9
Agri Business	10.2	1.5	11.6
Chemical & Pharmaceuticals	(0.0)	0.8	0.8
Financials	(0.1)	24.6	24.4
Cement	-	(4.6)	(4.6)
Shoes & Leather	-	0.6	0.6
Electronics and Electrical	-	(3.1)	(3.1)
Textile	-	(18.1)	(18.1)
of which			-
Spinning	-	*(25.5)*	*(25.5)*
Composite	-	*0.9*	*0.9*
Weaving	-	*(2.5)*	*(2.5)*
Others	49.8	(34.7)	15.1
Total	**61.7**	**(83.7)**	**(22.0)**

Advances decline as flows to private sector taper ….

The gross advances dipped marginally by 0.5 percent during H1-CY13 due to decline in credit flows to private sector **(Table 1.1)**. This decline was contributed by host of factors, like: (a) partial adjustment of inter-corporate circular debt of PKR 324 billion in June 2013 that enabled various corporate to retire their outstanding debt obligations to banks, (b) the deceleration of demand for credit in sugar sector (specifically in the second quarter of CY13) due to the government's purchase of 4.8 million tons of sugar and exceptional growth in sugar export[11], (c) the seasonal net-retirement in textile sector[12]; (d) increase in real cost of borrowing due to decline in inflation; and (e) banks continued cautious approach in extending fresh advances due to high credit risk.

[8] SBP raised minimum rate on saving deposits to 6 percent p.a. (from previous 5 percent p.a.) in May, 2012 followed by instructions to calculate the rate on monthly average basis effective from April, 2013.

[9] The weighted average return on saving deposits of banking sector increased by 20 bps from 6.18 percent on December 2012 to 6.38 percent on June 2013.Contrary to that, the weighted average return on fixed deposit declined by 61 bps from 7.95 percent on December 2012 to 7.34 percent on June 2013.

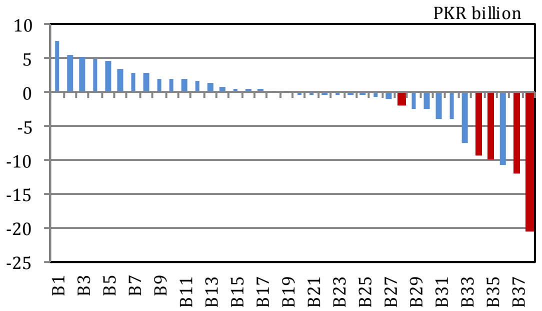
[10] In terms of Regulation O-5 of the Prudential Regulations for Corporate/Commercial Banking Foreign currency should not at any point exceed twenty percent of the local currency deposits of the banks.

[11] SBP third Quarterly Report – 2013.

[12] The extent of retirements during H1CY13 were lower than H1-CY12.

Figure 1.5

Bank-wise flow of Advances-net in H1-CY13

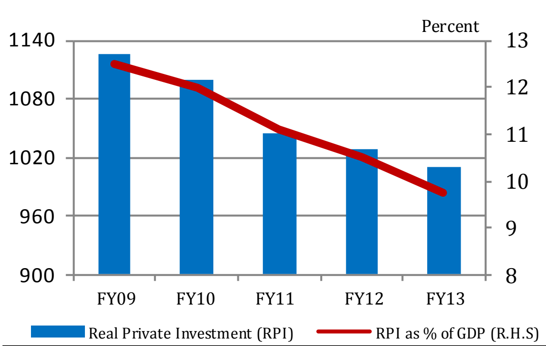


B stands for Bank and red bars indcates Top-5 large banks

Table 1.2 Segment-wise credit flows in H1-CY13			
			PKR billion
	Puplic Sector	Private Sector	Total
Fixed Investment	5.6	(24.8)	(19.3)
Workign Capital	6.1	(107.5)	(101.4)
Trade Finance	(7.4)	14.5	7.1
Commodity Finance	58.9	(6.3)	52.6
of which	-	-	-
Wheat Finance	*64.2*	*7.8*	*72.0*
Others	(0.0)	15.8	15.7
Total	**63.1**	**(108.3)**	**(45.1)**

Figure 1.6

Real Private Investment and GDP



Bank-wise data of advances showed a skewed distribution, as overall net-retirement in top-five banks was more than the decline in credit of entire banking industry **(Figure 1.5)**. The middle and small sized banks, however, were able to provide more credit to private sector which is a positive sign. Perhaps, the declining interest rates on government securities, high cost of deposits, and moderate credit risk in recent period prompted these banks to seek high returns through credit expansion.

Structural issues affected demand for credit….

Structural issues particularly lack of adequate energy supply and security concerns compelled businesses to operate below their optimal level, which resulted in low credit demand over the years. Most disbursements merely catered the seasonal and short-term working capital needs, while, due to underutilized prevailing production capacity and negligible business expansion, credit for fixed investment remained nominal. During H1-CY13, with the exception of commodity finance, most of the segments generally observed decline **(Table 1.2)**. The credit for trade finance, however, observed marginal improvement. Owing 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. Consumer financing got momentum mostly in "personal loans[13]" and "auto finance" segments.

…as Capital formation yet to pick up…

The decline in fixed investment loans is the reflection of squeeze in Real Private Investment (RPI) in the economy which, as a percent of GDP decreased for the fifth consecutive fiscal year to reach 9.7 percent **(Figure 1.6)**. It is expected that meaningful efforts to resolve the core issues, amongst others, the energy crisis and law & order at top, will help kick-start the economic activities and restore the private sector credit demand.

…and flows to production and transmission of energy subsided

Another area of concern is increasing concentration of loans in few economic sectors, particularly in PTES. Historically, the textile sector is the key user of the advances; however, over last few years and more specifically during CY12, banks' credit exposure in PTES increased significantly and touched 12.3 percent of the gross portfolio. However, government settled inter corporate circular debt in June-July 2013, which led to net

[13] The acceleration in "Personal Loans" segment is not broad based and mostly driven by one bank only.

Table 1.3: Flow of Banks' Investment in Govt. Securities				
				PKR billion
	H2 CY11	H1 CY12	H2 CY12	H1 CY13
MTBs	321	27	604	87
PIBs	198	38	138	109
Others	118	(7)	42	23
Total Govt. Securities	**637**	**59**	**784**	**219**
Total Investments	**435**	**222**	**736**	**250**
Investment in Govt. Securities to Total Investment (Percent)	*147%*	*26%*	*106%*	*88%*

Figure 1.7

Public Sector Commodity Finance Break-up

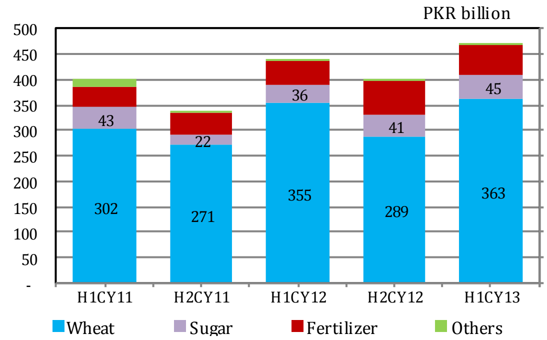


Figure 1.8

Deposits-Half Yearly Flows

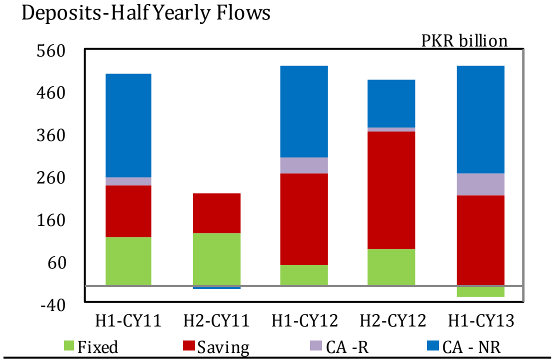
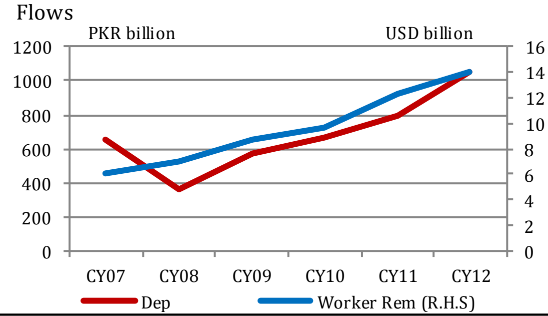


Figure 1.9

Workers' Remittances and Banking Deposits-cumulative Flows



retirement of PKR 50 billion in PTES and decreased its share in advances to 10.6 percent during the period under review. Although settlement of circular debt is expected to improve energy supply in the short term, addressing structural issues is necessary from the long term strategy perspective, which will create financing space for banks to enhance private sector credit (See **Box 1.1**).

Commodity financing touched new highs….

As indicated above, the seasonal credit disbursements for public sector commodity was the only prominent flow during the year. The self-liquidating commodity finance by public sector saw a new peak in H1-CY13 **(Figure 1.7)**. Wheat financing (77 percent share in overall commodity financing) increased by 26 percent, which largely resulted from increase in support price announced in Sep-12 from PKR 1050/40 kg to PKR 1200/40kg. Financing to sugar sector increased as Trading Corporation of Pakistan (TCP) purchased additional stock in Feb-13[14], while financing for fertilizers reduced owing to seasonal offloading of the fertilizer stocks[15].

Investment in Government papers somewhat decelerated…

The unprecedented and insatiable government funding needs due to swallowing fiscal overrun[16] were mostly met through schedule banks during the last few years **(Table 1.3).** Banks' investment in government papers remained high due to a number of benefits, i.e., zero credit risk, no capital charge on domestic sovereign debt, consistent stream of income with improving NIM, pilling up Statutory Liquidity Requirement (SLR) eligible securities. On the contrary, fewer funds were available to finance private sector activities. This has reshaped the balance sheet of schedule banks. The share of banks' investment in government securities to total assets increased to 37 percent in Jun-13 from 14 percent in June-2008.

The H1-CY13 was not an exception where banks invested another PKR 219 billion in government securities. The decomposed data of such investments depicts more buying of Pakistan Investment Bonds (PIBs) than Market Treasury Bills

[14] The TCP commodity financing stock was PKR 50 billion in Mar-13 which, due to TCP's offloading of the sugar stock reduced to PKR 45 billion in Jun-13 and further reduced to PKR 40 billion in Sep-13.

[15] The seasonal peak of fertilizer financing usually comes at the end quarter of CY due to imports of the fertilizer by the government to ensure its availability for harvesting of Rabi crops (mainly wheat).

[16] Several factors contributed to large fiscal deficient during last few years including insignificant growth in tax collection, dried up and uncertain foreign inflows, general subsidies especially on electricity, and losses incurred on several PSEs.

Figure 1.10

Substitution between Fixed and Saving Deposits

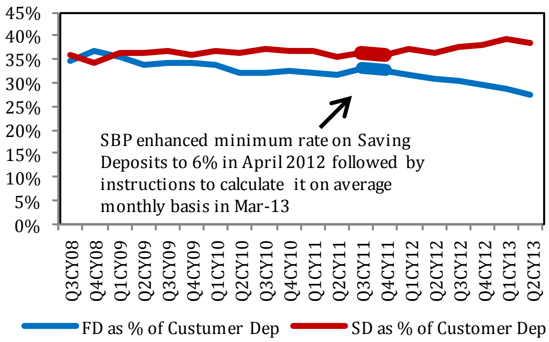


Figure 1.11

Maturity-wise flows in Fixed Deposits during H1CY13

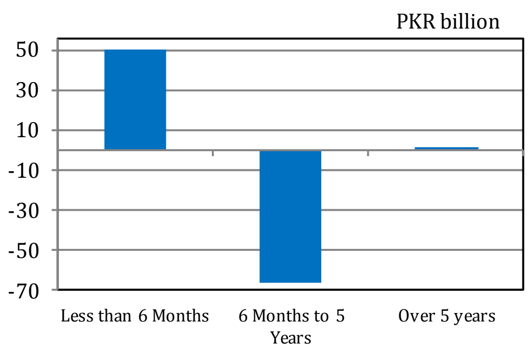
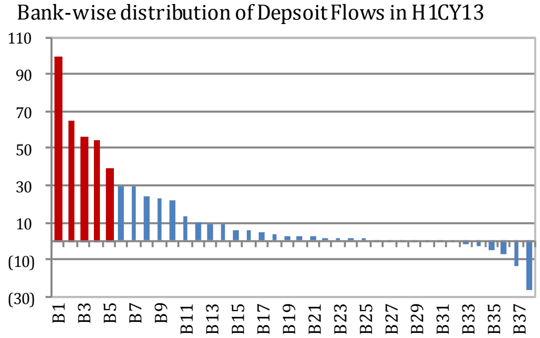


Figure 1.12

Bank-wise distribution of Depsoit Flows in H1CY13



B stands for bank and Red bars shows Top-5 large banks

(MTBs). This was, perhaps, due to banks' expectation of interest rate decline in line with phased reduction in SBP's policy rate as well as less government desire to finance its deficit through short-term funds to avoid frequent roll-overs.

Deposits catered the funding needs of the system..

The overall deposit base posted a steady growth of 6.23 percent (PKR 455 billion) entirely contributed by customer deposits (PKR 497 billion) while financial institutions' deposits declined by 13 percent (PKR 42 billion). The composition of the customer deposits reveals some contrasting pattern **(Figure 1.8)**. For example, while CASA deposits growth was higher than the overall deposit growth, fixed deposits after observing a decelerated growth pattern in last couple of years actually declined by 1.3 percent (PKR 26 billion) in H1-CY13.

The high CASA deposits growth in recent years may be attributed to multiple factors; (a) SBP enhanced ceiling of minimum rate on saving deposits to 6 percent in April 2012 which was further reinforced with the instructions to calculate the rate on monthly average balance[17] which increased real returns on saving deposits (b) banks concerted efforts to mobilize additional deposits for gaining reasonable risk free returns through investing in government securities[18], and (c) robust monthly flow of home remittances etc (**Figure 1.9).**

Fixed deposits saw a significant fall since SBP raised minimum rate on saving deposits. Noticeably, funds raised through National Savings Scheme (NSS) (the nearest substitute of fixed deposits) remained on rise. The mirror imaged growth pattern between fixed and saving deposits along with consistent and growing stream of funds raised under NSS probably shows some degree of substitution of fixed deposits to either more liquid saving deposits or higher yielding NSS instruments **(Figure 1.10)**.

However, despite overall decline in the fixed deposits, maturity-wise flow data reveals growth in short tenor fixed deposits (with maturity of 6 months or less) while long-term fixed deposits observed a sharp decline **(Figure 1.11).** Banks seems to have focused on managing cost of funds through short term and transactional deposits (current and saving) to minimize the impact of increase in minimum saving rate.

[17] It was observed that a large number of banks were paying minimum prescribed rate on saving deposits on minimum monthly balance. SBP vide its BPRD's circular No.1 dated March 15, 2013 instructed to pay minimum 6 percent rate on monthly average balance to safeguard the depositors' interest.

[18] Most of funds were invested in MTBs of shorter maturities (3, 6, and 12 months) than the fixed deposits.

Figure 1.13

Bank-wise distribution of Depsoit Flows in H1-CY13

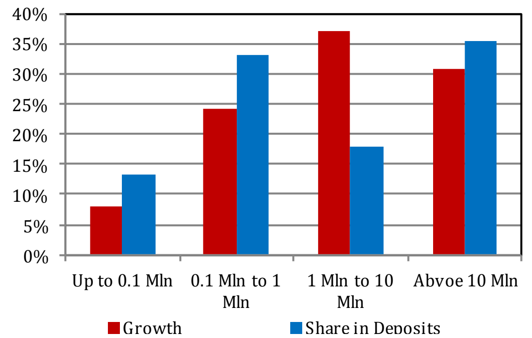
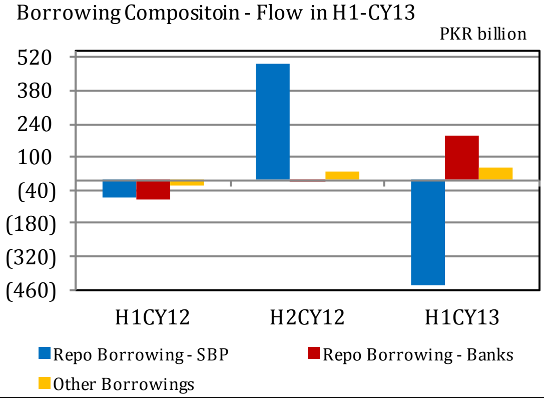


Figure 1.14

Borrowing Compositoin - Flow in H1-CY13



The deposit growth seemed mostly confined to large banks. Especially, top five banks with 54 percent share in assets of banking system contributed 69 percent in overall deposit growth of banking system. Some medium and small sized banks observed decline in their deposit base **(Figure 1.12).**

Size-wise deposit details exhibit some unsynchronized deposit contribution in growth compared to share. Deposit size within the range of PKR 1-10 million holding only 17.9 percent share in deposit base contributed 37 percent to deposit growth. In contrast, the contributions from other size-wise deposit segments were lesser than their respective shares in overall deposit base **(Figure 1.13).** This unparallel growth contribution may be due to migration of deposits within the size segments along with new deposits.

Bank borrowings shrink as investment in government securities decelerated…

Banks made net retirement of PKR 201 billion against borrowings from the financial institutions during H1-CY13 mostly from the SBP **(Figure 1.14).** The decline resulted due to improved liquidity profile of the banks owing to steady deposit growth, settlement of circular debt including cash in June CY13, net retirements in private sector loans and moderation in Federal Government reliance on bank borrowings.

Weekly data[19] show that financial borrowings remained below weekly average of Jan-June, 2013 during Q2-CY13. In the initial months of H1-CY13, SBP injected liquidity into the market to ease the liquidity pressures and smoothen the functioning of payment system. However, SBP reduced such injections in the second quarter owing to several factors like (a) to curtail medium term inflation anticipation and (b) to support the depreciating PKR through return on PKR[20].

Equity base of the banking sector grew moderately by 2.3 percent (3.1 percent in H1-CY12) at the back of retained earnings for H1-CY13. The slower growth seems to be an outcome of dividend payouts announced in the Annual General Meetings for the year CY13 and lower return earned by banks during the period under review.

[19] Since borrowing from financial institutions is transitory in nature, a more frequent data (such as weekly) gives a better picture of trend of flow of funds.
[20] See Monetary Policy Statement – September 2013.

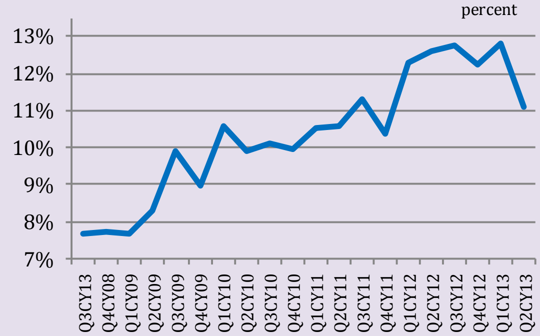
Box 1.1

Adjustment of Inter-Corporate Circular Debt in Energy Sector

The deficient energy supplies, kept the businesses operate far below their optimal level since long, which resulted in low credit demand for long-term funds. Most of the credit during last few years was disbursed for seasonal and short-term working capital needs, while flow of credit for fixed investment remained sluggish. The credit demand remained stagnant despite decline in the Weighted Average Lending Rate (WALR) by more than 400 bps due to slashing of SBP policy rate by 500 bps over the period Dec CY10 – Jun CY14. This is clearly indicative of the fact that cost of borrowing has not been the primary issue behind low credit demand. Rather a number of other issues stymied the private sector credit flows including persistent energy crisis.

Figugure B1.1

Share of Banks' advances in PTES



The rising inter-corporate circular debt is one key offshoot of persistent and severe energy crisis that led to high concentration of bank lending to PTES. The trend of financing reveal that share of banks' advances to PTES grew from 7.2 percent in Sep-08 to 12.3 percent in Mar-13 to reach PKR 512 billion (**Figure B1.1**).

The Government in order to resolve energy sector related issues settled inter corporate circular debt in June-July, 2013. The total debt outstanding was PKR 502 billion as of end May CY13, of which, PKR 342 billion was adjusted in end-June CY13[1]. The settlement was carried out through a mix of cash payments, PIBs, and adjustment of dividends to be received by Government on account of its shareholding in PTES (**Table B1.1**).

Table B1.1: Adjustment of Inter-Corporate Circular Debt in Energy Sector*

	PKR billion
Cash IPPs	161.23
PIB OGDCL	56.31
PIB PPL	23.36
PSO	81.33
of which	
CASH	*33.21*
PIBs	*48.12*
by GOP	19.71
Total	**341.96**
** As of end Jun-CY13*	

As a result of above adjustments, the PTES advances declined by PKR 69 billion to PKR 443 billion in Jun-13. Consequently, concentration of banks' gross exposure in the PTES also dropped to 10.6 percent in Jun-13 from 12.3 percent in Mar-13 with most of the retirement observed in large private sector banks.

Although the settlement of circular debt is a positive development and is expected to improve energy supply, yet this may be considered only a short-term remedial measure. Incidentally, similar measures were taken in CY11 and CY12. However, higher customers' default rate and other structural weaknesses continued to pile up the circular debt. These structural issues revolved around a highly inefficient transmission and distribution system, high generation cost, electricity theft, subsidies, etc. To circumvent build up of further circular debt and to avoid concentration of this financing on banks' balance sheets, the Government needs to take concerted efforts for improving the overall distribution and collection mechanism[2], which will create financing space for banks and enable them to enhance credit to the private sector.

[1] In July 2013, PKR 138.2 billion of circular debt was adjusted through settlement of payables against receivables of the power generation companies. The rest of PKR 23 billion (out of PKR 502 billion) of circular debt was withheld due to cases filed by IPPs in the Supreme Court.

[2] The Government of Pakistan formulated a much awaited National Energy Policy (2013-18) in July 2013 which aims at brining several improvements, including phasing out of subsidies, privatization of state owned power plants and DISCOs, lowering cost of power generation, restructuring of various related institutions and ministries, and formation of regional transmission and power trading system.