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Banking system assets grow by 8% to Rs 7.7 trillion in Jan-June 2011: SBP Financial Stability Review

The assets of Pakistan's banking system soared by 8 % or Rs 577 billion to Rs. 7.7 trillion during the first half of calendar year 2011 (January-June, 2011). This surge in banks' total assets, both in absolute and growth terms, was the most significant since 2007, says the State Bank of Pakistan's Financial Stability Review (FSR) released today.

Deposits increased by 9.4%, registering the highest half yearly growth during the last four years, it said, adding that net investments, with an increase of 22.4% during the first half of 2011, markedly outpaced the anemic growth of 1.04% in net advances.

The first-half yearly Review said that banks' profits before tax were up by 31% during the first half of 2011 to reach Rs. 77 billion, with Return On Assets (ROA) of 2.1% (1.8 % in June-10) and Return On Equity (ROE) of 21.9 % (17.7% in June-10). During Jan-June 2011, banks remained fairly liquid on the back of growing share of investments in government papers, it said, adding that further, banks' capital adequacy ratio also observed improvement, reaching 14.1% by June-2011.

It said that concentration in profits have dropped (share of top 5 banks down from 95 % in Dec-10 to 78 % in June-11), ensuring that even smaller banks have a share, albeit marginal, in industry profits. 'Further, growing profits have also helped reduce the number of loss making banks, from 17 in June-10 to 8 in June-11,' it said. However, the Review cautioned that source of profits is shifting away from interest income through advances to investments in government papers. Specifically, returns from investments in government papers now accounts for almost 30 % of banks' interest income, up from 24 % in June-2010, it added.

This suggests that growth in government borrowings has shored up banks' earnings, the Review said and added that this trend is neither desirable nor sustainable, first because it compromises intermediation function and second as any sharp cut in discount rate can discernibly affect banks' profits.

The Review stressed that there has been growing evidence of banks' flight towards quality as net investments, mainly in government securities, now constitute around 34 % of banks' assets compared with 28 % in June, 2010. 'The share of net advances has witnessed a concomitant drop, from 47.6 to 43.9 % during the same period', it said and added that unsurprisingly, Advances-to-Deposits ratio has further dropped from 63.0 % in June, 2010 to 56.7 % by June, 2011.

According to the Review, while government's reliance on the banking sector heightens the concerns about private sector crowding out, poor credit off-take by the private sector has other causes as well that include severe energy crises and challenging economic environment.

Credit risk remained a major challenge as banks accumulated Rs. 31 billion of fresh Non-Performing Loans, pushing infection ratio from 14.7 % to 15.3%, the Review said and added that public sector commercial banks and mid-sized local private banks appear more vulnerable to higher credit risk. However, going forward, the results of the stress tests showed that the banking system is resilient to shocks emanating from a challenging macroeconomic and business environment, it observed.

The Review said that Islamic banking institutions (IBIs) have registered 17.5% growth during H1-CY11, with bulk of incremental assets channeled into government securities. Islamic banks appear more liquid, solvent and profitable when compared with rest of the banking sector but face unique risks like reputational risk and displaced commercial risk, it said.

Referring to other components of the financial system, the Review said that domestic financial markets remained stable during the half year under review, despite some bouts of mild strain. External inflows kept the value of domestic currency almost stable, as PKR depreciated by a marginal (0.35 %) against the dollar. The capital market managed to post a growth of 4 % during the half year under review.

The Review said that during the period under review, the asset base of the Development Finance Institutions (DFIs) managed to grow marginally by 4 %, primarily on account of stronger growth in investments. 'Share of advances in total assets remained intact (around 35 %), though at significantly lower level than what DFIs' nature of business would warrant,' it added.

However, the trading volumes and activities in the corporate debt market largely remained low. The derivatives market, on the other hand, shrank further as insipid credit to private sector coupled with stable exchange rate and interest rate environment dampened the demand for new derivative contracts.

The Review said that in contrast, the mutual funds industry witnessed its revival as the money market investments improved the net assets of the industry by 24 % in H1-CY11. 'The insurance industry witnessed a growth of 16.6 % in its asset base with the life business experienced a much strong growth (24 %),' it added.

During the half year under review, the payment systems have functioned smoothly, with amount transacted through retail payment system growing by 14 % (YoY) against 11.6 % in the corresponding period last year. In terms of volume, share of e-banking transactions has gained momentum, reaching 42 % by June-11, the Review added.

It said that in the area of branchless banking, Pakistan is experiancing a rapid expansion, with four banks offering services through various operational setups. As more banks are planning to enter this growing segment, there is strong potential to significantly improve financial inclusion in the years ahead, the Review added.

While discussing the future outlook, the FSR said that a mild pick-up in private sector credit is likely as the borrowing cycle of some key industries resumes, though receding commodity prices would keep the growth in check. Further, the challenging business environment in general and banks' risk aversion amid high credit risk would limit the possibility of a perceptible reversal in asset mix away from the government papers,' it said.

'The current monetary policy stance would make banks' asset selection challenging in the months ahead; banks will either have to live with lower returns on their investments (a key contribution to profits in recent times) or to aim for greater private sector credit, which in a difficult economic environment, would truly test their ability to adroitly manage an already high credit risk,' the Review added.

Complete text of Financial Stability Review is available at SBP website: www.sbp.org.pk

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