VIS

Credit Rating Company Limited

BANKING INDUSTRY

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INTRODUCTION

The banking sector is a vital component of both the Pakistani and global economies, serving to safeguard depositors' assets and provide loans to individuals and businesses. Regulated by the federal government (and sometimes state governments), banks play a crucial role in maintaining economic stability. Essentially, banking involves accepting deposits from individuals or businesses and lending that money to borrowers, earning a profit from the interest (may change) rate difference. Additionally, banks facilitate everyday transactions through credit cards, debit cards, and checking accounts.

In Pakistan, the banking sector is the backbone of the country's financial system, representing a significant portion of its financial assets. It comprises various institutions that offer a range of financial services to both individuals and businesses.

Types of Banks:

- Commercial Banks: These include both conventional and Islamic banks. They provide various financial services to individuals and businesses. They can be public (government-owned) or private.
- Islamic Banks: Operating under Shariah principles, interest free and using profit-sharing models.
- Specialized Banks: These focus on specific areas such as agriculture, housing, and development.
- Micro-Finance Banks: They cater to small-scale borrowers and promote financial inclusion.

ECONOMIC OVERVIEW

GLOBAL

The global economy in July 2024 presents a picture of sluggish recovery with underlying vulnerabilities. Growth projections hover around 3.2% for 2024 and 2025, marking a continuation of subdued trends compared to historical averages. This slow progress is further complicated by uneven performance across regions, with developed economies expected to experience a slight uptick while emerging markets face a potential moderation in growth. Inflation remains a pressing concern, though forecasts anticipate a gradual decline throughout the remaining year and into 2025[1]. However, the threat of rising food and energy prices due to geopolitical tensions continues to cast a shadow. The ongoing impact of climate change further adds to the complexity of the situation. Despite these challenges, the global economy has demonstrated surprising resilience. The possibility of a "soft landing" that avoids a recession remains on the table, although continued vigilance and international cooperation on issues like trade, climate change, and debt management will be essential for navigating these headwinds and achieving sustainable growth in the long-term[2].

PAKISTAN

Pakistan's economy exhibits a mix of recent growth and persistent obstacles at the start of FY’24. Despite a 5.97% GDP expansion in FY’22, fueled by strong agricultural, industrial, and service sectors, growth contracted sharply to 0.2% in FY’23. This volatility underscores underlying vulnerabilities, particularly high fiscal deficits, rising debt, and dwindling foreign exchange reserves, which heighten the economy's sensitivity to external pressures like fluctuating global commodity prices. Inflation remains a concern, squeezing household budgets with rising food and energy costs. However,

[1] *https://www.imf.org/en/Publications/WEO/Issues/2024/04/16/world-economic-outlook-april-2024*
[2] *https://www.worldbank.org/en/publication/global-economic-prospects*

the International Monetary Fund (IMF) approved the Stand-By Arrangement (SBA) program in Jul'23 and reached a staff-level agreement (SLA) on a new 37-month $7 billion extended fund facility (EFF) on July 12, 2024. Steadfast implementation of the program—including through continued fiscal restraint, energy tariff adjustments, and the continued high policy rate at 19.5% following a recent 100bps rate cut on July 30, 2024 —enabled new official external inflows, allowing a loosening of import management measures, and some recovery in confidence. Looking ahead, the World Bank anticipates subdued economic activity in the near term, with growth projections of 1.8% for FY'24. Long-term success hinges on tackling external imbalances, controlling inflation, and fostering investment in key sectors to achieve sustainable economic expansion.[3]

BANKING INDUSTRY

GLOBAL

The global banking industry in 2024 finds itself in a state of cautious optimism. While recent quarters enjoyed a profitability surge due to rising interest rates, a slowdown and potential recessions loom on the horizon, threatening loan growth, a key revenue stream. This necessitates a delicate balancing act for banks.

On the one hand, higher interest rates in 2022 and 2023 have led to improved net interest margins, boosting profits. However, a sluggish global economy and the specter of recession have dampened loan demand, impacting earnings. Further complicating the landscape is the ongoing digital transformation. The rise of FinTech (financial technology) companies necessitates investment in digital infrastructure and innovation for traditional banks to stay competitive. Geopolitical tensions and potential trade disruptions add another layer of risk, potentially destabilizing global financial markets and hindering international banking operations.

Regulatory frameworks are also evolving to address issues like cybersecurity and financial inclusion, requiring further adaptation from banks. The long-term success of the global banking industry rests on its ability to navigate this intricate web of challenges. Embracing digitalization, managing risks effectively, and demonstrating agility in a complex geopolitical environment will be paramount for sustained growth[4,5].

PAKISTAN

The banking sector in Pakistan has been navigating a challenging macroeconomic landscape. Despite facing headwinds such as high inflation, elevated interest rates, and geopolitical uncertainties, the sector has demonstrated resilience and adaptability in supporting economic stability.

One of the important factors contributing to the sector's resilience has been its strong capitalization and liquidity. Banks in Pakistan remain well-capitalized, with an industry-wide CAR of 19.7%. This ensures that banks are equipped to absorb potential shocks and maintain financial stability. Moreover, profitability metrics remain healthy, with a return on equity

[3] *https://thedocs.worldbank.org/en/doc/140b30353b40dbb294cca42bcb86529a-0310062024/original/Pakistan-Development-Update-April-2024.pdf*
[4] *https://www.mckinsey.com/industries/financial-services/our-insights/global-banking-annual-review*
[5] *https://www.imf.org/en/Publications/GFSR*

(ROE) of 27.1% based on CY-23 results, underscoring the sector's ability to generate sustained returns amidst challenging operating conditions.[6]

A) Asset Mix

By YE'23, the sector's asset base grew by 29.5% (YE'22: 19.1%) to Rs. 46.4 trillion, reflected mainly in investments in government securities, while advances growth slowed due to a challenging macroeconomic environment. Investments made up 56.1% (YE'22: 51.4%) of total assets, reflecting structural imbalances in the economy like the large fiscal deficit and the government's reliance on domestic banking resources for financing. Growth in advances decelerated to 3.0% from 16.8% in 2022, largely due to subdued economic activity and high public sector borrowings.

On the funding side, deposits rose by 24.2% (YE'22: 8.0%) in YE'23, driven by rate-sensitive deposits responding to high policy rates. Despite this, the share of deposits in total liabilities fell to 66.8% from 69.6% in the previous year, due to the sharp increase in the asset base. Borrowings surged by 48.8% YoY, raising their share in funding to 26.8% from 23.3% in CY22, with ~80% of additional borrowing coming from the State Bank of Pakistan (SBP), indicating banks' increased reliance on central bank liquidity.

PKR Billion	2021	2022	2023
Total Assets	30,058	35,796	46,364
Investments (net)	14,554	18,400	26,019
Advances (net)	10,121	11,818	12,178
Borrowings	4,738	7,845	11,673
Deposits	21,720	23,461	29,128

Table 1: Financial Soundness Indicators and Quarterly Compendium of the Banking System

B) Credit Risk

The banking sector's asset quality remains stable. Non-performing loans (NPLs) are well-covered by total provisioning coverage, totaling 92.7% of NPLs. While the gross infection ratio increased slightly to 7.6% in 2023 from 7.3% in 2022, the net infection ratio remained exceptionally low at 0.6%. Banks significantly increased general provisions by Rs 35.1 billion in 2023, compared to Rs. 9.1 billion in 2022, to prepare for the implementation of IFRS-9 accounting standards in 2024.

Sector-wise analysis shows that the textile sector, which has the largest share in banks' advances, contributed the most to the increase in NPLs during CY23. Additionally, NPLs in agribusiness, the auto sector, and among individuals also rose. Agribusinesses faced high input costs such as fertilizer and petroleum, along with the lingering impact of floods during the monsoons of 2022 and 2023, which strained borrowers' cash flows. The auto sector experienced a decline in sales, while elevated inflation reduced the purchasing power of individuals.

[6] *Financial Soundness Indicators and Quarterly Compendium of the Banking System*

PKR Billion	2021	2022	2023
Advances (Gross)	10,905	12,646	13,101
NPLs	860	924	995
Gross Infection	7.9%	7.3%	7.6%
Provisioning Coverage	91.2%	89.5%	92.7%
Net Infection	0.7%	0.8%	0.6%

Table 2: Financial Soundness Indicators and Quarterly Compendium of the Banking System

C) Investment Mix and Liquidity

By YE'23, investments increased by Rs 7.6 trillion, marking a growth rate of 41.4%, up from 26.4% in YE'22. This growth was largely driven by government securities, which now make up 53.0% of the banking sector's assets. Shorter tenor Market Treasury Bills (MTBs) and floating rate Pakistan Investment Bonds (PIBs) accounted for 58.0% of total investments. About 90% of the government securities were in the Available-for-Sales (AFS) and Held-for-Trade (HFT) categories, with average durations of 2.4 months and 1.1 months, respectively. Banks also showed interest in fixed-rate instruments like PIBs and Fixed Rental Rate Sukuk, possibly indicating their views on the tightening cycle.

The increased holding of government securities helped maintain a strong liquidity profile for the banking sector in CY23. The sector also met Basel-III standards for Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), ensuring compliance with liquidity requirements.

D) Profitability

In CY23, the banking sector's after-tax profit soared to Rs 642.2 billion, with key indicators showing improvement over CY22. The after-tax Return on Assets (ROA) increased to 1.6% (YE'22: 1.0%), and the after-tax Return on Equity (ROE) rose to 27.1% (YE'22: 16.9%). While fee-based and foreign exchange incomes grew, the primary driver of profit growth was Net Interest Income (NII), as tighter monetary policy led to faster growth in interest income compared to expenses. Rate-volume analysis indicated that the rate component significantly impacted earnings and expenses on advances, investments, and deposits. Borrowing costs increased due to higher volumes.

Non-interest expenses grew by 32.5%, aligning with higher administrative costs in a high inflation environment and branch network expansion. Although taxation expenses remained high, income tax as a percentage of profit before tax slightly decreased to 50.1% from 52.1% in CY22.

PKR Billion	2021	2022	2023
Profit Before Tax	451	703	1,287
Profit After Tax	264	336	642
Equity	1,942	2,086	2,787
ROA	1.0%	1.0%	1.6%
ROE	14.1%	16.9%	27.1%

Table 3: Financial Soundness Indicators and Quarterly Compendium of the Banking System

E) Capitalization

By YE'23, the banking sector's solvency improved, with the Capital Adequacy Ratio (CAR) rising to 19.7% from 17.0% in YE'22. This increase was due to higher regulatory capital growth outpacing the growth in total Risk-Weighted Assets (RWA). Higher profits allowed banks to retain earnings, boosting Tier-I Capital, while Tier-II capital grew due to revaluation gains on AFS securities. Limited growth in overall advances kept the increase in Credit RWA, which make up 73% of Total RWA, in check, positively impacting solvency.

In recent years, banks' exposure to government securities, which require no capital charge for credit risk and low capital charge for market risk, has grown. To prevent excessive leverage, banks must maintain a minimum leverage ratio of 3.0% per Basel standards. Although the leverage ratio has decreased from 4.8% YE'18 to 4.1% YE'23, it remains above the minimum requirement.

SIZE-WISE CLASSIFICATION OF BANKS

VIS banking sector review covers 25 commercial banks operating in Pakistan, including 5 public sector banks and 20 private sector banks. Size-wise classification of these banks, in terms of domestic deposits, is provided below[7].

LARGE BANKS (DOMESTIC DEPOSITS MARKET SHARE > 5.5%)

Ranked based on Market Share Deposit Dec'23		Market Share Deposit				Market Share Advances				Capital Adequacy Ratio		Net NPLs to Tier 1 Equity		Return on Average Asset		Liquidity Coverage Ratio	
Bank	Rating (CRA)	Dec'22	Rank	Dec'23	Rank	Dec'22	Rank	Dec'23	Rank	Dec'23	Rank	Dec'23	Rank	Dec'23	Rank	Dec'23	Rank
Habib Bank Limited	AAA/A-1+ (VIS)	14.4%	1	13.9%	1	14.3%	1	14.3%	1	17.3%	5	5.1%	4	1.2%	7	64.7%	6
National Bank of Pakistan	AAA/A-1+ (VIS & PACRA)	11.9%	2	13.2%	2	12.1%	2	13.2%	2	25.5%	2	5.5%	5	0.9%	8	73.4%	3
United Bank Limited	AAA/A-1+ (VIS)	8.2%	3	8.4%	3	8.5%	4	5.8%	7	16.6%	7	12.6%	8	1.3%	6	81.8%	1
Meezan Bank Limited	AAA/A-1+ (VIS)	7.4%	4	8.0%	4	8.5%	3	8.0%	3	22.4%	3	0.4%	1	3.0%	1	68.0%	5
Bank Alfalah	AAA/A-1+ (PACRA)	6.6%	7	7.4%	5	6.4%	8	6.5%	5	16.7%	6	3.9%	3	1.3%	5	71.0%	4
Bank Al Habib	AAA/A-1+ (PACRA)	7.0%	5	6.9%	6	7.0%	6	7.3%	4	15.8%	8	5.7%	6	1.4%	4	62.7%	7
MCB Bank Limited	AAA/A-1+ (PACRA)	6.1%	8	6.5%	7	6.7%	7	5.0%	8	20.4%	4	6.2%	7	2.6%	2	74.0%	2
Allied Bank Limited	AAA/A-1+ (PACRA)	6.8%	6	6.0%	8	7.2%	5	6.4%	6	26.2%	1	0.5%	2	1.8%	3	58.3%	8

MEDIUM BANKS (DOMESTIC DEPOSITS MARKET SHARE 2.5-5.5%)

Ranked based on Market Share Deposit Dec'23		Market Share Deposit				Market Share Advances				Capital Adequacy Ratio		Net NPLs to Tier 1 Equity		Return on Average Asset		Liquidity Coverage Ratio	
Bank	Rating (CRA)	Dec'22	Rank	Dec'23	Rank	Dec'22	Rank	Dec'23	Rank	Dec'23	Rank	Dec'23	Rank	Dec'23	Rank	Dec'23	Rank
Bank of Punjab	AA+/A1+ (PACRA)	5.5%	1	5.5%	1	5.3%	1	6.9%	1	18.4%	2	9.7%	5	0.6%	5	48.0%	5
Askari Bank Limited	AA+/A1+ (PACRA)	5.1%	2	4.6%	2	5.2%	2	5.4%	2	18.4%	3	3.6%	3	1.2%	4	55.8%	3
Faysal Bank Limited	AA/A-1+ (VIS & PACRA)	3.5%	4	3.7%	3	4.0%	3	4.9%	3	17.5%	5	5.3%	4	1.6%	3	53.0%	4
Habib Metropolitan Bank L	AA+/A1+ (PACRA)	3.9%	3	3.6%	4	3.8%	4	3.6%	4	18.3%	4	0.6%	1	1.7%	2	73.7%	2
Standard Chartered Bank	AAA/A-1+ (PACRA)	3.2%	5	2.6%	5	2.0%	5	1.9%	5	20.1%	1	1.8%	2	4.4%	1	92.7%	1

[7] *Excluding Silk Bank and First Women Bank Limited due to unavailability of financials.*

SMALL BANKS (DOMESTIC DEPOSITS MARKET SHARE <2.5%)

Alphabetical order		Market Share Deposit				Market Share Advances				Capital Adequacy Ratio		Net NPLs to Tier 1 Equity		Return on Average Asset		Liquidity Coverage Ratio	
Bank	Rating (CRA)	Dec'22	Rank	Dec'23	Rank	Dec'22	Rank	Dec'23	Rank	Dec'23	Rank	Dec'23	Rank	Dec'23	Rank	Dec'23	Rank
Bank Islami Limited	AA-/A-1 (PACRA)	1.9%	2	1.9%	1	1.8%	3	2.3%	1	23.8%	1	9.6%	5	1.9%	2	56.9%	6
Soneri Bank Limited	AA-/A-1+ (PACRA)	1.8%	3	1.9%	2	1.8%	4	1.7%	3	18.4%	5	6.9%	4	1.0%	5	56.2%	7
JS Bank Limited	AA/A-1+ (PACRA)	2.1%	1	1.7%	3	2.0%	2	1.7%	4	12.5%	9	32.4%	8	0.7%	7	59.3%	5
Dubai Islamic Bank	AA/A-1+ (VIS)	1.5%	4	1.2%	4	2.2%	1	2.1%	2	18.0%	7	1.2%	1	1.5%	3	42.6%	9
Bank Of Khyber	A+/A-1 (VIS & PACRA)	1.1%	5	1.0%	5	1.1%	5	0.9%	5	18.3%	6	26.6%	7	1.0%	6	70.0%	3
Sindh Bank	AA-/A-1+ (VIS)	1.0%	6	0.8%	6	0.6%	9	0.6%	9	16.2%	8	79.0%	9	0.7%	9	81.6%	1
Albaraka Bank Limited	A+/A-1 (VIS)	0.8%	7	0.7%	7	0.8%	6	0.7%	6	19.3%	4	13.1%	6	1.3%	4	70.3%	2
MCB Islamic Bank Limited	A+/A-1 (PACRA)	0.7%	8	0.7%	8	0.8%	7	0.7%	7	23.8%	1	5.7%	2	8.8%	1	68.0%	4
Bank Makramah Limited	NA	0.5%	9	0.6%	9	0.5%	10	0.4%	10	-	-	-	-	-	-	-	-
Samba Bank Limited	AA/A-1 (PACRA)	0.5%	10	0.4%	10	0.7%	8	0.7%	8	21.3%	3	6.1%	3	0.7%	8	53.0%	8

RECENT DEVELOPMENTS

The Pakistani banking sector is undergoing significant transformations to meet international standards and promote sustainable practices. Regarding financial reporting, the implementation of International Financial Reporting Standard 9 (IFRS-9) has seen recent adjustments. While initially planned for all companies by 2019, mandatory application for banks was deferred to January 2022. Recognizing the complexity, the SBP granted a further extension for larger banks and Development Finance Institutions (DFIs). Recognizing the complexity, the SBP has granted further extension for Financial Institutions (FIs) to 31 December 2024.

In a separate but equally crucial development, the banking sector is embracing Environmental, Social, and Governance (ESG) initiatives. The SBP's Green Banking Guidelines issued in 2017 provide a framework for banks to assess environmental risks in lending. Furthermore, collaboration with the International Finance Corporation (IFC) on the Pakistan Sustainable Banking Project bolsters banks' Environmental and Social Risk Management (ESRM) practices. Capacity building efforts like the NIBAF ESRM Training of Trainers Project create a pool of local ESG experts to support banks in long-term integration. The issuance of Green Bonds, adhering to the Securities and Exchange Commission of Pakistan's (SECP) Green Bond Guidelines (2021), allows for financing environmentally friendly projects. These initiatives highlight a commitment towards sustainable banking within the Pakistani financial landscape.

SECTOR OUTLOOK

OVERALL ASSESSMENT/OUTLOOK: STABLE

Looking ahead, the banking sector is poised to navigate a landscape filled with both opportunities and challenges. The sector’s continued focus on investments, particularly in government securities, reflects structural imbalances in the economy, such as large fiscal deficits. This trend is likely to persist as the government relies on domestic resources for financing needs. However, this heavy investment focus also means that banks must manage the associated risks effectively.

Credit demand is expected to remain subdued in the short term due to ongoing economic challenges. The weak economic activity and tight macro-financial conditions have dampened the growth in the loan portfolio. Despite this, certain sectors like sugar, chemicals, pharmaceuticals, automobiles, and textiles showed increased borrowing activity, indicating potential areas of growth.

Operational risks are on the rise with the expansion of banking services and digitization. Effective risk management and regulatory oversight will be essential to mitigate these risks and ensure the sector's stability. The sector's profitability is expected to remain strong, supported by higher net interest/markup income. However, non-interest expenses are likely to rise due to inflation and branch network expansion.

Overall, the banking sector is well-positioned to navigate future challenges with a strong foundation. The Capital Adequacy Ratio (CAR) remains well above regulatory requirements, and the sector's liquidity profile is comfortable. By effectively managing investments, credit demand, and operational risks, the sector can sustain its stability and growth in the coming years.

RESEARCH & PUBLICATIONS

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