SECTOR UPDATE

Banking Industry

January, 2020

The banking industry in Pakistan constitutes 20 private and 5 public sector commercial banks. Industry classification is done on the basis of market share in domestic deposits. Banks have been classified into 3 categories: **Large Banks** (market share > than 6%), **Medium Banks** (market share ranging between 3-6%) and **Small Banks** (market share < than 3%).

Table 1: Industry Classification (Based on Deposit Market Share, as of Dec'18)

LARGE BANKS	MEDIUM BANKS	SMALL BANKS
National Bank of Pakistan (14.3%)	Bank AL Habib Limited (6.0%)	JS Bank (2.4%)
Habib Bank Limited (14.1%)	Meezan Bank Limited (5.9%)	Soneri Bank Limited (2.0%)
United Bank Limited (8.3%)	Bank Alfalah Limited (5.1%)	BankIslami Pakistan Limited (1.4%)
MCB Bank Limited (7.9%)	The Bank of Punjab (4.5%)	Dubai Islamic Bank Pakistan Ltd (1.4%)
Allied Bank Limited (7.4%)	Askari Bank Limited (4.3%)	The Bank of Khyber (1.3%)
	Habib Metropolitan Bank Limited (4.1%)	Silk Bank Limited (1.0%)
	Standard Chartered Bank (Pakistan) Limited (3.2%)	Sindh Bank Ltd (0.9%)
	Faysal Bank Limited (3.1%)	AlBaraka Bank (Pakistan) Limited (0.7%)
		MCB Islamic Bank (0.5%)
		Samba Bank Limited (0.5%)

**Market share of 23 banks is mentioned in the table. The remaining 2 banks not mentioned include Summit Bank Limited and First Women Bank Limited, which have been excluded given lack of data publicly available.*

… Industry Brief

The Pakistani banking industry continues to be characterized by its reliance on the Government of Pakistan (GoP) for lending operations and profitability. In turn, GoP remains reliant on borrowing from commercial banks, to meet fiscal shortfalls. This relationship is particularly captured by the fact that sovereign debt issuances constitute roughly a third of the sector's asset base, with the ratio increasing to 40%, if public sector advances are taken into account. As a result, domestic credit to private sector, in Pakistan, remains one of the lowest in comparison to regional counterparts.

During the period 2018 & 9M'19, the industry growth has moderated vis-à-vis a double digit growth posted during the period 2014-2016. The industry growth is mainly a function of deposit growth, which has remained subdued during 2018-9M'19 period (9M'2019: 4.8%; 2018: 9.5%; CAGR 2015-2017: 12.1%). The trend can be attributed to the Government's tax documentation drive and the general macroeconomic slowdown.

The sector concentration has generally reduced during Dec'16-Dec'18, with Medium & Large Banks gaining market share, to the tune of 1.6% and 1.2% respectively, while Small Banks have collectively lost market share. Concentration in terms of profitability persists, with Small Banks contributing mere 4% of the industry profitability, despite holding deposit market share of 13.2%. During the 2-year period 2016-18, Medium Banks have done exceptionally well in terms of profitability, with the same contributing 42% of the industry profits vis-à-vis 24%; this trend can partly be attributed to adverse profitability trends in Large Banks on account of overseas losses.

Aggregate profitability of the industry, having peaked during the 3-year period 2015-2017, has trended down subsequently. In the most recent period (9M'2019), the sector's RoAA (before tax) slightly improved to 1.5% vis-à-vis 1.4% reported in 2018.

Amidst the prevailing economic slowdown, rising inflation and high interest rate situation, the overall credit risk in the economy is considered heightened. Accordingly, Non-performing Loans, which had remained range bound, grew by 15% in 2018 and 12% in 9M'2018. Nevertheless, given commensurate growth in portfolio, the uptick in infection has been relatively measured (Sep'19: 8.8%; Dec'18: 8.0%; Dec'17: 8.4%).

Industry liquidity & capitalization remains strong, given the sizable holding of liquid assets (sovereign securities) providing adequate coverage to deposits, and CAR & Tier I CAR of 16.7% and 13.8% respectively as of Sep'19.

Going forward, given our expectation of uptick in NPLs, portfolio infection is expected to reach double digits. On the deposits front, we expect the rate of growth in deposits to increase. Even though issues on the macroeconomic front, such as the slowing economy and prevailing tax documentation drive, will persist in the medium term, our positive outlook mainly derives impetus from the prevailing low level of financial inclusion in the country, which depicts significant growth opportunities for the banking industry, as and when financial inclusion picks pace. The profitability is generally expected to increase on the back of better spreads, as the full impact of interest rate increase materializes, albeit risks to profitability remain in terms of potential hits from credit impairment.

ECONOMIC OVERVIEW

Having posted strong economic growth during the five-year period (FY14-18), averaging 4.7%, the country's economy has subsequently been undergoing a slowdown. GDP growth projections for the medium term remain dismal at less than 4%; albeit we do expect normalization towards the long term growth rate of 5%.

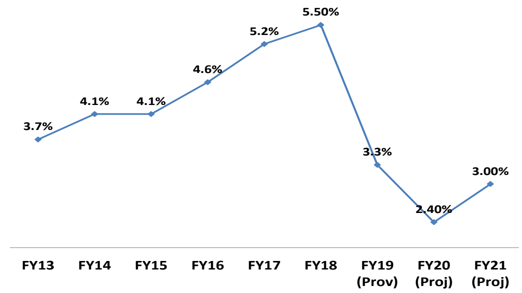


Figure 1: GDP Growth - Pakistan

Coming out of a major external account crises, as the one witnessed in FY18, and a burgeoning fiscal imbalance, the GoP has had to take necessary structural adjustments, which have somewhat contained the external pressures. These adjustments include tightening of both fiscal and monetary policies to slow domestic demand and control inflation and restore macroeconomic stability. In this regard, the State Bank of Pakistan (SBP) has raised the interest rates by 750bps since Jan'18, making interest rates in Pakistan the highest in the region. In addition, the domestic currency (PKR) has been significantly devalued relative to the green back. Prior to the new government taking charge, the PKR was already trading lower by 10% by end-H1'CY2018. Since then, the PKR has experienced another 29% depreciation by Sep'19 (USD/PKR Dec'17: 110.4; Jun'18: 121.5; Sep'19: 156.4). The significant devaluation of the PKR in combination with one of the highest interest rates in the region have translated in making Pakistani sovereign issuances, a popular investment avenue for foreign fixed income funds. Subscriptions from these funds have translated in inflow of foreign currency in excess of USD 1b so far. The SBP is eyeing for these inflows, which are termed as 'hot money' inflows, to surge to USD 3b by end-FY20.

Pakistan's primary economic concern remains its consumption & import driven growth model, wherein the country has gone through a number of consumption-led booms, which are followed by short-term crises and IMF-administered bailout programs. While the country's exports have remained relatively stagnant, the prior government's policy of supporting PKR resulted in emergence of significant external account imbalances, which grew to crisis level by FY18. With the tax base depicting significant import dependency – given that import tariffs formed a major chunk (44.6%) of tax collections – the measures undertaken for general demand compression (and hence import compression), have translated in challenges on the fiscal front.

… Current Account Deficit

Table 2: FX Reserves & Current Account Deficit

	FY13	FY14	FY15	FY16	FY17	FY18	FY19 (Prov)	FY20 (Proj)	FY21 (Proj)
FX Reserves (as of fiscal year-end) (in USD' Millions)	6,008	9,098	13,526	18,143	16,145	9,765	7,280	11,231	NA
Current Account Deficit (in USD' Millions)	(2,496)	(3,130)	(2,795)	(4,867)	(12,621)	(19,897)	(13,830)	(6,621)	(5,933)
Current Account Deficit (% of GDP)	1.10%	1.30%	1.00%	1.70%	4.10%	6.30%	4.90%	2.40%	2.00%

Source: IMF Program Forecast

Pakistan has, from time to time, depicted vulnerability on the external front as a result of which it continues to pursue financial support from IMF, with the latest USD 6.6b Extended Fund Facility being the 13th in the series of facilities sought from IMF. In addition to this, the country has also sought financial support from close allies, such as the Kingdom of Saudi Arabia (KSA) and China. Even though Pakistan has consistently remained in an external deficit, the country has experienced 2 periods of drastic deficits, with the former being during the 2007-2010 global financial crises and the latter, i.e. the most recent one, occurring in FY18, when external deficit reached an absolute high of USD 20b. The GoP responded by undertaking major adjustments in the exchange rate parity. The currency devaluation, along a number of protectionist measures undertaken by the GoP, translated in a relatively milder deficit of USD 13.5b in FY19. So far, during the 4-month period, Jul-Oct'19, the country's deficit was reported at USD 1.5b vis-à-vis 5.6b during SPLY.

Table 3: Current Account Composition (Figures in USD' Billions)

	FY13	FY14	FY15	FY16	FY17	FY18	FY19 (Prov)	Jul-Oct'18	Jul-Oct'19
Exports	24.8	25.1	24.1	22.0	22.0	24.8	24.3	8.0	8.2
Imports	40.2	41.7	41.4	41.3	48.7	56.6	52.8	19.0	14.7
Remittances	13.9	15.8	18.7	19.9	19.4	19.9	21.8	7.6	7.5

As illustrated in the table above, the shrinkage observed in the current account deficit so far, has mainly resulted from import compression, while export performance has broadly remained stagnant. Going forward, we do expect exports to improve, on the back of favorable exchange rate parity. Overall, we expect GoP to meet the external account targets agreed with IMF.

… Fiscal Account Deficit

Table 4: Fiscal Account

All Figures in PKR' Billions unless stated otherwise	FY17	FY18	FY19	FY20(P)	FY21(P)	FY22(P)	FY23(P)	FY24(P)
Revenue	**4,962**	**5,265**	**4,934**	**7,246**	**9,012**	**10,720**	**12,198**	**13,442**
- Tax Revenue	3,969	4,467	4,473	6,328	7,984	9,579	10,949	12,080
- Non-Tax Revenue	967	761	427	838	947	1,059	1,170	1,291
- Grants	25	37	33	81	80	82	78	71
Expenditure	**6,801**	**7,488**	**8,380**	**10,419**	**11,625**	**12,791**	**13,810**	**15,048**
- Federal	3,588	3,918	4,946	6,262	6,822	7,301	7,743	8,354
- Provisional	1,726	2,065	2,328	2,673	3,024	3,379	3,735	4,120
- Development Expenditure & net lending (incl. PSDP)	1,487	1,506	1,049	1,484	1,779	2,111	2,333	2,574
Fiscal Deficit	(1,839)	(2,223)	(3,412)	(3,173)	(2,613)	(2,071)	(1,612)	(1,606)
Fiscal Deficit (as a % of GDP)	5.8%	6.5%	8.9%	7.6%	5.5%	4.0%	2.8%	2.6%
- External Sources	30%	35%	12%	57%	39%	32%	39%	5%
- Banks	49%	49%	65%	30%	43%	48%	43%	66%
- Non-Banks	21%	16%	22%	13%	18%	21%	18%	28%

On the fiscal front, the issues have mounted, with fiscal deficit as a % of GDP having closed in at 8.9% for FY19 vis-à-vis target of 7.0%. The above figure presents targeted reduction in fiscal deficit over the next 5-year period, as agreed with IMF. As reflected at the end of the table, commercial banks will continue to be a major source of deficit financing.

Fiscal performance in the ongoing year has been positive, with fiscal deficit standing at 0.6% of GDP in Q1'FY20, about 1% better than IMF target. The provisional drop in fiscal deficit is largely attributable to the growth in non-tax revenues, which primarily emanated from the higher central bank earnings.

The country continues to be faced by a myriad of fiscal challenges, including a narrow tax base, a problematic energy sector (requiring subsidies and interest payments on burgeoning circular debt issue), loss-making State-Owned Enterprises (SOEs) and limited institutional capacity at provincial level to raise taxes. Dependence on federal transfers has been sizeable, with allocation of federal taxes to provincial budgets averaging ~45%, while debt servicing, defense spending and subsidies given have taken up on average 34%, 20% and 16% of the federal revenues respectively. This leaves limited surplus for development and social spending.

IMF has set a target for the GoP to achieve growth of 37.0% in its overall revenue, which is considered ambitious. So far in Q1'FY20, tax revenues generated were higher by 17%, while non-tax revenues almost tripled. Achieving IMF program fiscal targets for FY20, is considered a challenging task for the authorities.

… Significant sovereign dependency on the Banking sector crowds out the private sector

The consistent fiscal deficits have translated in significant sovereign dependency on the banking sector for financing, thus crowding out the private sector; this is particularly evident from the ratio of domestic credit to private sector (as a % of GDP), being the lowest among regional counterparts. Even though, the domestic credit to private sector has depicted stints of uptick in 70s, 80s and latter part of 2000s, the rise has always been arrested by the strong public sector appetite for funding. Given the envisaged fiscal deficits, and Rs. 1t per annum borrowing planned from the banking sector over the next 5-year period, the aforementioned phenomenon is likely to persist.

Figure 2: Domestic Credit to Private Sector (%of GDP) - Source: World Bank

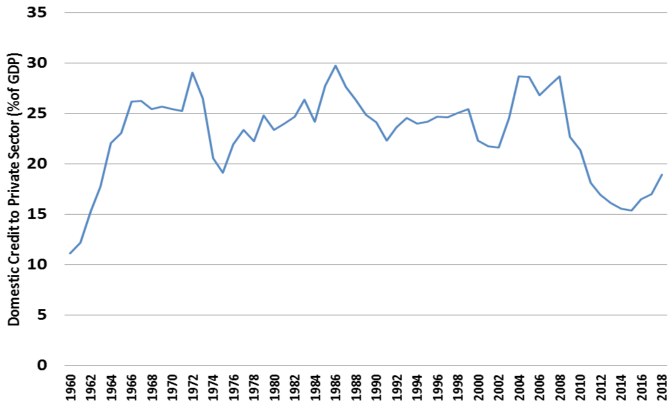
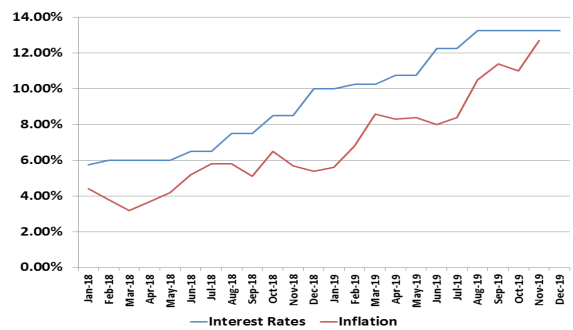


Table 5: Domestic Credit to Private Sector (of GDP) – Comparison with regional counterparts

Pakistan	19%	2018
India	50%	2018
Sri Lanka	45%	2016
Bangladesh	47%	2018
Iran	66%	2016
Nepal	88%	2018

… Interest Rate Expectations

Figure 3: Interest rate & Inflation



In view of the rising inflation forecasts, SBP has been tightening the monetary policy, which has accumulated into a 750bps uptick in interest rate over a 2-year period. As illustrated in the figure 4, the real interest rate has remained positive, albeit it was the highest during the period Dec'18-Feb'19, subsequent to which the inflation caught up with the interest rates. The YoY inflation was reported at 12.7% for Nov'19. The MoM inflation, having peaked in Nov'19, is likely to recede in the coming months. Given an expectation of drop in inflation, a potential interest rate cut cannot be ruled out. However, the timing of the cut will depend on policy objectives of the central bank, which, at present, is focused on attracting domestic bond placements from international funds. On the contrary, the central bank has made it clear that the interest rates will follow the projected inflation, which is pointing towards a drop. All in all, the policy rate is likely to remain unchanged over the near term (Mar'20), while a 50 -100 bpts can be expected over the medium term (Jun'20).

BANKING SECTOR

...Slowdown in Banking Sector Growth

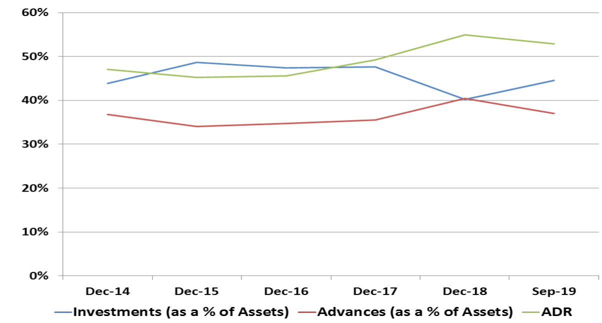
Banking sector growth has slowed down during the period 2018 & 9M'19, mainly precipitated by a slowdown in deposit growth; the latter is attributed to the Government's tax documentation drive and the general macroeconomic slowdown.

The sector's asset mix has posted contrary trend in 9M'2019 vis-à-vis 2018. In 2018, the proportionate exposure to advances was increasing and accordingly the investment portfolio exposure was dropping. The trend reversed in 9M'2019, which also resulted in a drop in sector ADR from its peak of 55% as of Dec'18 to 52.9% as of Sep'19. Given sizable fiscal deficit funding requirements, averaging Rs. 1tr over a 5-year period, we expect investments (as a % of assets) to be maintained or even increase. On the other hand, growth in advances is expected to remain range bound.

Table 6: Banking Sector Assets & Deposits (Figures in PKR' Billions, unless stated otherwise)

	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	Sep-19
Assets	12,106	14,143	15,831	18,342	19,682	21,652
Growth		17%	12%	16%	7%	10%
Deposits	9,230	10,389	11,798	13,012	14,254	14,945
Growth		12.6%	13.6%	10.3%	9.5%	4.8%

Figure 4: Asset Mix



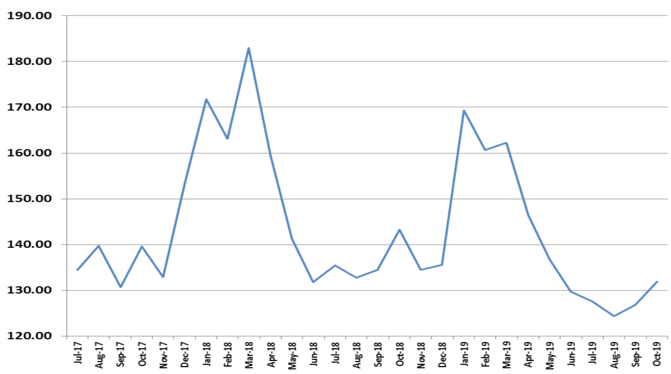
In view of the depressed economic growth momentum in combination with a high interest rate environment, credit off take has been impacted, which was more pronounced in 9M'19, as illustrated in table 7. It is pertinent to mention that, credit growth declined to 1%, notwithstanding the expected uptick in financing requirements as a result of the 10-15% depreciation in domestic currency post year-end 2018.

Table 7: Advances Portfolio Growth

	Dec-14	Dec-15	Dec-16	Dec-17	Dec-18	Sep-19
Advances	4,930	5,330	6,013	7,029	8,525	8,624
Growth	7.7%	8.1%	12.8%	16.9%	21.3%	1.2%
-Private Sector	3,623	3,887	4,403	4,988	6,003	6,001
Growth	8.4%	7.0%	13.3%	13.3%	20.4%	0.0%
-PSEs	620	666	835	1,074	1,398	1,596
Growth	21.9%	7.4%	25.4%	28.6%	30.2%	14.2%

Lending to manufacturing sector, which forms a major part (61%) of private sector lending only grew by 1.8% during 9M'19. The slow pace of growth in credit to manufacturing sector, amidst a high inflation environment, is mainly attributable to the declining industrial activity, as also reflected by the trend in Large-Scale Manufacturing (LSM) index.

Figure 5: Large-Scale Manufacturing (LSM) Index Trend

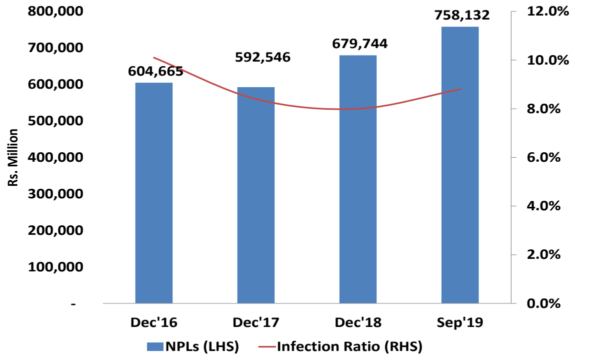


Given the availability of sovereign securities - offering risk-free debt at attractive rates - , slow macroeconomic growth projections, and a heightened credit risk environment, we expect credit off take to remain depressed in the short term, while some recovery can be expected post-2020.

…Heightened credit risk environment to test asset quality

The combination of economic slowdown, currency depreciation induced high (double-digit) inflation and high interest rate environment, the domestic credit risk environment is considered heightened. The currency depreciation has negatively impacted several businesses with import dependencies, which include automobile manufacturers & auto-part makers, cement producers, oil marketing companies, chemical companies and steel producers among others. Conversely, export-based sectors, such as textile, have benefitted.

Figure 6: NPLs & Infection



So far, NPLs, which had remained relatively stationary during the period 2014-2017, grew by 15% in 2018 and 12% in 9M'19. About three-quarters of the uptick in NPLs can be attributed to the corporate portfolio, which is the mainstay of the lending operations, constituting 71% of the portfolio. Nevertheless, portfolio infection has remained range-bound. Besides corporate lending, Agriculture and SME segments were also notable contributors.

Table 8: Segment-wise Breakup of Portfolio

	% of Portfolio *	Impairment		
		Dec'17	Dec'18	Sep'19
Corporate	71%	8.8%	8.1%	9.0%
Commodity	10%	0.8%	0.6%	0.9%
Consumer	7%	6.2%	5.0%	4.8%
SME	5%	16.9%	14.9%	18.0%
Agriculture	4%	12.1%	16.9%	20.9%
Others	4%	7.4%	10.1%	8.7%
Total	-	8.4%	8.0%	8.8%

*As of Sep'19

In terms of sector-wise exposures, the credit portfolio depicts some concentration towards the energy and textile segment. Even though the textile segment has high infection ratio, the sectors NPLs have been falling in 2018 and 9M'2019. In turn, the major contributors to the increasing NPLs were the Energy, Agri business, sugar and consumer finance segments, as also illustrated in table 9.

Table 10: Sector-wise Breakup of Portfolio

As of Sep'19	% of Portfolio *	Impairment
Production/Transmission of Energy	17.0%	3.9%
Textile	12.5%	16.7%
Individuals	8.8%	8.3%
Agribusiness	8.1%	10.4%
Chemical & Pharmaceuticals	3.3%	5.6%
Sugar	2.6%	23.1%
Financial	2.8%	4.5%
Cement	2.1%	2.4%
Automobile/Transportation	2.0%	10.1%
Electronics	1.4%	16.9%
Shoes & Leather garments	0.4%	16.0%
Insurance	0.1%	0.1%
Miscellaneous	39.0%	7.7%

Table 9: Sector Contribution to Growth in NPL - Periodic

	2018	9M'2019
Agribusiness	19%	19%
Production/Transmission of Energy	6%	23%
Sugar	30%	16%
Individuals	9%	1%
Others	36%	41%

- The most significant increase in NPLs was contributed by the Sugar sector, which was on account of a large Group-specific non-performance of a Sindh-based concern. It is pertinent to mention that the non-performance was not on account of any systemic issue in the sector.
- The sizable contribution from agribusiness segment pertains to agricultural loans given to farmers. The non-performance in this regard is attributable to adverse weather patterns, which have affected agricultural yield.
- The notable contribution from the Energy segment is mainly attributable to non-performance of electricity distribution companies, owing to high loss ratios in the segment, in addition to liquidity challenges.

Table 11: Banking Sector Asset Quality

	Large Banks			Medium Banks			Small Banks		
	Dec'17	Dec'18	Sep'19	Dec'17	Dec'18	Sep'19	Dec'17	Dec'18	Sep'19
Advances as a % of Assets (Median)	31.1%	34.6%	34.5%	39.4%	46.4%	47.5%	47.2%	52.9%	51.7%
Gross Infection (Median)	7.9%	8.8%	9.7%	9.6%	7.2%	6.8%	5.5%	5.8%	4.3%
Net Infection (Median)	0.8%	0.8%	1.0%	0.6%	0.5%	0.9%	1.1%	2.1%	2.1%

- Despite an increasing trend, Large Banks are well-positioned with lower advances to assets ratio vis-à-vis industry. Conversely, Medium & Small Banks remain more exposed to credit risk given higher advances to assets ratio.
- The Small Banks' higher credit risk exposure is also evident from their impairment, which is the highest among other categories.

Table 12: Bank-wise Infection

Large Banks Infection Levels	Dec'18		Sep'19	
	Gross Infection	Net Infection	Gross Infection	Net Infection
National Bank of Pakistan	12.6%	0.8%	13.0%	0.9%
Habib Bank Limited	6.6%	0.8%	6.7%	1.0%
United Bank Limited	8.8%	1.8%	11.4%	2.4%
MCB Bank Limited	9.0%	1.1%	9.7%	2.0%
Allied Bank Limited	3.5%	0.1%	3.5%	0.1%
Medium Banks Infection Levels	**Dec'18**		**Sep'19**	
	Gross Infection	**Net Infection**	**Gross Infection**	**Net Infection**
Bank AL Habib Limited	1.1%	0.2%	1.4%	0.3%
Meezan Bank Limited	1.3%	0.0%	1.7%	0.1%
Bank Alfalah Limited	3.6%	0.6%	4.2%	0.8%
The Bank of Punjab	11.6%	1.5%	12.5%	2.1%
Askari Bank Limited	7.2%	0.4%	7.2%	1.1%
Habib Metropolitan Bank Limited	7.3%	1.0%	6.3%	0.9%
Standard Chartered Bank (Pakistan) Limited	9.3%	0.3%	8.5%	0.7%
Faysal Bank Limited	8.3%	1.2%	9.1%	2.2%
Small Banks Infection Levels	**Dec'18**		**Sep'19**	
	Gross Infection	**Net Infection**	**Gross Infection**	**Net Infection**
JS Bank	3.3%	2.1%	4.2%	2.9%
Soneri Bank Limited	5.8%	1.6%	5.2%	1.5%
BankIslami Pakistan Limited	5.8%	3.8%	5.5%	2.5%
Dubai Islamic Bank Pakistan Ltd	1.9%	0.6%	2.6%	1.1%
The Bank of Khyber	4.7%	0.6%	4.3%	0.9%
Silk Bank Limited	6.4%	2.2%	4.0%	2.1%
Sindh Bank Ltd	31.4%	26.3%	46.2%	36.9%
AlBaraka Bank (Pakistan) Limited	8.8%	3.2%	10.7%	8.9%
MCB Islamic Bank	0.0%	0.0%	0.0%	0.0%
Samba Bank Limited	4.3%	0.3%	4.0%	0.2%
Total	8.0%	1.0%	8.8%	1.4%

- Segment-wise split suggests slight deterioration in asset quality of Large Banks, wherein NBP's portfolio depicts the highest infection followed by UBL and MCB. However, adequate provisioning has kept net infection of Large Banks on the lower side.
- Among the Medium Banks, Bank Al Habib and Meezan Bank stand out with lowest infection ratios across the sector. On the contrary, Bank of Punjab and Faysal Bank have the highest impairment within this segment.
- Within the Small Banks, Sindh Bank and Al Baraka have the highest gross infection level across the segment.
- Barring Small Banks, overall provisioning coverage for the banking sector is considered adequate (>90%).

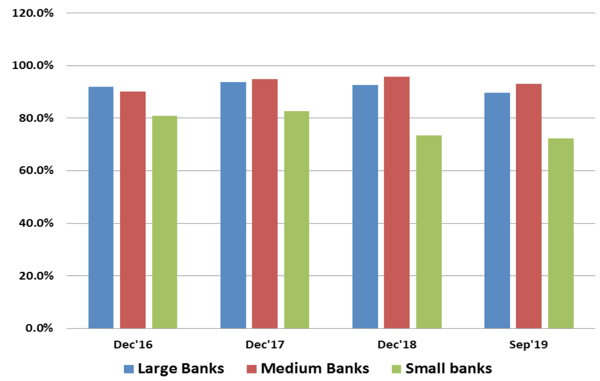


Figure 7: Banking Segment-wise Breakup of Provisioning Coverage

- Within the Medium Banks segment Meezan, SCB and Bank Al Habib stand out for higher provisioning coverage.
- On the contrary, provisioning coverage for Small Banks has trended downwards, mainly precipitated by JS and Sindh Bank.

…Infection Expectations

Going forward, infection in the portfolio may increase further if slowdown in GDP growth continues and interest rates remain elevated for a prolonged period of time. Cyclical sectors and leveraged players are expected to contribute to faster pace of NPL formation. Increase would be more pronounced for banks where ADR is on the higher side and where exposure to Commercial and SME segment is sizeable. Banks that have pursued a strategy of lending to top-tier clients and blue chip clients are expected to continue to maintain superior asset quality indicators. Some of the issues that may translate in an uptick in impairment for the sector are as follows:

- While overall business risk profile of the power sector is considered manageable (given take or pay contracts and guaranteed returns), liquidity risk for the sector continues to remain elevated given sizeable stock of outstanding circular debt and increasing capacity payments in the backdrop of weak fiscal position of the government.
- Sector dynamics for cyclical sectors (cement, automobile and long & flat steel) have weakened due to slowdown in demand and sizeable capacities that have come online or are expected to come online. Moreover, increase in borrowings due to debt taken for expansion and increasing working capital requirements (due to increase in capacities and rupee devaluation) along with high interest rates are expected to stretch cash flows for most players. For automobile sector, entry of new players remains a concern and is expected to result in competitive landscape over the medium term.
- Sectors that have high leverage and low margins (sugar, edible oil) will also pose a risk to higher NPLs during the period.

Given continued increase in NPLs and limited growth in financing portfolio, gross infection in the portfolio may reach double digits by Dec'20 but is expected to remain well below the historical peak of 15.7% as at end-2011.

…Liquidity generation has been sound while higher mix of advances has slightly constrained its maintenance

- In terms of deposit composition, Large Banks lead the market with the highest ratio of Current & Saving Accounts (CASA) as well as (non-remunerative) Current Accounts (CA)
- In addition, Large Banks lead in retail deposit segment, as evident from the ratio of individual deposits to total deposits being much higher for Large Banks. While adding to the granularity of the deposit base, individual deposits are usually considered sticky.
- In bank-specific terms, Meezan Bank, MCB, Bank Al Habib and Sindh Bank lead the market, with individual deposits constituting more than 60% of their deposit base.
- Large banks have an advantage over segments, given that these banks form a major portion (~55%) of the aggregate branches in the industry.
- Large Banks are also well-positioned, in terms of liquidity as evident from their Liquid Assets to Deposits Ratio.
- With sovereign securities being a popular investment avenue among banks, liquidity position of the overall industry is considered sound, which is particularly evident from the fact that LCR for all banks in the industry (except Silk Bank) is in excess of 100%.

Table 13: Liquidity Indicators & Banking Segment-wise Medians (Dec'18)

	Large Banks	Medium Banks	Small Banks
CASA (Customer Deposits)	74.4%	71.5%	54.3%
CA (Customer Deposits)	35.3%	33.5%	25.0%
Individual Deposits	55.6%	44.4%	38.8%
Gross ADR	51.9%	62.9%	74.6%
Liquid Assets to Deposits & Borrowings	60.6%	47.3%	31.8%

Table 14: LCR & NSFR – Banking Segment-wise Median

LCR			
	Dec'17	Dec'18	Sep'19
Large Banks	170.0%	172.9%	170.2%
Medium Banks	198.1%	168.5%	182.0%
Small Banks	139.0%	116.5%	146.5%
NSFR			
	Dec'17	Dec'18	Sep'19
Large Banks	158.3%	141.1%	145.0%
Medium Banks	177.2%	139.9%	146.5%
Small Banks	112.7%	122.1%	114.4%

... Rapid branch expansion has driven Medium Banks profitability while overseas losses have restricted growth in profitability for Large Banks

- Banking sector profitability, after peaking in 2015, continued to decline for the third consecutive year in 2018 owing to pressure on spreads (maturity of PIBs), one-off expenses & settlement payments and regulatory actions (transaction tax on deposits, super tax and deposit insurance).
- Recent spread improvement has largely translated into significant improvement in efficiency ratio for the overall banking sector, which stands at 56.4% for 9M'19 (2018: 59.4%; Dec'17: 57.1%).
- Medium Banks have outperformed the overall industry with respect to return metrics reflected by significant improvement in efficiency, ROAA and ROAE. Better efficiency has mainly been driven by Bank Alfalah (2018: 59.0%; 2017: 66.9%), Meezan Bank (2018: 54.6%; 2017: 60.7%) and Standard Chartered (2018: 47.4%; 2017: 54.8%).
- Better profitability of Medium Banks has been a product of fast branch expansion in the segment and relatively quicker spread improvement (VIS rated companies).Within the Small Banks, Sindh Bank and Al Baraka have the highest gross infection level across the segment.
- On the contrary, weakening in Large Banks profitability has largely been a function of higher credit and compliance related costs pertaining to its overseas operations. This is reflected by the fact that overseas provisioning costs for the top 3 banks clubbed have grown by 76% since 2016 (2018: Rs. 89.1b; 2017: 59.9b; 2016: Rs.50.7b). It is also pertinent to mention that HBL and UBL have booked sizeable losses from its overseas operations in 2018, to the tune of Rs. 12.7b and Rs. 8.6b respectively. Therefore amidst challenging overseas operations, HBL and UBL have strategized to consolidate its foreign loan book with domestic operations and exit from certain markets deemed as loss-making.

Table 15: Banking Sector Profitability Metrics

	2017	2018	9M'19
RoA (before tax)	1.6%	1.4%	1.5%
RoA (after tax)	0.9%	0.8%	0.9%
RoE (before tax)	20.4%	18.5%	21.8%
RoE (after tax)	12.0%	11.5%	12.3%
Net Interest Income/Gross Income	72.3%	75.4%	79.6%
Cost to Income Ratio	57.1%	59.4%	56.4%
Trading Income to Gross Income	5.9%	2.0%	-0.4%
Personnel Expenses to Non-Interest Expenses	44.3%	42.7%	41.4%

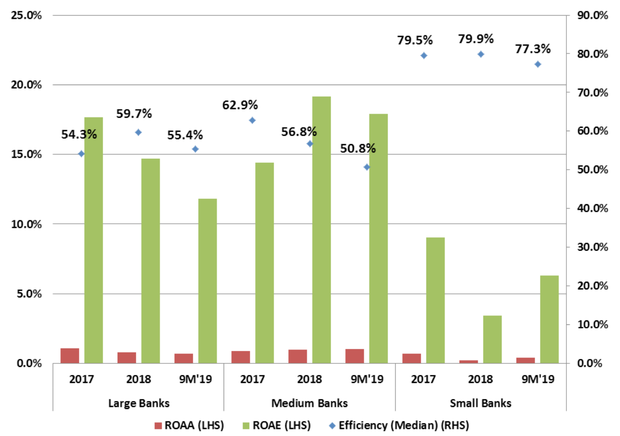


Figure 8: Segment Wise Profitability Metrics

Table 16: Overseas Performance NBP vs. HBL vs. UBL

	NBP			HBL			UBL		
Rs. in m	**2016**	**2017**	**2018**	**2016**	**2017**	**2018**	**2016**	**2017**	**2018**
Profit before tax	1,231	707	1,483	891	(1,424)	(12,652)	5,650	(338)	(8,615)
Total Assets	117,019	124,805	165,654	319,613	217,329	258,288	403,456	324,913	335,504
Overseas NPLs	30,846	31,747	39,182	16,182	16,782	22,962	12,054	24,054	40,642
Overseas Provisioning	29,499	30,809	38,329	13,152	15,177	20,735	8,086	13,884	30,055

…Sector earnings set to increase amidst tight monetary policy

- Going forward, we expect profitability to improve considerably over the next 18 months as full impact of increase in interest rate on spreads materializes with a lag given faster re-pricing of liabilities vis-à-vis assets. This lagged & directly proportional relationship between spread and interest rate is illustrated in Figure 9.
- Aggressive participation is expected in long-tenor bonds in overview of the inflation outlook.
- Over the medium term, balance sheet growth along with improvement in spreads, is expected to off-set higher credit cost, and translate into healthy growth in profitability.
- Extent of improvement in profitability will depend on timing and quantum of discount rate reversal and impact of implementation of IFRS-9 (expected implementation in 2020).

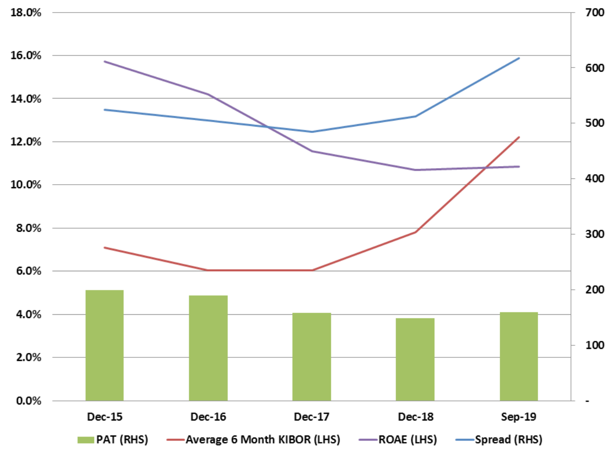


Figure 9: Banking Sector Profitability

- Other key risks to profitability may emerge from implementation of Treasury Single Account (TSA) which may result in liquidity and profitability challenges for banks. The impact may be significant for select public sector and provincial government owned banks. Impact for Large Banks is expected to be manageable given that public sector deposits represent a smaller proportion of overall deposits and cost of funds for government is significantly higher vis-à-vis Bank's average cost of funds.
- In terms of access to low cost deposit base, HBL, UBL and Meezan have enjoyed an advantage over peers largely based on their large branch network. However Alfalah and MCB have also made up ground, wherein the former has one of the best Current Asset proportion while the latter has the best CASA ratio in the sector.

…Capitalization metrics remain strong, and are expected to be supported by positive outlook on profitability

Table 17: Segment-wise Capitalization Metrics Medians

	SBP Benchmarks	Large Banks			Medium Banks			Small Banks		
	Dec'19	**Dec'17**	**Dec'18**	**Sep'19**	**Dec'17**	**Dec'18**	**Sep'19**	**Dec'17**	**Dec'18**	**Sep'19**
Tier-1 CAR	10.0%*	12.1%	13.4%	15.0%	11.0%	12.1%	13.3%	10.5%	11.2%	12.3%
CAR	12.5%*	16.0%	17.7%	18.2%	13.6%	14.0%	15.3%	13.4%	12.3%	13.3%
Net NPLs to Tier-1 Equity	NA	4.7%	5.4%	N/A	4.7%	4.3%	N/A	4.3%	16.5%	N/A
Leverage	3.0%	4.0%	4.6%	4.5%	4.2%	4.3%	4.2%	5.3%	5.2%	4.7%
*CAR requirement for 3 select Domestic Systemically Important Banks (D-SIBs) are higher										

- Industry wide capital ratios have strengthened with a healthy buffer against SBP requirements. As of Sep'19, Tier 1 CAR for the sector stood at 13.8% (Dec'18: 13.0%; Dec'16: 12.5%) while overall CAR was reported at 16.7% (Dec'18: 15.9%; Dec'17: 15.3%).
- Large banks have remained well-capitalized wherein MCB and ABL have the strongest Tier-1 capitalization within the segment. Future outlook in terms of capital adequacy for this segment is positive, given lower exposure to credit risk and strong existing capital buffers. However bank-specific concerns remain, specifically in case of NBP, wherein adverse outcome to an ongoing litigation may result in significant deterioration of capital buffers.
- Median Tier 1 CAR for Medium Banks has also remained well above the required cushion albeit select players within this category do face capital constraints. Bank of Punjab, Bank Al Habib and Askari Bank have relatively lesser space against the required cushion. In contrast, Meezan Bank has adequately addressed its capital constraints by recent Tier 1 debt and rights shares issuance. Going forward, overall capital adequacy for this group is expected to remain strong given strong profitability prospects in the short to medium term.
- Capitalization for smaller players is slightly under pressure as the cushion against SBP prescribed ratios is relatively smaller. Silk Bank, JS Bank and AlBaraka Bank have fallen short of the SBP required Tier 1 CAR. Sindh Bank's CAR has improved since Sep'19, given recent equity injection in Oct'19. Within the segment, Samba Bank has the strongest capitalization.
- At present CAR non-compliant banks include JS Bank, Al Baraka Bank, Silk Bank and Summit Bank, which collectively constitute a little less than 5% of the banking industry deposits.

Table 18: Bank-wise CAR & Tier 1 CAR (Sep'19)

Large Banks	Tier 1 CAR	Total CAR
National Bank of Pakistan	13.09%	17.13%
Habib Bank Limited	13.54%	17.09%
United Bank Limited	15.03%	19.39%
MCB Bank Limited	16.17%	18.15%
Allied Bank Limited	18.25%	22.88%
Medium Banks	**Tier 1 CAR**	**Total CAR**
Bank AL Habib Limited	11.35%	14.71%
Meezan Bank Limited	14.67%	17.63%
Bank Alfalah Limited	13.39%	16.87%
The Bank of Punjab	11.23%	14.66%
Askari Bank Limited	11.25%	12.73%
Habib Metropolitan Bank Limited	13.30%	13.86%
Standard Chartered Bank (Pakistan) Limited	13.95%	15.92%
Faysal Bank Limited	16.51%	18.45%
Small Banks	**Tier 1 CAR**	**Total CAR**
JS Bank	9.60%	12.07%
Soneri Bank Limited	12.25%	15.17%
BankIslami Pakistan Limited	11.53%	15.55%
Dubai Islamic Bank Pakistan Ltd	13.26%	15.68%
The Bank of Khyber	12.64%	12.64%
Silk Bank Limited	8.03%*	10.43%*
Sindh Bank Ltd	11.53%	11.53%
AlBaraka Bank (Pakistan) Limited	9.84%	11.93%
MCB Islamic Bank	13.54%	13.28%
Samba Bank Limited	18.31%	18.39%
First Women Bank	NA	39.10%

* as of Jun'19

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