Banking Industry

SECTOR UPDATE

August, 2021

MACROECONOMIC REVIEW - PAKISTAN

The economy of Pakistan is characterized by frequent boom and bust cycles, the consequences of which have intensified, as the country has had to frequently rely on external bailouts from IMF, thus pushing the debt higher on a timeline. Pakistan ran into a familiar bust cycle in FY18, with the new Government inheriting one of the worst external account crises in the country's history. Since coming into power, the new Government has taken a familiar approach by entering into a USD 6.6b Extended Fund Facility (EFF) with the IMF, being the 22nd time Pakistan approached the IMF. Furthermore, the Government adopted a market-based exchange rate system and tightened the monetary policy. The adjustment period took its toll on the economy, reducing the country's growth below 2%, an indicator which was already trending below regional counterparts, as illustrated in Figure 1. At the same time, inflation during this period trended above regional counterparts, as illustrated in Figure 2.

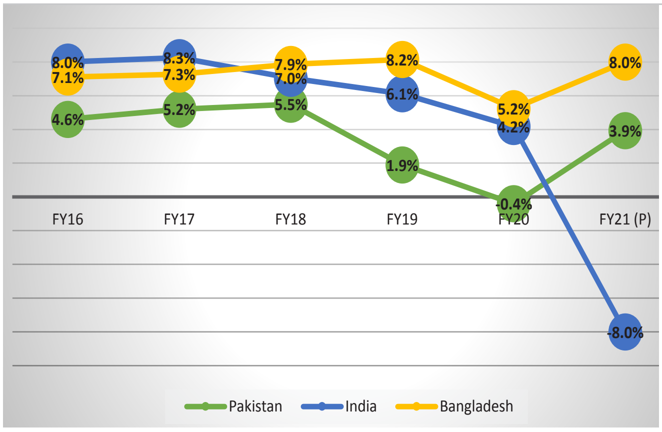

Figure 1: GDP Growth (Pakistan vs Regional Counterparts)

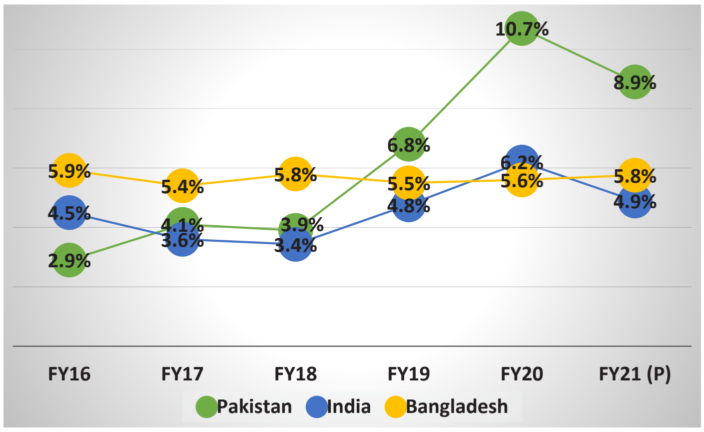

Figure 2: Inflation (Pakistan vs Regional Counterparts)

The latter half of year FY20 was marred by the pandemic outbreak, which resulted in the economy contracting by 0.4%, being the first time it happened over a period of 68 years. However, the Government of Pakistan's (GoP) adaptive approach towards managing Pakistan's vulnerable economy during the pandemic, has been superior to regional counterparts. As a result economic recovery started materializing in FY21, as reflected by the GDP growth estimate of 3.9%, which notably exceeded expectations of lender multilateral agencies. It can be argued that much of this growth is attributable to a low base effect, caused by the 0.4% contraction in the preceding year. However, even after taking the same into consideration, the economic recovery is commendable and largely attributable to success of GoP's Covid protection & relief measures. This is also evident from Pakistan being ranked 3rd on the Economist's "Return to Normalcy' index in June 2021.

Going forward, the GoP has made strong growth projection on the basis of measures it has taken in reviving the construction and automobile sector. However, structural impediments to GDP growth persist, mainly being Pakistan's low savings to GDP that translates into lower Investment Spending to GDP, which ranges between 15-17%, notably lagging Bangladesh (32%) and India (28%) and the overall average of lower middle economies, which is close to ~30%. Unless this impediment is addressed, matching GDP growth rates of regional counterparts will remain a challenge.

External & Fiscal Risk:

Apart from its consequences, in terms of the toll on human lives it has taken and its impact on the lower earning segments of the society, the pandemic had a slight silver lining for Pakistan's external account balance in terms of much higher remittance receipts and lower trade deficits, which has been monumental in curtailing the current account deficits. The growth in remittances has been driven by the drop in international travel, as a result of which much of the money being remitted to Pakistan is being done through official channels. The breakup of the country's current account balance is provided in the table below. As reflected in the table, Pakistan's balance of good services and primary income has been shrinking on a timeline, as a result of GoP's import curtailment approach. Furthermore, secondary income (largely remittance receipts) posted strong improvement, and for full year FY21 at USD 29.4b i.e. 27% higher than preceding year. Provisional figures for 11M'FY21 suggest that current account balance is likely to close near a miniscule deficit for FY21.

Table 1: Current & Fiscal Account Balance (Source: SBP)

	FY17	FY18	FY19	FY20	9M'FY21
CURRENT ACCOUNT BALANCE (A+B)	**(12,270)**	**(19,195)**	**(13,434)**	**(4,449)**	**883**
A – BALANCE ON GOODS, SERVICES & PRIMARY INCOME	**(35,673)**	**(42,766)**	**(38,192)**	**(29,884)**	**(23,689)**
BALANCE ON TRADE OF GOODS	**(25,998)**	**(30,903)**	**(27,612)**	**(21,109)**	**(18,732)**
• **EXPORT OF GOODS**	22,003	24,768	24,257	22,536	18,698
• **IMPORT OF GOODS**	48,001	55,671	51,869	43,645	37,430
BALANCE ON TRADE ON SERVICES	**(4,661)**	**(6,426)**	**(4,970)**	**(3,316)**	**(1,363)**
• **EXPORT OF SERVICES**	5,915	5,851	5,966	5,437	4,371
• **IMPORT OF SERVICES**	10,576	12,277	10,936	8,753	5,734
BALANCE ON PRIMARY INCOME	**(5,014)**	**(5,437)**	**(5,610)**	**(5,459)**	**(3,594)**
• **PRIMARY INCOME CREDIT**	696	726	578	479	412
• **PRIMARY INCOME DEBIT**	5,710	6,163	6,188	5,938	4,006
B – SECONDARY INCOME (NET)	**23,403**	**23,571**	**24,758**	**25,435**	**24,572**
• **SECONDARY INCOME CREDIT**	23,604	23,800	24,990	25,802	24,797
• **SECONDARY INCOME DEBIT**	201	229	232	367	225
	FY17	**FY18**	**FY19**	**FY20**	**9M'FY21**
FISCAL BALANCE	**(1,864)**	**(2,260)**	**(3,445)**	**(3,376)**	**(1,652)**
A – TOTAL REVENUE	**4,937**	**5,228**	**4,901**	**6,272**	**4,993**
TAX	**3,969**	**4,467**	**4,473**	**4,748**	**3,765**
• **FEDERAL**	3,648	4,066	4,072	4,334	3,395
• **PROVINCIAL**	322	401	402	414	370
NON-TAX	**968**	**761**	**427**	**1,524**	**1,278**
B – TOTAL EXPENDITURE	**6,801**	**7,488**	**8,346**	**9,649**	**6,645**
CURRENT EXPENDITURE	5,198	5,854	7,104	8,532	6,085
• **INTEREST PAYMENTS**	1,348	1,500	2,091	2,620	2,104
• **DEFENSE**	888	1,030	1,147	1,213	784
• **PROVINCES**	1,726	2,065	2,328	2,516	NA
• **DEVELOPMENT & NET LENDING**	1,681	1,622	1,219	1,204	723

On the fiscal front, the deficit came in at 3.5% of GDP for 9M'FY21. However, for full year FY21, the provisional estimates for budget deficit exceed 7%. The GoP unveiled Budget FY22 in the 2nd week of June' 2021, which projects the current account deficit to increase in FY22, albeit remain contained under 1%, and fiscal deficit to come in at 6.3% of GDP. In view of the increase in international oil prices, higher propensity of import growth vis-à-vis exports, lesser likelihood of remittances to follow same growth as observed in FY21, containing the current account deficit under 1% will likely be a challenge for the GoP, while there is a likelihood of moderate fiscal slippage by up to 1% from the deficit target of 6.3%. Development expenditure budget, under PDSP has been augmented by 37% which is viewed positively, while GDP growth target has been set at 4.8%. Going forward, focus is mainly on the upcoming 6/7th review of the IMF due in September 2021. Risks to GoP envisaged upward economic trajectory remain, in form of the recent delta variant Covid outbreak, from which Pakistan has been relatively less affected so far.

Banking Sector Review

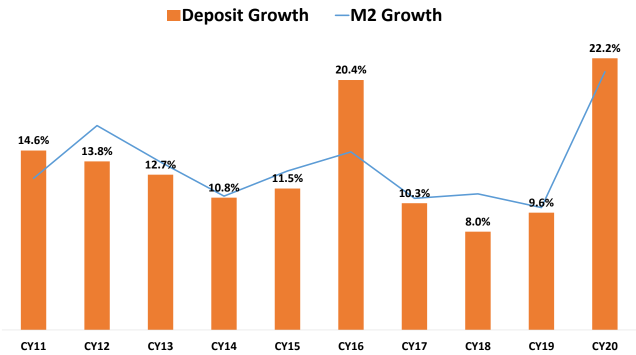

Figure 3: Deposit Growth (Source (SBP)

Pakistan's banking sector growth swelled in 2020, being supported by the strong growth in deposits. In context of 5-year historical deposit growth (2016-2020), deposit growth in CY20 was reported notably higher. This stronger deposit growth is largely a result of contraction in consumer spending, with two-thirds of SBP's bi-monthly Consumer Confidence Surveys indicating a decline in Consumer Confidence Index.

The year 2020 was marred by the pandemic–induced slowdown, which kept advances growth subdued. Growth in sector advances came in at 1% for 2020 and another 1% for Q1'2021, lagging the 4% uptick posted in 2019. Alternatively, sector participants continued to grow their investment portfolios, by channeling the excess liquidity towards low risk weight sovereign securities. This is evident from the decline in ADR and growth in proportionate share of investments, which comprised about 50% of the banking sector assets as of Mar'21. Over 90% of the investment portfolio comprises investment in sovereign securities.

The SBP introduced a number of Covid relief measures to support borrower repayment capacity and encourage financing growth and thus investments spending, amidst a grim international investment outlook. As per SBP, total relief provided to the business community exceeded Rs. 2tr. This included over Rs. 910b of loan restructurings and deferments, Rs. 436b financing under concessionary lending schemes (Temporary Economic Refinance Facility) and more than Rs. 210b disbursements under SBP's staff layoff prevention scheme (SBP Rozgar Scheme). SBP's measures were monumental in supporting the business community weather the pandemic related challenges.

Table 1: Current & Fiscal Account Balance (Source: SBP)

	Dec-18	Dec-19	Dec-20	Mar-21
Banking Sector Balance Sheet				
Assets	**19,682**	**21,991**	**25,124**	**25,750**
• Advances (net)	7,955 (40%)	8,249 (38%)	8,292 (33%)	8,365 (32%)
• Investments	7,914 (40%)	8,939 (41%)	11,935 (48%)	12,924 (50%)
Liabilities	**18,276**	**20,333**	**23,261**	**23,938**
• Deposits	14,254	15,953	18,519	18,521
• Borrowings	3,001	2,932	3,217	3,842
Equity	**1,406**	**1,658**	**1,862**	**1,812**
Financial Indicators				
ADR	**55.0%**	**51.0%**	**44.3%**	**44.7%**
Gross Infection	**8.0%**	**8.6%**	**9.2%**	**9.3%**
Net Infection	**1.0%**	**1.3%**	**0.8%**	**1.0%**
Cost to Income Ratio	**59.4%**	**56.8%**	**49.3%**	**54.4%**
RoA (After Tax)	**0.8%**	**1.5%**	**1.8%**	**1.9%**
RoE (After Tax)	**11.5%**	**12.3%**	**14.5%**	**14.0%**
Net NPLs to Capital	**5.6%**	**7.2%**	**3.6%**	**4.7%**
CAR	**15.9%**	**16.6%**	**18.4%**	**18.1%**
Tier I CAR	**13.0%**	**13.6%**	**14.6%**	**14.4%**

The phenomenon of public sector financings crowding out the private sector continues. During 11M'FY21, credit to private sector grew by 7% or Rs. 490b, in absolute terms (Jun'20 Rs. 6.9b; May'21: Rs.7.4b). Despite the aforementioned growth, private sector advances constituted less than 30% of the banking sector's asset base, while credit to private sector as a % of GDP continues to lag regional counterparts. As a domestic credit rating agency, VIS views this as a business model dependency, given excessive holdings of sovereign securities in relation to asset base. Lately, the ruling Government and SBP and have made efforts to improve credit to private sector. These include refinement of foreclosure laws to promote private sector housing finance, while SBP has also instructed commercial banks to enhance their mortgage financing portfolios to at least 5% of advances book. In order to promote SMEs, SBP has plans in place to introduce collateral free loans of up to Rs. 10m for cottage industry.

SBP's directive to ease the monetary policy, by reducing interest rate by 625 bpts, from 13.25% to 7.00%, has impacted the sector's net interest margins. Unlike other economies, where reduction in interest rates translates in adequate volumetric advances growth to support banking revenues, Pakistani banking sector's profitability has historically receded in response to interest rate reduction. The reduction in spreads materializes with a slight lag, mainly as deposits reprice faster than advances. This is evident from the trend line in figure 4.

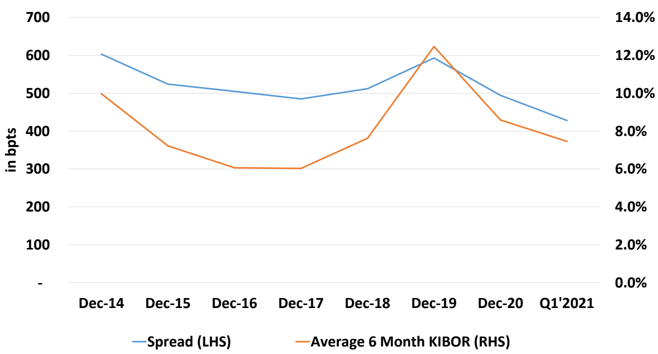

Figure 4: Spread & KIBOR Trend

As a result of the aforementioned lag, the banking sector profitability remained strong through 2020, with the exception of Q4, when the spread contraction actually materialized. Banking spread came under further pressure during Q1'2021. Going forward, with benchmark rate likely to persist at similar level, at least in the short to medium term horizon, banking spread is likely to remain under pressure during 2021.

Asset quality concerns, which were the primary focus of analysts last year when pandemic related lockdowns started, have been somewhat abated, mainly as SBP's Covid relief measures such as lowering the interest rates and allowing roll over of principal, and in some cases full restructuring, aided the borrowers repayment capacity. Even though moderate increase in NPLs was noted, gross infection remained lower than analyst expectations. This is mainly because the Covid relief measures have not yet been lifted, while IFRS 9 implementation stands deferred, limiting the estimation of expected credit losses. Credit risk concerns in the Pakistani banking industry are partly assuaged by the sizable holdings of sovereign securities, being the lowest risk in the domestic context, and industry ADR, which stands on the lower side.

In conclusion, the overall banking sector of Pakistan depicts strong liquidity, given significant exposure in sovereign securities. The loss absorption capacity of the sector is considered adequately strong, with net NPLs to Capital standing at 4.7% as of Mar'21. Overall capital adequacy of the sector is strong, given aggregate CAR of more than 18% and almost all banks, with the exception of 3 small-sized banks, complying with minimum capital requirements. However, it is pertinent to mention that the higher CAR is a result of the strategy of sector participants to maintain low ADR by investing a significant proportion in sovereign debt. As economic growth picks pace and as excess liquidity is channeled away from the low risk weight sovereign securities and towards private sector credit, the CAR is likely to be rationalized. Furthermore, as and when Covid relief measures are lifted, we might see an increase in NPLs; the resultant higher provision requirements in a low margin environment, is likely to weigh on industry RoAA going forward.

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[1], is provided below.

Large Banks (Domestic Deposits Market Share > 5%[2])

As of Dec'20, these 7 large-sized banks cumulatively hold 59.6% of the domestic deposits, gaining 0.7% additional market share in 2020. Off these 7 banks, top-3 are classified as Domestic-Systemically Important Banks (D-SIBs) by the SBP. As per SBP's D-SIB selection quantitative criteria, total exposures of the Bank (which is reported as the denominator in leverage calculation) should be at least 3% of the country's GDP at market prices. As per VIS calculations, all of these large banks comply with this criteria. At present, Meezan Bank Limited (MEBL) is classified in the Sample D-SIBs, as disclosed in their financial statements. Whether the remaining 3 banks are classified in this list or not, has not been publicly disclosed.

		Market Share - Deposits				Market Share - Advances				Capital Adequacy Ratio		Net NPLs % TIER 1 Equity		Return on Avg. Assets		Liquidity Coverage Ratio	
Large Banks (in alphabetical order)	Rating (CRA)	Dec'20	Rank	Dec'19	Rank	Dec'20	Rank	Dec'19	Rank	Mar. '21	Rank	Mar. '21	Rank	3 yrs Avg.	Rank	Mar. '21	Rank
Allied Bank Limited	AAA/A1+ (PACRA)	6.6%	6	6.6%	5	5.5%	4	5.5%	5	26.2%	1	0.5%	1	1.1%	3	209.0%	6
Bank Al Habib	AAA/A1+ (PACRA)	5.7%	7	5.4%	7	5.3%	5	5.1%	7	14.1%	7	0.7%	2	1.0%	5	281.0%	2
Habib Bank Limited	AAA/A1+ (VIS)	13.6%	1	13.4%	1	10.9%	2	10.7%	2	19.7%	5	4.3%	5	0.7%	7	245.0%	4
MCB Bank Limited	AAA/A1+ (PACRA)	6.7%	5	6.8%	4	4.9%	6	5.3%	6	20.1%	4	4.0%	4	1.4%	2	250.0%	3
Meezan Bank Limited	AAA/A1+ (VIS)	6.8%	4	5.8%	6	5.9%	3	5.7%	3	18.4%	6	1.6%	3	1.9%	1	229.0%	5
National Bank of Pakistan	AAA/A1+ (VIS & PACRA)	12.7%	2	13.2%	2	11.9%	1	11.9%	1	21.9%	3	12.2%	7	1.1%	3	156.0%	7
United Bank Limited	AAA/A1+ (VIS)	7.7%	3	7.6%	3	4.8%	7	5.6%	4	23.8%	2	7.3%	6	1.0%	5	361.0%	1

1 Even though, as per VIS Commercial Banks Methodology, market positioning of Banks take into account the market share for both advances and deposits. However, the usage of domestic deposit market share is based on the rationale that it's the primary factor driving the industry's asset growth and market positioning in these changes significantly in certain cases. For example Bank Alfalah is the 8th largest in terms of deposits and 3rd largest in terms of financings. Accordingly, this necessitates selection of a single parameter.

2 Market shares stated herein differ from the market shares reported in VIS rating reports. This is mainly because market shares herein have been calculated from SBP quarterly Financial Soundness Indicators reports instead of SBP's monthly scheduled banks deposit reporting.

A comparison of these banks, in light of VIS Commercial Banks Methodology, gives edge to the top 3 banks, given higher market shares and systemic importance. In terms of growth and profitability, MEBL is ranked the highest, as inferred from its RoAA (3-year average), while growth rate stood about 2x of the industry in 2020. As a result, MEBL gained a full 1% market share YoY. MEBL's systemic importance is further underlined by the fact that it's the largest bank in the Islamic banking segment, holding about 37% of Islamic bank deposits as of Dec'20.

Medium Banks (Domestic Deposits Market Share 2.5-5.0%[3])

There are 6 medium-sized banks operating in the industry, holding a cumulative market share of 22.8% of the industry, which hasn't depicted any change since last year. With the exception of Faysal Bank Limited (FABL) and Standard Chartered Bank – Pakistan (SCB), all other banks in this category are rated at 'AA+'.

		Market Share - Deposits				Market Share - Advances				Capital Adequacy Ratio		Net NPLs % TIER 1 Equity		Return on Avg. Assets		Liquidity Coverage Ratio	
Medium Banks (in alphabetical order)	**Rating (CRA)**	**Dec'20**	*Rank*	**Dec'19**	*Rank*	**Dec'20**	*Rank*	**Dec'19**	*Rank*	**Mar. '21**	*Rank*	**Mar. '21**	*Rank*	**3 yrs Avg.**	*Rank*	**Mar. '21**	*Rank*
Standard Chartered (Pak)	AAA/A1+ (PACRA)	3.0%	5	2.9%	5	3.8%	4	3.8%	4	16.6%	2	7.3%	3	1.8%	1	605.0%	1
Askari Bank Limited	AA+/A1+ (PACRA)	4.3%	3	4.3%	2	4.3%	3	4.1%	3	14.5%	5	0.0%	1	0.8%	4	187.0%	4
Bank Alfalah	AA+/A1+ (PACRA)	4.4%	2	4.5%	1	6.1%	1	5.5%	1	15.6%	3	8.3%	4	1.0%	2	185.0%	5
Bank Of Punjab	AA+/A1+ (PACRA)	4.5%	1	4.3%	2	4.9%	2	4.8%	2	14.3%	6	17.1%	6	0.9%	3	129.0%	6
Faysal Bank Limited	AA/A1+ (VIS & PACRA)	2.9%	6	2.9%	6	2.8%	6	2.7%	6	19.5%	1	9.1%	5	0.8%	5	216.0%	3
Habib Metro Bank Limited	AA+/A1+ (PACRA)	3.7%	4	3.8%	4	3.7%	5	3.2%	5	15.0%	4	2.7%	2	0.5%	6	233.0%	2

In terms of deposit growth, Bank of Punjab (BOP) gained the most notable market share, at 0.2%, in 2020. On the other hand Bank Alfalah (BAFL) stands out in terms of notably higher advances market share vis-a-vis deposits, indicative of ADR being on the higher side. BOP has the highest gross infection in this segment along with the lowest CAR. On the other hand FABL has the lowest rating in this category, mainly on account of lower market share, depressed profitability and higher net NPL to Tier I vis-à-vis peers.

Small Banks (Domestic Deposits Market Share <2.5%[4])

There are 12 small-sized banks operating in Pakistan, holding an estimated market share of ~12%; the reasoning for the estimation is mainly that 3 of these 12 banks have capital adequacy issues and reporting is not up to date. The banks pose risk to the overall banking sector, albeit their market share (less than 2.5% of banking sector deposits) is small and operations are being closely monitored by the regulator.

There is significant competition for deposits in this segment, with cost generally tilting on the higher side. The main reason for these banks lagging the bigger banks is their franchise values, given much lower branch network than medium and large-sized banks. Accordingly profitability indicators of these banks trend on the lower side vis-à-vis medium and large-sized banks. There is significant room for merger & consolidations in this segment, which could help unlock much needed synergies for smaller banks. Alternatively, organic growth is likely to be too costly for smaller, in view of SBP's branch expansion guidelines, which require banks to open a minimum number of rural branches for urban branch expansion. Nevertheless, mergers and acquisitions in the Pakistan banking sector have remained subdued, with the exception of AlBaraka's acquisition of Burj Bank in 2016, we haven't noted any consolidation in the past 5-year period.

3 Market shares stated herein differ from the market shares reported in the rating reports. This is mainly market share herein has been calculated from SBP quarterly Financial Soundness Indicators reports instead of the month schedule banks deposit reporting.

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		Market Share - Deposits				Market Share - Advances				Capital Adequacy Ratio		Net NPLs % TIER 1 Equity		Return on Avg. Assets		Liquidity Coverage Ratio	
Small Banks (in alphabetical order)	**Rating (CRA)**	**Dec'20**	*Rank*	**Dec'19**	*Rank*	**Dec'20**	*Rank*	**Dec'19**	*Rank*	**Mar. '21**	*Rank*	**Mar. '21**	*Rank*	**3 yrs Avg.**	*Rank*	**Mar. '21**	*Rank*
Albaraka Bank Limited	A/A1 (PACRA) A+/A1 (VIS)	0.9%	7	0.8%	7	1.1%	6	0.9%	7	12.7%	8	26.5%	7	0.1%	6	161%	5
Bank Islami Limited	A+/A1 (PACRA)	1.5%	3	1.4%	3	1.6%	4	1.5%	4	15.2%	4	25.9%	6	0.4%	5	220%	3
Bank Of Khyber	A/A1(PACRA) A+/A-1 (VIS)	1.1%	5	1.1%	5	1.5%	5	1.3%	5	17.0%	1	16.3%	5	0.5%	2	120%	7
Dubai Islamic Bank	AA/A1+ (VIS)	1.3%	4	1.3%	4	2.2%	3	2.0%	3	16.4%	2	11.1%	3	1.1%	1	172%	4
First Women Bank Limited	A-/A2 (PACRA)	NA		NA		NA		NA		NA		NA		NA		NA	
JS Bank Limited	AA-/A1+ (PACRA)	2.3%	1	2.3%	1	2.8%	1	2.7%	2	12.8%	7	44.6%	8	0.1%	6	299%	2
MCB Islamic Bank Limited	A/A1 (PACRA)	0.5%	8	0.5%	9	0.9%	7	0.6%	10	12.3%	9	1.1%	2	-0.4%	8	110%	9
Samba Bank Limited	AA/A1 (VIS)	0.4%	9	0.5%	9	0.8%	8	0.7%	9	14.9%	5	0.5%	1	0.5%	2	118%	8
Silk Bank Limited	A-/A2 (RW) (VIS)	NA		0.9%	6	NA		1.3%	5	NA		NA		NA		NA	
Sindh Bank	A+/A1 (VIS)	1.0%	6	0.8%	7	0.8%	8	0.9%	7	14.0%	6	178.9%	9	-2.3%	9	433%	1
Soneri Bank Limited	AA-/A1+ (PACRA)	1.9%	2	1.9%	2	2.8%	1	2.8%	1	15.4%	3	12.3%	4	0.5%	2	135%	6
Summit Bank Limited	Suspended (VIS)	NA		NA		NA		NA		NA		NA		NA		NA	

Excluding Samba Bank Limited (Samba), Soneri Bank Limited (SNBL) and JS Bank Limited (JSBL), all other bank in this category are rated in the 'A' Band. One bank that particularly stands out, in terms of asset quality concerns, is Sindh Bank, with the worst gross infection and the highest net NPL's to tier I equity. However ratings herein are mainly being supported by the sponsor profile. In terms of profitability, Dubai Islamic Bank (DIB) leads the category with the highest RoAA (3 year average).

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