

# Banking Industry

July, 2020

## Economic Overview

The novel coronavirus outbreak, which started in December 2019, has developed into a world-wide pandemic, with the World Health Organization (WHO) officially recognizing the same as a pandemic in March 2020. Global economic activity was affected in Q1'20, albeit Q2'20 saw a complete lockdown across the globe with more than half the world's population effectively being asked to adhere to social distancing protocols.

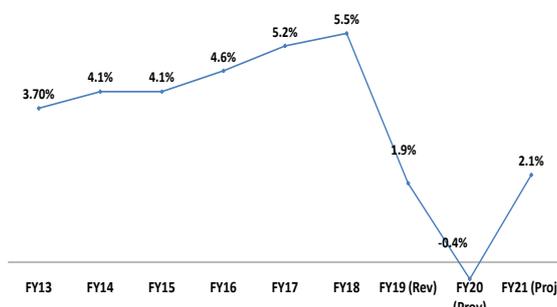


Figure 1: GDP Growth

Pakistan's economy, which had been undergoing an adjustment phase, subsequent to experiencing an external account crisis in FY18, has been significantly impacted, as reflected from the GDP contraction in FY20 (GoP projects GDP to contract by 0.38%), which, although an anomaly in context of the long-term trend, is in line with the contraction in the global GDP.

Given the slowdown in economic activity, large scale manufacturing has witnessed a sizable decline during March 2020 and April 2020 reducing by 22.95% and 41.89%, respectively. The reduced activity has adversely impacted GoP's revenue generation measures, as a result of which fiscal balance for FY20 is likely to be higher than IMF-GoP agreed target. So far, the impact on the external front has been relatively measured, with lower trade deficit (YoY) owing to a drop in oil prices, the external risk could increase in case of a prolonged slowdown in exports and remittance inflows.

## ... Fiscal Deficit

Table 1: Fiscal Deficit

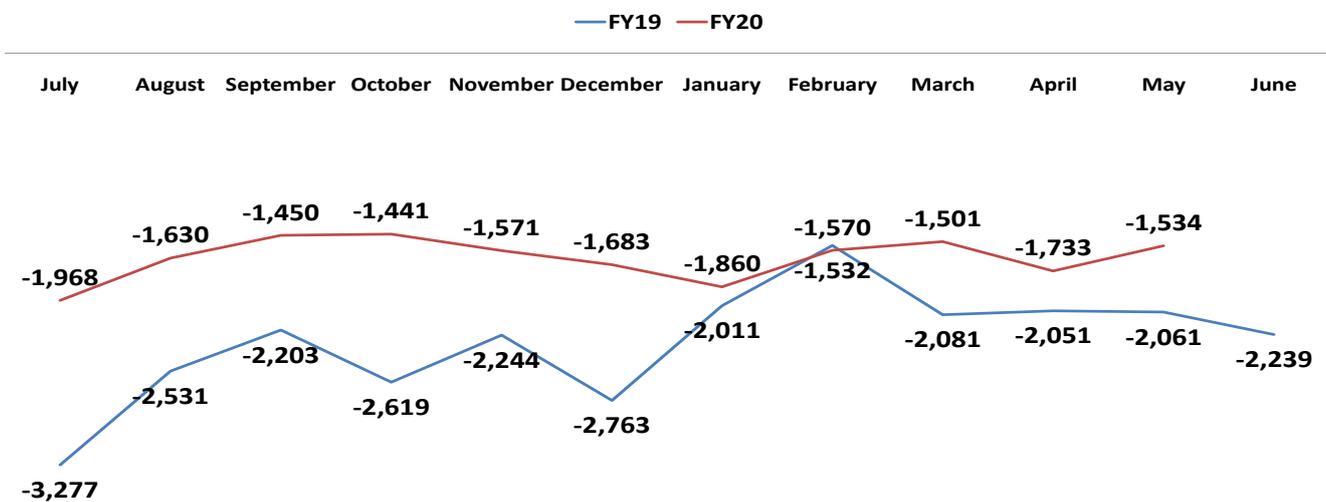
All Figures in PKR' Billions unless stated otherwise	FY20 (Budget)	FY20 (Revised)	FY21 (Budgeted)
Net Tax Revenue	3,462	3,102	3,700
- Tax Revenue	5,822	4,208	5,464
- Non-Tax Revenue	894	1,296	1,109
- Less: Provisional Transfers	(3,255)	(2,402)	(2,874)
Total Expenditure	(7,036)	(6,814)	(7,136)
- Current Expenditure	(6,193)	(6,114)	(6,319)
• Debt Servicing	(2,891)	(2,709)	(2,946)
• Defense	(1,153)	(1,227)	(1,289)
• Subsidies ( Current )	(272)	(350)	(209)
• Others	(1,877)	(1,828)	(1,874)
- PDSP (net)	(701)	(564)	(650)
- Other Developmental Expenditure	(86)	(66)	(70)
- Net Lending	(57)	(70)	(98)
Fiscal Deficit	(3,574)	(3,712)	(3,437)
Fiscal Deficit (as a % of GDP)	7.2%	9.1%	7.0%

- The country's fiscal deficit (as a % of GDP) widened further and missed the budget target. The above table presents the provisional figures, from the Government of Pakistan.
- For FY21, the Government of Pakistan, in its Budget 2021, has projected 27% increase in tax revenues and 11% reduction in expenditures. This will allow GoP to reduce fiscal deficit to an envisaged FY21 target of 7.0%.
- In view of the pandemic and slow economic activity, achieving the envisaged budget revenue targets will be challenging.
- The budget deficit is envisaged to be funded by domestic debt (~¾th), foreign debt (~¼th ) and privatization proceeds (~5%).

### ... Current Account Deficit

- Pakistan's trade and current account deficit has declined by 28% and 70%, respectively during FY20, primarily due to lower imports and some growth in remittances.

Figure 2: MoM Balance of Payment (SBP)



- The country's remittances, which play a major role in plugging in the external shortfall, have remained relatively less impacted vis-à-vis regional peers coming in at USD 23.1b, during FY20 6.4% higher than SPLY. During the pandemic-affected period i.e. Q4'FY20, the remittances were 7.3% higher than SPLY.
- However, it is pertinent to mention that an increase in worker layoffs as has been reported by Ministry of Overseas Pakistanis may result in slowdown in remittances, going forward.
- Current account deficit can be expected to remain at 2% of GDP.
- The external account has depicted relative stability. Given the downturn in oil prices and low reliance on exports (10.4% of GDP) and tourism (0.1% of GDP) along with debt relief of over \$5billion (from IMF, G20 and World Bank and Asian Development Bank), external account is expected to depict limited volatility in the short-term.

## ... Banking Sector

Table 2: Banking Industry Financial Stability Indicators (SBP)

All Figures in PKR' Billions unless stated otherwise	Dec'18	Dec'19	Mar'20
Total Assets	19,682	21,991	22,150
Investments (net)	7,914	8,939	9,640
Advances (net)	7,955	8,249	8,182
Deposits	14,254	15,953	15,918
Borrowings	3,001	2,932	3,049
Equity	1,406	1,658	1,692
Profit After Tax	243	304	79
Provisioning Charges	36	68	23
Non-Performing Loans	680	761	806
Non-Performing Loans (net)	110	141	146
Gross Infection	8.0%	8.6%	9.1%
Net Infection	1.0%	1.3%	1.5%
Net NPLs to Equity	5.6%	7.2%	7.8%
CAR	15.9%	16.6%	17.0%
Tier I CAR	13.0%	13.6%	13.6%
ADR	55.0%	51.0%	50.9%

- The novel coronavirus outbreak is expected to have adverse impact across the economy, with certain sectors like textile, automobiles, electronics and entertainment, being affected more than others.
- As of the date of this report, Pakistan had reported more than 276'000 cases with the pandemic likely to stretch beyond Q2'2021. Development of an effective vaccine can certainly end the pandemic sooner. Our assessment of the banking sector takes this downside into consideration.
- Collectively, sector financial risk indicators have significantly strengthened since the last financial crises of 2008. In terms of capitalization, the industry boasts a CAR of 17%, ADR of 51% and about 50% of the asset base is liquid (Mar'20). These ratios are indicative of strong loss absorption buffers, while the excess liquidity available with the banks should allow them to navigate through the crises.
- Private sector lending, which we expect to be the most affected stood at Rs. 5.5tr as of April, 2020, of which 8.1% was outstanding against the SME sector. In contrast to deposits, private sector lending constitutes roughly a third.
- SBP, in an effort, to promote financial stability, ensure continued credit supply to the economy and maintain confidence in the banking system, has taken a few measures, which include the following:
  1. These allow banks to defer principal payments for up to a year, while also allowing other clients facing major liquidity constraints, a full restructuring of their existing transaction.
  2. The policy rate has been reduced by 625 basis points to 7% (Dec'19: 13.25%)
  3. Capital conservation buffer has been waived by 100 basis points to 1.5%
  4. For SMEs, the regulatory limit for extension of credit has been increased to Rs. 180m (up 44%) and
  5. Allowed debt burden ratio for consumer loans has been enhanced from 50% to 60%.
- By end-Jun'20, the quantum of deferment requests received stood at Rs. 593b, merely ~7% of the industry advances. The SBP has outlined end-Sep'20 as the deadline for application for SBP relief measures.

- The SBP mandated relaxations are expected to delay the impact of the non-performance from reflecting on the asset impairment ratios. Accordingly, the asset impairment ratio of the industry is expected to broadly remain intact in the short-term. The uptick in impairment ratio is likely to materialize as and when the SBP relief period matures, i.e. Jun'21.
- In the short-term, the deferment of principal and mark-up payments and further requirement of short-term financing for the industry will require additional channelization of liquid assets towards lending. Nevertheless, industry liquidity is considered to be strong.

	PKR in billions
<b>Loans Deferred</b>	593
<b>Loans Restructured</b>	126
<b>Loans sanctioned for wages</b>	119
<b>Loans sanctioned for hospitals</b>	6.4
<b>Loans sanctioned for investments</b>	10.4

**Table 3: Relief Granted (SBP)**

- The industry profitability is expected to weaken going forward on account of the following:
  - So far, the interest rate has already dropped by 625 basis points; this sharp drop in interest rates and narrowing of the interest rate corridor is expected to negatively affect banking spread. A review of historical banking spread in low interest regime indicates that spread shrinkage is likely going to be ~50 basis points. However, in the near term (Q2 & Q3), the spreads may post short term improvement, as a result of faster re-pricing on liabilities vis-à-vis assets. This short-term spread improvement will likely keep the spreads intact for the ongoing year.
  - The adverse credit risk environment – on account of the Covid-19 outbreak – is expected to translate in increased provisioning burden.
  - In view of the reduced economic activity and trade volumes, fee-related income and overall ancillary income will reduce with most Banks expecting a 10% reduction in 2020. This, along with projected spread shrinkage in 2021, will likely have an adverse impact on efficiency ratios across the industry.
  - The SBP maintains its deadline for IFRS 9 implementation at January 1 2021, with deadline for pro-forma accounts preparation being Oct'20. The full provisioning impact of the same is expected to be sizable. As per due diligence interviews with banks, the provisioning requirement from the same could range from 1-2% of the advances portfolio. However, given the expected increase in provisioning charges, the same is likely to be deferred.

- The industry's capitalization has been reinforced over the past decade, subsequent to previous financial crises of 2008. Amidst depressed profitability, and expected loan losses and required (under IFRS 9), the capital adequacy of the sector is expected to recede. In view of the same, it is likely that the SBP may choose to further delay the implementation of IFRS-9. Albeit, so far SBP's deadline for full implementation remains set for Dec'21.

PKR' Billions	Mar'20
<b>CAR</b>	17.0%
<b>Tier I CAR</b>	13.6%
<b>Capital to Assets</b>	7.2%
<b>Net NPLs to Capital</b>	7.8%
<b>Investment in Equities to Capital</b>	8.2%

**Table 4: Industry Capitalization (SBP)**

- Overall we expect stand-alone credit risk profiles across the sector to weaken. However, some of our outstanding ratings incorporate element of sponsor support into the rating assessment. For such cases, VIS will assess the ability of sponsors to continue with the support that has been demonstrated in the past given the challenging environment in their domestic home markets.
- It is evident that the banking industry is expected to go through a stressed phase, with profitability concerns and increased loan loss expectations particularly in 2021.
- While these projections are expected to test the asset quality of the sector, we expect capitalization buffers reinforced over the past decade to provide adequate cushion to absorb these loan losses.

- In addition, VIS expects regulatory support to continue for the sector through a number of initiatives if the crisis prolongs. These may not be limited to a further extension in principal payment timeframe from the current 1 year and relaxation in regulatory limits to major sectors that are affected.
- The technology driven solutions adopted by the sector over the past decade are expected to enable most banks to transition a portion of the customer base away from branch environments.

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