November 2015

JCR-VIS
SECTOR UPDATE

Commercial Banks

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The banking industry in Pakistan has grown at a Compound Annual Growth Rate (CAGR) of 13.2%[1] over the last 5 years (2009-2014) while deposits held by the banking industry have posted a CAGR of 14.0% over this period. However, despite this, financial inclusion remains on the lower side in comparison to regional counterparts as illustrated in Table 1. With consistent growth in assets, total assets of the banking industry comprise 42% of the GDP which is on the lower side.

Table 1: Financial Inclusion Indicators 2014

	People with Bank Accounts (%)	People with Formal Savings (%)	People with Formal Borrowings (%)
Pakistan	13	3	2
Sri Lanka	83	31	18
India	53	14	6
Bangladesh	31	7	10
China	79	41	10
Kazakhstan	54	8	16
Iran	92	22	32

** People implies the entire adult population of a country i.e. aged 15 and above*

Source: World Bank

The banking industry of Pakistan had a cumulative asset base of 13.2trillion at end-June'2015. Overall health of the banking industry is considered strong as indicated by an industry CAR of 15.7% and an overall strong liquidity profile for most banks, though individual banks depict varying profiles, with some of the larger institutions having further built on to their financial strength while there are other banks having comparatively weaker risk profiles. Lending strategy of banks remains conservative subsequent to experiencing high delinquencies in the 2008-10 period. Moreover, high returns on government securities ensured that profitability remained strong without exposing the balance sheet to credit risk. On a timeline basis, the industry's Advances to Deposits Ratio (ADR)has trended down from its peak of 75% in 2008 to 48% as of end-2014.While monetary easing in response to improved macro-economic indicators is targeted to incentivize private sector credit off take, this has yet to materialize; private sector credit has increased by just 5.5% between July 2014-March 2015, vis-à-vis 10.0% in the corresponding period of the prior year. Lower growth in financing is attributable to fall in oil and other commodity prices during the period.

JCR-VIS has gathered from several meetings with JCR-VIS rated clients, that in lieu of the decline in interest rates, most banks plan to grow in high margin segments such as consumer/SME, going forward. Growth in high margin segments may

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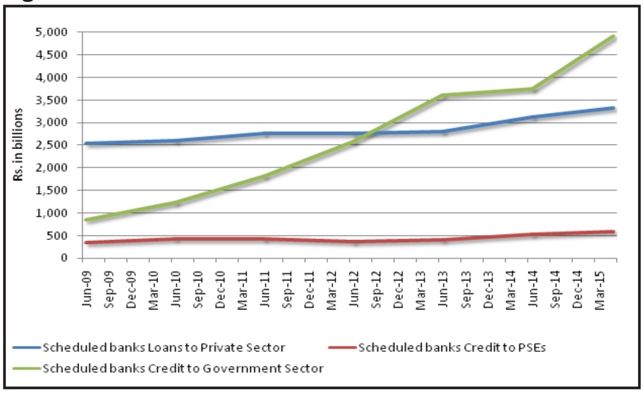
[1] *In terms od assets*

Figure 1: Credit Offtake Trend



result in weakening in risk profile of banks. As necessitated by infrastructure needs, growth in energy sector financing is also anticipated.

Asset quality indicators of the sector have showcased gradual improvement in recent years, subsequent to gross infection touching a peak of 15.3% in 2011, as pace of fresh accretion of NPLs tapered off by 2012 and there has been a decline in gross NPLs in the last two years. Given the high provisioning coverage of 82.7% at end-June'2015, the impact of past NPLs has largely been absorbed. The industry's net infection at end-June'2015 was manageable at 2.3%.

For investors, the banking industry remains an attractive avenue with net return on equity standing at 16.2% in 2014. In the backdrop of declining trend in inflation, most banking institutions preemptively opted to increase their participation in the long-term Government of Pakistan bonds resulting in an aggregate PIB subscription of Rs. 1,915b during 2014. Volumetric growth in earning assets, improved interest income from high yielding PIBs, higher capital gains in addition to relatively lower provisioning charges (Two banks had undertaken significant provisions in 2013), translated in a 47% growth in earnings of the banking sector in 2014.

Developments

In November 2014, the State Bank of Pakistan (SBP) imposed a moratorium on KASB Bank Limited resulting in a technical default with all deposits in excess of Rs. 300,000 being locked in for a period of 6 months. Adverse impact as a direct result of the moratorium was experienced by smaller sized banks which witnessed major attrition in deposits just prior to year-end.

In the backdrop of lower inflation, discount rates have also witnessed a declining trend from a high of 10% in November 2014 to 6.5% as of September 2015. This is expected to result in pressure on spreads of the banking sector. However, this is also expected to result in sizeable revaluation surplus and capital gains for banks on their PIB portfolios. Recently in May 2015, the SBP also undertook an initiative to restructure the interest rate corridor, and introducea target rate, in an effort to reduce the volatility of overnight repo rate. This resulted in a narrowing of the interest rate corridor to 250bpts vis-à-vis 300 bpts previously. The return on saving deposits previously had been linked to the repo rate. In view of the recent adjustment in the interest rate corridor, the downward adjustment in cost of saving deposits was less than the re-pricing of loans.

We expect that most banking institutions, that have significant exposure in PIBs in relation to their deposit base, would be able to whether the impact of ongoing spread compression on their profitability until these PIBs mature; majority of the PIBs with commercial banks have a maturity profile of 3 years ending over 2016-17.

Industry Classification

Although the overall industry statistics depict a healthy profile, the industry features considerable stratification as about 64% of the deposits are held by 7 banks, of which 2 of the largest banks alone hold 28% of total deposits. Besides theselarge banks, the industry is composed of a few medium sized banks and several small sized banks. Given that risk profile of banks within different classifications varies widely, we have accordingly split our industry analysis on the basis of market share in deposits.Median statistics for each segment are presented in Appendix A.

Very-Large Banks (Banks with Market Share >10%)

This group comprises just 2 banks that cumulatively hold about 28% of the banking industry deposits, having significant systemic importance. Risk profile of these institutions varies with National Bank of Pakistan (NBP) being a state owned bank and in addition to commercial banking activities, also acts as an agent to the SBPand handles all treasury transactions for the Government of Pakistan whilst Habib Bank Limited (HBL) isthe largest commercial bank in Pakistan, also having international outreach that contributes about 10% of its pre-tax profits.

During 2014, in line with the slow credit-offtake in the economy, fresh lending remained limited with a reduction in asset allocation to advances for both banks. Exposure to advances comprises a higher proportion of asset base for NBP as compared to HBL. Moreover, portfolio composition features a relatively higher exposure to public sector companies with almost one-fourth of public sector lending by NBP alone. Asset quality indicators, on gross basis, are weaker in comparison to large sized banks (discussed below). However given that provisioning in this regard has largely been undertaken, net infection of HBL and NBP at 1.8% and 3.6% respectively, is considered manageable. In comparison to HBL and other large sized banks in the industry, infection within NBP's portfolio is on the higher side.

Cumulative market share, in terms of deposits,of these 2 banks has trended down in the outgoing year to 27.9% from 28.6% previously, as HBL's market share declined by 0.7% while NBP's market share depicted a marginal uptick. Albeit, deposit mix has showcased improvement in 2014, which was more pronounced in case of HBL that had 'Current & Saving Account' (CASA) proportion of 80% as of end-2014 and improved granularity in deposits. Liquidity profile of both institutions is considered strong, which in addition to a sizeable stock of liquid assets on books, also draws strength from the strong market access.

Capitalization of these banks is considered robust as evident from mean CAR of 16.2%. However, NBP's tier-1 CAR is on the lower side in comparison to HBL and other larger sized banks. Moreover net NPLs as a proportion of tier-1 equity is also relatively high for NBP at 20% (2013: 25%) as against 7.4% for HBL and a median of 5.2% for other large 5 banks. Capitalization levels are expected to continue to improve on account of internal capital generation. Given that these banks are likely to qualify as Systemically Important Financial Institutions (SIFI), they may also attract additional capital charge under BASEL III.

In terms of profitability, HBL features one of the best efficiency ratios in the industry whilst efficiency of NBP compares adversely to the next 5 large banks in the industry. Moreover cost of deposits of NBP at 5.8% is also higher than large sized banks (top-5) that have an average cost of deposits of 4.7%. Going forward,core profitability (excluding capital gains) indicators of both HBL and NBPare expected to depict steady increase over the short-term. On a comparative basis, vis-à-vis other large banks, NBP and HBL have much lower allocation to PIBs in relation to their deposits, in view of which, the impact of spread compression is likely to emerge sooner, unless other factors such as cost of deposits and return on financings experiences any material change.

Large Banks (Banks with Market Share > 5%)

This group comprises 5 banks, of which 3 are ex-public sector commercial banks (PSCB) that have been privatized, whilst the other 2 are private sector banks set up in the early 1990s. Financial indicators of this group are healthy across the board with sound liquidity, capitalization and asset quality indicators.

Median asset allocation to advances for this group stands at 36.3%with no apparent outlier. The group's asset quality indicators are sound, with median gross infection of 6.8%. Median net infection of the group stands at 1.2% which is the lowest among all groups.

The group features considerably high liquidity levels on account of a median asset allocation to investment portfolio being 50.9%. Given that major proportions of these portfolios represent exposure to Government of Pakistan backed instruments, the median liquid asset coverage of deposits and borrowings stands at 68.0%.

Deposit market share of this group has largely been maintained (2014: 36.4%; 2013: 36.3%). As competition in the market becomes increasingly intense, with several small& medium sized banks undertaking branch expansion, some dilution in market share may be expected. Of the entire group, Bank Al-Habib Limited and Bank Alfalah Limitedfeature the highest deposits per branch which stands in excess of Rs. 900m. Median Advances to Deposits Ratio (ADR) for large banks stood at 45.8% (2013: 43.9%). An uptick in ADR is expected in line with higher forecasts of GDP growth and the ongoing monetary easing.

Most banks in this segment are well-capitalized as reflected by a median CAR of 14.9% with Bank Alfalah Limited featuring the lowest CAR of 12.8%.Net NPLs as a % of tier-1 equity (NPT) is low albeit, outliers include Bank Alfalah Limited with NPT ratio of 15.1% against a group median of 5.2%.

In terms of profitability, this group has been faring relatively well on account of low cost of deposits and the presence of resources to capitalize on the declining interest rate scenario. We expect impact of spreadcompression due to decline in interest rates will be somewhat delayed on this segment as a major proportion of assets are invested in PIBs. Within the segment, banks like MCB, ABL and UBL are relatively well positioned to absorb the impact of declining interest rates.

	HBL	NBP	UBL	MCB	ABL	BAFL	BAHL	Group Median
PIBs as a % of deposits	21.0%	24.8%	34.9%	47.8%	39.5%	30.3%	34.1%	34.1%

In terms of cost of deposits, the group has the lowest median of 4.8%. Median efficiency indicator of the segment has receded on account of higher net mark-up margin and growth in fee related income. In absolute terms, the segment's profitability grew by 13%. Banks in the very largeand large group are well positioned to take advantage of growth opportunities that may come with expected Chinese investment in the country while we may also witness enhanced lending in high yielding segments.

Medium-sized Banks (Banks with Market Share > 2% &<5%)

This group comprises 6 banks. Financial risk profile of banks within this group varies widely. Although largely profitability and liquidity indicators of this group are considered strong, overall capitalization level warrants some enhancement in the backdrop of BASEL III implementation.

Asset base of these banks varies from Rs. 300b-500b. Apart from Faysal Bank Limited, the group's asset allocation strategy is similar to large sized banks with median asset allocation towards advances being 39.2%. In 2014, all these banks, except Meezan Bank Limited, posted lower ADRs. In the absence of any fresh issuance of GoPIjarah Sukuk, the more established players in the Islamic banking segment enhanced their lending portfolios as deposits continued to grow.

Asset quality indicators of the group varies significantly with Bank of Punjab having the highest gross infection of 28.2% while Meezan Bank Limited had the lowest gross infection of 3.8%. On gross basis, this group had amedian infection ratio of 14.9%. With the exception of Bank of Punjab, provisioning coverage is high and accordingly median net infection is low at 2.4%. Asset quality indicators of the group are considered good with impact of past provisioning having largely been absorbed. However, the outlier i.e. Bank of Punjab with a net infection of 17.0% will continue to experience a drag on profitability as it provides for NPLs. Lending portfolios largely include exposure to the private sector.

Overall liquidity of this group is also considered adequate with median liquid asset coverage of deposits being 59.9%. Overall deposit market share of this group has increased to 23.6% vis-à-vis 22.9% previously. We expect to witness continued expansion in network by most banks in this peer group.

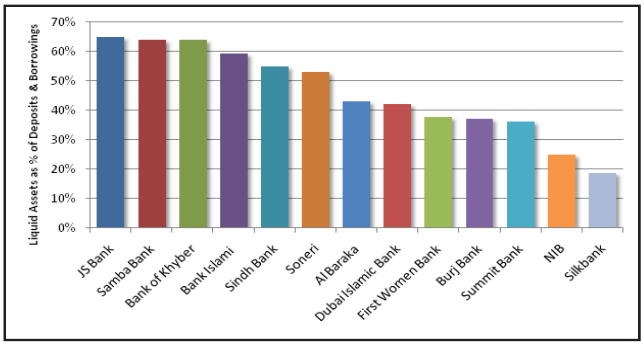
Banks within this group have also witnessed some pressure on capitalization over the last few years.However, with improvement in profitability and decline in ADR, median CAR of the group has trended upwards from 11.8% to 12.6%. Within the group, banks like Standard Chartered Bank Limited and Habib Metropolitan Bank Limited fare relatively well with CAR of 18.9% and 17.3%, respectively. On the other hand, CAR of Bank of Punjab is considerably below the group median at 10.2%. Overall NPT ratio of the group has reduced substantially in the outgoing year to 15.1% from 20.5%. Outliers include Bank of Punjab and Faysal Bank Limited with NPT ratios of 188.4% and 28.8%, respectively.

In absolute terms, post-tax earnings of this group jumped by 12% (excluding Askari Bank Limited that posted a major loss in 2013 on account of provisioning). Two banks within the group have cost of deposits considerably lower than the group median of 6.1%, including Standard Chartered and Meezan Bank Limited. Efficiency ratio of all banks has showcased improvement and accordingly median efficiency of the group has improved from 70.5% to 61.8%.

Small-sized Banks (Banks with Market Share < 2%)

This group includes 13 banks in total with significant variation in their risk profiles, with some of these being relatively new entrants in the market. Most of the banks in this peer group have faced challenges in meeting the enhanced minimum capital requirements stipulated under the local banking regulations. With the onset of BASEL III, pressures on asset quality and compression in spreads, the operating environment for banks with weak financial risk profile has become more challenging.

Asset allocation strategy of the group in general has been relatively aggressive with a median asset allocation towards advances being 44.8%. Unlike medium sized banks which posted a sizable dip in ADR, overall ADR of this group trended up in 2014 and stood at the highest among all groups.This can be attributed to deposit attrition experienced by banks in this group in the out-going year.



Overall deposit market share for this group fell marginally in 2014 from 12.2% to 12.1%. However banks with stressed capitalization levels, experienced major deposit attrition; these included Burj Bank Limited and First Women Bank Limited that posted a decline of 39.6% and 26.7%,respectively. Liquidity profile of the group varies widely with median liquid asset coverage of deposits standing at 43.8%, trending down from 54.8%. Outliers include NIB Bank Limited and Silk Bank Limited.

With a numberof banks having already undertaken capital enhancement measures, there may be an improvement in the risk profile of this group.Although median CAR of the group and NPT ratio have improved on a timeline basis to 17.0% (2013: 14.6%) and 12.1% (2013: 21.1%), respectively, several outliers still exist. A number of banks in this group are still non-compliant with SBP specified Minimum Capital Requirement and CARregulatory requirement. Given that profitability of this group has remained weak, in some cases, existing sponsors have shown reluctance for equity injection. Few banks in this group may witness mergers and acquisitions to allow them to comply with regulatory requirement.

Asset quality indicators of this group have showcased improvement on a timeline basis with median gross infection reducing to 9% (2013: 10.1%). On net basis, median infection for the group has also reduced substantially from 4.0% to 2.9%. Outlier includes NIB Bank Limited having net infection of 5.5%.

On an aggregate basis the group reported a loss in excess of Rs. 1b in 2013 which has reversed in 2014 with a cumulative profit of Rs. 3.7b. The group still faces challenges in meeting administrative overheads as indicated by an efficiency ratio of 88.5%. Banks with efficiency ratios relatively better than group median include Bank of Khyber (58.9%), Soneri Bank Limited (68.3%), Sindh Bank Limited (70.9%) and JS Bank Limited (77.5%). Excluding impact of one-time capital gain, profitability outlook for this group largely remains weak on account of FSV expiration and reduction in mark-up income.

Appendix A: Median Statistics for each Market Segment

	Very-Large Banks		Large Sized Banks		Medium Sized Banks		Small Sized Banks	
	2014	2013	2014	2013	2014	2013	2014	2013
Asset Base	1,656	1,489	842	734	415	354	103	88
Advances as a % of Assets	36.0%	38.8%	36.3%	36.4%	39.2%	41.6%	44.8%	44.3%
Investments as a % of Assets	43.6%	39.2%	50.9%	49.5%	43.2%	39.6%	31.0%	34.4%
Deposits	1,340	1,209	668	608	331	293	84	75
ADR	44.6%	47.8%	45.8%	43.9%	45.1%	50.0%	65.0%	52.5%
Gross Infection	13.9%	14.1%	6.8%	6.8%	14.9%	14.6%	9.0%	10.1%
Net Infection	2.7%	3.0%	1.2%	1.5%	2.4%	2.8%	2.9%	4.0%
Liquid Assets to Deposits Ratio	63.5%	59.9%	68.0%	66.8%	59.9%	57.5%	43.8%	54.8%
CAR	16.2%	14.8%	14.9%	14.3%	12.6%	11.8%	17.0%	14.6%
Tier - I CAR	12.6%	11.9%	10.9%	10.8%	10.7%	10.6%	12.6%	14.2%
Net NPLs to Tier - 1 equity	13.7%	16.5%	5.2%	3.9%	15.1%	20.5%	12.1%	21.1%
Efficiency	54.4%	57.6%	47.8%	53.9%	61.8%	70.5%	88.5%	91.7%
Cost of Deposits	5.1%	5.1%	4.8%	4.6%	6.1%	6.1%	7.6%	6.7%

Very-Large Banks	Large Sized Banks	Medium Sized Banks	Small Sized Banks
Habib Bank Limited	Allied Bank Limited	Askari Bank Limited	Al Baraka Islamic Bank Pakistan Limited
National Bank of Pakistan	Bank Al-Falah Limited	Bank of Punjab	Bank of Khyber
	Bank Al-Habib Limited	Faysal Bank Limited	Bank Islami Limited
	MCB Bank Limited	Habib Metropolitan Bank Limited	Burj Bank Limited
	United Bank Limited	Meezan Bank Limited	Dubai Islamic Bank Limited
		Standard Chartered Bank Pakistan Limited	First Women Bank Limited
			JS Bank Limited
			NIB Bank Limited
			Samba Bank Limited
			Silk Bank Limited
			Sindh Bank Limited
			Soneri Bank Limited
			Summit Bank Limited