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Banking sector manages to grow by decent pace in H1CY20: SBP

KARACHI: The State Bank of Pakistan (SBP) Wednesday said the performance of the banking sector in second half (July-Dec) of this calendar year (CY20) depends upon the trajectory of COVID-19, economic recovery, and the evolving policy environment. The SBP has issued the Mid-Year Performance Review (MPR) of the Banking Sector for the year 2020. The review comprehensively covers the performance and soundness of the banking sector for the period January to June 2020 (H1CY20).

According to performance review, despite challenging economic conditions in the wake of COVID-19 outbreak, the banking sector's performance remained satisfactory and it managed to grow by a decent pace of 7.8 percent during the first half of this fiscal year (H1CY20).

However, SBP mentioned that the ongoing Coviod-19 Pandemic is still a challenge for the economy and profitability of the banking sector may come under stress due to low interest rate.

"While financial conditions in the form of interest rates and asset prices remained supportive, the recent uptrend in virus infections presents a challenging scenario and profitability of the banking sector may come under stress in the next half (July-Dec) of the year, mainly due to low interest rate environment," it added.

At the same time revaluation gains on government securities, if realized, may offset the impact to a certain extent and the rise in zero risk weighted Government securities will likely strengthen Capital Adequacy Ratio of the banking sector.

According to the SBP, globally the situation also remains uncertain, especially in key trading economies such as the United States, Euro Area, and the Middle East and in this backdrop, the outlook for the private sector advances presents a mixed picture.

The LSM index has increased by 3.66 percent (on a year-on-year basis) during July-August, 2020. Further, seasonal uptick during H2CY20 may stimulate demand. However, the downside risks remain due to the possibility of another wave of the disease that may trigger re-imposition of strict lockdowns.

Similarly, looming uncertainty about the timing of recovery in the foreign markets could subdue demand from export oriented sectors such as Textiles. Besides demand for credit, in case of crystallization of downside risks, the repayment capacity of the borrowers could weaken that may lead to further rise in NPLs in the second half of this year.

The SBP estimated that banks' investments are likely to remain strong during the second half of CY20. The pandemic related uncertainties would take time to subside, hence banks' risk averse behavior may keep lending flows subdued. Consequently, government securities may remain a preferable alternative.

Like elsewhere, the incidence of COVID-19 is rising in Pakistan. As such banks need to keep a close watch on the associated developments and assess the implications of how this re-escalation of pandemic could affect their asset quality and solvency.

According to performance review, the first half of CY20 witnessed the Global Health Crisis (GHC) triggered by the COVID-19 outbreak and in Pakistan's, country-wide lockdowns and social distancing restrictions started coming into effect from March 2020.

Similarly, the financial markets that remained turbulent during the initial phase of the outbreak have regained optimism and the fall in business confidence seems to have bottomed out. However, the mitigating measures taken by the Federal and Provincial Governments as well as the State Bank provided support to the economy and the financial sector.

The banking sector, both Conventional and Islamic, managed to grow by focusing mostly on risk-free earning assets. The asset base expanded by 7.8 percent to Rs 23.7 trillion during H1CY20 compared to 5.3 percent in H1CY19 due to acceleration in investments by 22.8 percent or Rs 2 trillion.

The strong 9.8 percent growth in deposits as against 6.8 percent last year, provided the necessary funding support. It was the highest acceleration since H1CY0715. The compositional analysis indicates that Savings and Current Account (Non-Remunerative) deposits together explain 90 percent rise in total deposits during H1CY20.

The surge in deposits provided the necessary funding support to finance the robust rise in investments. Advances, however, observed a mild contraction during H1CY20, mainly due to the slackness triggered by countrywide lockdowns and social distancing restrictions to contain the pandemic. The advances (net), however, contracted by 2.2 percent to Rs 8 trillion. The asset quality, however, observed some deterioration due to increase in stock of classified loans.

The reduction in private sector advances was broad-based; though financing to textiles, cement, and sugar sectors increased during the first half of CY20. Sans SBP supportive measures, the contraction in advances could have been much deeper.

The contraction in advances during H1CY19 was a manifestation of economic stress prevailing due to COVID-19. The uncertainty created by the pandemic and the ensuing lockdowns dented the business confidence leading to fall in demand for loanable funds. As a result, advances contribution in asset flows, which averaged around 44 percent since 2016, turned negative for the first time in the last 7 years.

In case of Private Sector Advances (PSA), the contraction amounted to Rs 150.1 billion (or 2.4 percent). However, considering that SBP had taken timely policy measures to contain the risks associated with COVID-19, this contraction could have been much deeper otherwise. The decline in PSA was primarily a manifestation of weak demand as countrywide lockdown resulted in business closures, restricted mobility and muted economic activity.

The MPR mentioned that the policy measures rolled out by the SBP enabled the banks to enhance profitability, improve resilience and limit the credit risk. The earnings marked visible improvement as profitability jumped by 52 percent on YoY basis. This improvement resulted from higher interest income, deceleration in interest expenses and rise in non-interest income.

With better profitability, the soundness of the banking sector further strengthened as Capital Adequacy Ratio (CAR) increased to 18.7 percent in June-20 from 17.0 percent in December-19.

The SBP conducted the 6th wave of the Systemic Risk Survey in August-2020. The survey results indicate that respondents perceive key risks for the financial system to be mostly exogenous and global in nature. The survey results indicate that at present and for the next six months the respondents consider global risks and domestic macroeconomic risks to be important.

"Importantly, the policy measures rolled out by SBP to mitigate the implications of COVID-19 have been very well received by the stakeholders. Regarding the incidence of COVID-19 in Pakistan, survey participants expect its impact on the financial sector to wither away as the time lapses. However, banks need to remain vigilant against the re-escalation of a pandemic that could implicate the asset quality and solvency of the banking sector," the SBP said.

The review also highlighted that the SBP's policy measures facilitated the banking sector in conserving the capital, enhancing the lending capacity and increasing the loss absorption ability. As a result, despite some increase in credit risk, the banking sector demonstrated improved profitability and enhanced resilience.

Asset Quality, however, deteriorated during H1CY20 retracting from the marginal gains witnessed in H2CY19. The Non-performing loans (NPLs) ratio (Gross Non-Performing Loans - NPLs to Gross Total Loans) increased to 9.7 percent by the end of H1CY20 against 8.8 percent and 8.6 percent by the end of H1CY19 and H2CY19, respectively. However, net NPLs to loans ratio, which is a better measure of credit risk, increased only marginally from 1.7 percent to 1.9 percent.

Investments of the banking sector amid weaker demand for advances and abundant liquidity surged by Rs 2 trillion during the first half of CY20. Investments in Government securities explain more than 90 percent (Rs 1.9 trillion) rise in investment flows during the reviewed period. Also, banks invested in TFCs/Debentures to the tune of Rs 130.9 billion during H1CY20.

Profitability of the banking system rose significantly with profit after tax at Rs 125.8 billion for H1CY20, a rise of 52 percent over the same period last year. This was the highest level of earnings ever recorded in any H1 since the availability of data from H1CY04.

The review mentioned that the favorable interest rate environment facilitated higher net interest income (NII) and larger gains on sale of government securities. Besides, the SBP's measures to contain the credit risk also contributed.