Faysal AssetManagement

Banking Sector- Lower Yields on Govt. Investments Drag Profits

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The provisional numbers reported by banks show that banking sector profitability declined to Rs.137.8 billion in Jul-Mar FY17 from Rs. 231.7 billion during previous year.

Table 4.9:Absolute Change in Government Domestic Debt
billion Rupees

	FY16	FY17	FY17		
	Jul-March		Q1	Q2	Q3
Government domestic debt	**1,205.5**	**1,120.1**	**759.8**	**-193.2**	**553.5**
Permanent debt	754.2	-561.8	-746.2	26.0	158.4
Of which					
PIBs	622.6	-644.9	-780.9	0.0	136.0
Prize bond	94.1	83.1	34.8	26.0	22.4
Floating debt	354.9	1,599.9	1,480.0	-243.9	363.8
Of which					
MTBs	540.6	1,077.9	568.1	62.8	447.0
MRTBs	-219.2	734.6	911.9	-94.1	-83.2
Unfunded debt	96.2	82.0	26.0	24.6	31.3
Foreign currency loans	0.1	0.0	0.0	0.0	0.0

Table 3.1: Changes in Monetary Aggregates
flows in billion Rupees

	Q3		Jul-Mar	
	FY16	FY17	FY16	FY17
Reserve money	99.3	50.3	433.6	314.3
Broad money (M2)	197.9	110.2	677.6	756.1
A. Net foreign assets	-66.7	-264.2	83.8	-284.8
SBP	-38.3	-189.7	141.4	-155.2
Scheduled banks	-28.5	-74.5	-57.6	-129.7
B. Net domestic assets	264.6	374.4	593.8	1,040.9
Budgetary borrowing*	354.8	287.6	538.0	694.7
SBP	-96.3	-100.5	-525.5	792.2
Scheduled banks	451.1	388.0	1,063.5	-97.5
Credit to private sector	27.7	77.9	323.4	438.6
Credit to PSEs	11.1	114.0	11.7	197.0
Other items (net)	-60.9	-24.6	-178.1	-166.9

*On cash basis
Data source: State Bank of Pakistan

The banking industry`s profits dropped 40% to Rs.137.8 billion during the nine months to March as yields on government bonds, heavily relied on by banks as they are risk-free, remained low.

Moreover, the direct tax collection grew 10.2% during the July-March period compared to a growth of 15.4% a year earlier.

The slowdown can be traced to a reduction in the corporate tax rate amid slower pace of increase in corporate profitability.

Banks` interest in government securities, as evident from the bidding pattern in recent auctions, also revived during the quarter to March. However, the offer-to-target ratio was much higher for treasury bills than for Pakistan Investment Bonds (PIBs), according to the State Bank of Pakistan`s (SBP) third quarterly report.

Against a target of Rs.2.5 trillion, commercial banks offered Rs.4.3tr for Treasury bill auctions held during the third quarter.

Most of offers were for three-month and six-month tenors. The government accepted significantly higher amount compared to the target to facilitate the retirement of maturing PIBs in the quarter.

Besides, there was a shift in government borrowing away from the SBP during the second and third quarters of the outgoing fiscal year. The government retired Rs.177.3bn to the central bank during the two quarters after borrowing heavily from the SBP in the first quarter. This retirement was made possible through a drawdown of government deposits held with the SBP and increased borrowing from commercial banks.

PIB auctions depicted a relatively different picture in the January-March quarter. As a whole, the government did not meet pre-auction targets as banks were bidding for higher rates. With these developments, the composition of Pakistan`s domestic debt saw a shift, i.e. a significant substitution of long term debt with short-term debt.

With an increase of Rs.1.6tr in July-March, the share of floating debt rose to 44.8% by end-March from 36.7% by end-June 2016.

While short-term borrowings helped curtail the servicing cost, they worsened the maturity problem and increased the government exposure to rollover and repricing risks.

For instance, the debt re-fixing in one year increased to 53.6% in December 2016 from 47.7% in June 2015, the SBP report said, adding that the average time to maturity fell to 2.1 years in December 2016 from 2.3 years in June 2015.

In terms of ownership, although a part of government securities shifted to non-bank financial institutions through secondary market trading, around 80% of the government securities are still held by the commercial banks.

Like commercial banks, nonbanks also substituted their investment from PIBs to treasury bills during the first quarter of 2016-17. However, increased investment in both types of bonds represented fresh investment during second and third quarters.

Banking spread decreased by 29 bps during Jul-Mar FY17. Advances by commercial banks, on the other hand, recorded a substantial increase

The decision to continue with the low policy rate regime helped maintaining the growth momentum in private sector credit, which had gathered tremendous pace from Q2-FY17 onwards. This policy support became crucial because a large part of recent bank lending appears to be financing firms' capital expenditures. In Jul Mar FY17 also, 42% of the total increase in businesses' credit came from fixed investment loans.

Compared to the preceding quarter, liquidity conditions in the interbank market were somewhat tight in Q3-FY17. This was linked directly to an alteration in t government's pattern of budgetary borrowing: rather than primarily borrowing from SBP and retiring its debt to scheduled banks (as it had been doing during HFY17), the government opted to borrow from scheduled banks during the quarter.

As a result, the overnight rates remained 8 basis points above the policy rate on average during Q3, compared to around 2 basis points in the previous quarter. Commercial banks' recourse to SBP's reverse repo facility was also more frequent.

Figure 4.7: Holdings of MTBs and PIBs

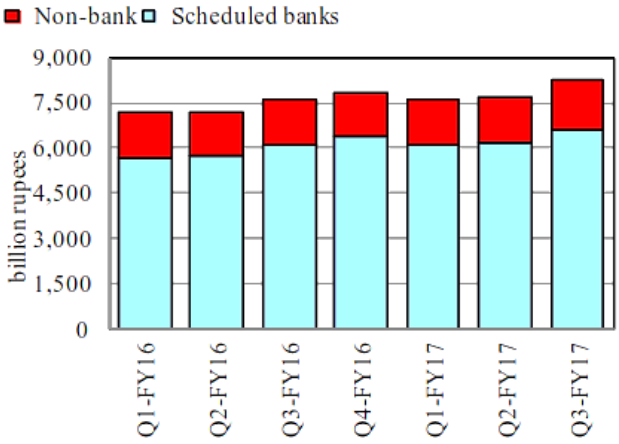


Table 4.10: PIB and T-bills Auction Profile*

billion Rupees

	Target	Offer	Accepted	Maturity**
Q1-FY17				
T-bills	1,450.0	3,066.0	1,680.4	1,178.0
PIBs	300	995.4	678.5	1683.9
Total	**1,750.0**	**4,061.2**	**2,358.9**	**2,861.9**
Q2-FY17				
T-bills	1,300.0	1710.6	1,048.4	1,058.4
PIBs	200	234.7	0.0	35.5
Total	**1,500.0**	**1,945.2**	**1,048.4**	**1,093.9**
Q3-FY17				
T-bills	2,550.0	4,319.8	2,888.8	2,522.2
PIBs	150.0	323.6	132.4	207.6
Total	**2,700.0**	**4,643.4**	**3,021.2**	**2,729.8**
Grand total Jul-Mar-FY17	**5,950.0**	**10,649.8**	**6,428.5**	**6,685.6**

* Face value and competitive bids only; ** Principal plus coupon payments for PIBs

Reverting back to government borrowings, banks participated actively in all the T-bill auctions that were held during the quarter. In the seven T-bill auctions during the Third quarter, scheduled banks placed bids in excess of the auction targets (Figure 3.2a).

Figure 3.2a: Auction Profile of T-bills

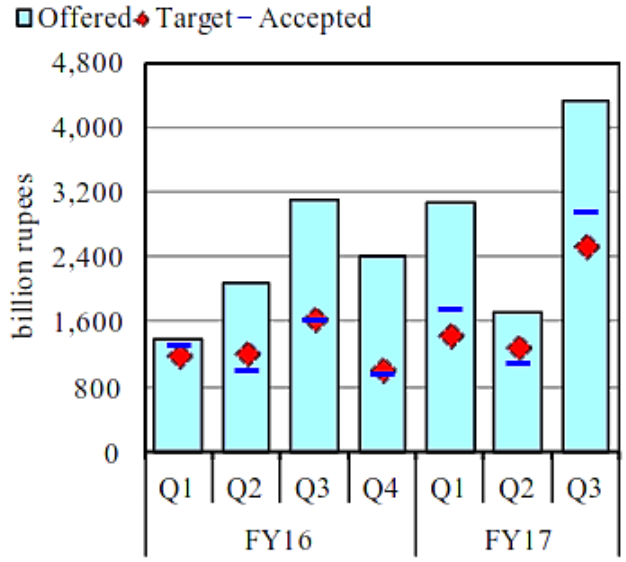
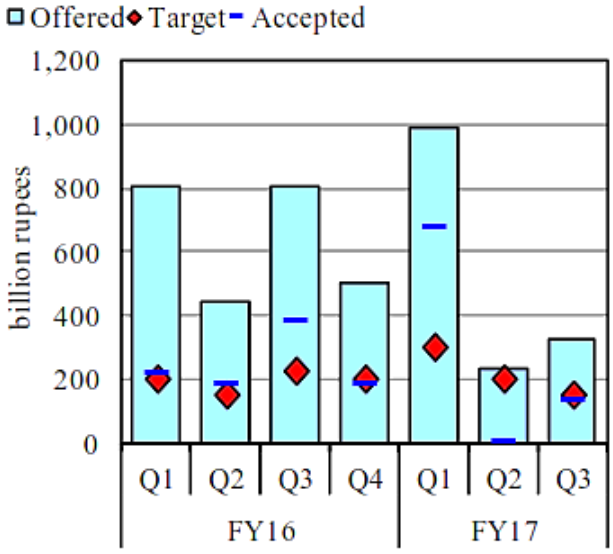


Figure 3.2b: Auction Profile of PIBs



Government duly raised a combined amount of Rs. 441.3 billion (net of maturity) from the auctions. From scheduled banks' perspective, there was a clear preference for shorter tenor T-bills (3- and 6-month), indicating their anticipation that interest rates had bottomed out.

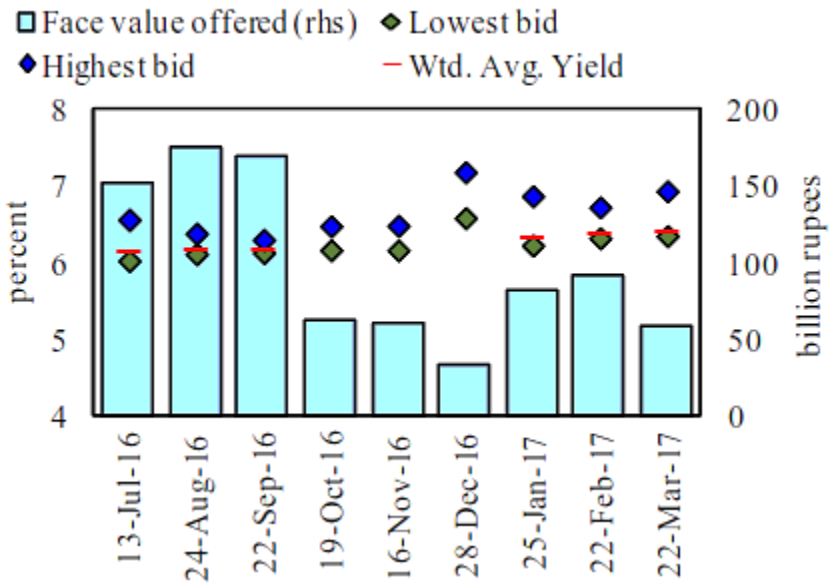
This anticipation was also reflected in PIB auctions, where banks' participation was relatively muted as compared to T-bills.

However, unlike the auction outcome of December 2016, when banks had bid for a very small amount at excessively high rates, all the three auctions in Q3-FY17 were successful (Figure 3.2b).

Not only did banks increase the offered amounts (especially in the auctions held in January and February), but the rate at which they bid at, was also fairly reasonable vis-à-vis previous cut-off yields (Figure 3.3).

Overall, the government raised (net of maturity) Rs. 132.4 billion from PIBs during Q3-FY17, against the target of Rs. 150.0 billion. This was a markedly different outcome from the scrapped auctions of the previous quarter.

Figure 3.3: Bidding Pattern for 3-Year PIBs



Banks generated deposits worth Rs. 604.9 billion during Jul-Mar FY17 – the highest level since FY10 – compared to significantly lower mobilization of Rs. 217.5 billion in the same period last year.

This argument is based on discussions with commercial bankers regarding investment avenues and returns, as well as the decline in net NPL to net loans from 2.8% in March 2015 to 1.6% by March 2017.

Unlike the case of conventional banks, there is a dearth of investment avenues for Islamic banks and IBBs, compounded by infrequent government auctions of Ijarah Sukuk. Thus, IBs and IBBs are aggressively competing with their conventional counterparts in the credit market.

- Deposits and other accounts of scheduled banks stood at Rs. 11,421.34bn till June 16.
    - Deposits and other accounts of all commercial banks stood at Rs.11,347.13bn.
    - Deposits and other accounts of specialized banks stood at Rs.74.21bn.
- Total assets of all scheduled banks stood at Rs.16,025.97bn.
    - Total assets of commercial banks stood at Rs. 15,769.45bn, , while total assets of specialized banks at Rs.256.52bn.
- Gross advances of scheduled banks stood at Rs.6,009.88bn.
    - Advances by all commercial banks increased to Rs.5,840.76bn from Rs5,812.84bn, whereas advances of specialized banks stood at Rs.169.11bn.

- Borrowings by all scheduled banks rose to Rs.2,389.78bn.
    - Borrowings by commercial banks stood at Rs. 2,354.08bn. Borrowings by specialized banks stood at Rs.35.70bn.
- Investments of all scheduled banks stood at Rs.7,928.50bn.
    - Investments by commercial banks stood at Rs. 7,869.13bn, whereas investment by specialized banks stood at Rs. 59.37bn.
- Cash and balances with treasury banks of scheduled banks increased to Rs. 976.08bn.
    - Cash and balances of commercial banks stood at Rs.972.49bn. Cash and balances of specialized banks were at Rs. 3.59bn.
- Notes in circulation stood at Rs. 4,041.09bn as at June 16, according to the State Bank of Pakistan.
- Approved foreign exchange increased in the week under review stood at Rs. 719.08bn.

Thus, banking sector's growth momentum is likely to be supplemented by favorable macroeconomic conditions that should partially offset the impact of lower interest rates.

Furthermore, asset quality is steadily improving (infection ratio 9.9% in 1QCY17) and has lowered the risks to the banking sector equity.

We have 'Overweight' stance on the banking sector, however we emphasize bottom-up stock picking is essential given 'Risk is back on the table'.

We believe trade premium should be given to banks that made a pragmatic shift in expanding their loan book. Our preference is for MSCI plays HBL, MCB and UBL in the top-tier and BAFL, in Mid-tier.