

BANKS UPDATE

Liquidity management: A priority amidst uncertainty

Narrowing gap between liquidity required and liquidity maintained

A clear signal reflecting the emergent threat was the rapid deterioration in excess liquidity maintained by banks against the reserve requirements of the SBP; banking sector excess liquidity is suspected to have dipped to less than 2% above the reserve required from more than 13% excess a year earlier.

SBP slashes reserve requirements adding PKR 250bn to market liquidity

The SBP has cut the CRR requirement by 400bps to 5% of DTLs of less than 1yr in a phased manner adding more than PKR 120bn of liquidity to the interbank market. In addition SLR requirements of 19% would now only apply to DTLs of less than 1yr whereas earlier it applied to the entire stock of DTLs; adding a further PKR 125bn to the system. The central bank also announced a cap of 70% on the ADR while banks above the limit have 6mo till Mar09 to adhere to this requirement.

Key beneficiaries to be HBL, NBP and ABL

Within the IGI Universe, the largest beneficiaries of the CRR cut will be HBL and NBP as they have the highest proportion of DTLs with less than 1yr maturity. Meanwhile UBL, MCB and ABL had DTLs less than 1yr in the range of 60-70%. ABL will be the key beneficiary followed by MCB and UBL with regards to the revised SLR; the regulatory change will free up estimated 20-30% DTLs from the reserve requirement.

Underweight stance on Pakistan banks

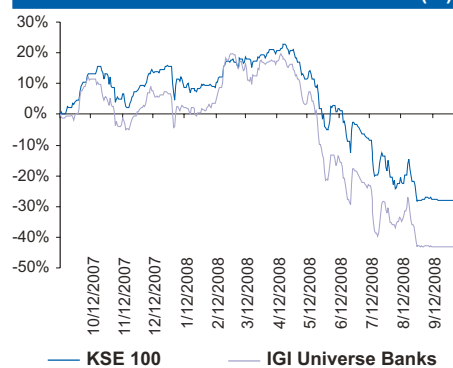
Macro headwinds, including sharp deceleration in GDP growth to the 3% range, concerns over rising NPLs, net interest margin contraction, slowing balance sheet growth and the system wide liquidity crunch are the key downside risks facing Pakistan banks. This will limit the earning potential in the near to medium term. Going forward, the dearth of upside value drivers underpins our 'Neutral to Underweight' stance on Pakistan banks.

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Relative Price Performance (%)



Source: Bloomberg

Daily Summary

Equities

	KSE100	Turnover All Shares (mn)	Market Cap All Shares (PKR bn)
17.10.08	9,184.24	0.19	2,840.22
16.10.08	9,184.24	1.31	2,840.62
Change	0.00	(1.12)	(0.40)

Forex (PKR/USD)

Bid	Offer	O/N	6-month
83.10	83.20	12.90	12.73

Money Market Repo (%)

CFS MK-II

	Total Value (PKR bn)	Average Rate (%)
17.10.08	11.89	59.46
16.10.08	12.09	50.28

Futures

	Net Open Interest (PKR bn)	Volume (mn share)
17.10.08	0.31	0.00
16.10.08	0.31	0.00

Commodity Prices

	Price	Change
WTI (USD/bbl)	71.85	2.00
Gold (USD/oz)	787.70	(16.80)

SCRA

	Balance (USD mn)	Net flow (USD mn)
17.10.08	(233.94)	(2.88)

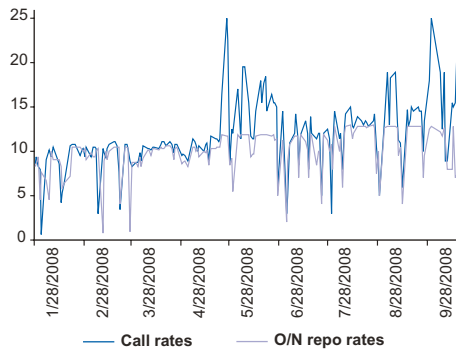
Source: KSE, SBP, BR & IGI Research



Liquidity management: A priority amidst uncertainty

As stated in our *Economics and Strategy Sep08* we expected liquidity risk to supersede inflation concerns in the following weeks. With inflation averaging 20% in FY09, real rates in the negative and the currency depreciating by nearly 22% in just 1Q FY09 the threat of capital flight had become a very real concern. The stock of DTLs Jun08 at PKR 3.7tn reflected a rapid decline; down PKR 147bn by Sep 27'08. Panic was pushing market rates into dangerous territory with O/N Call money rates soaring to 40% as banks and particularly NBFCs were short on meeting their financial obligations.

Money Market Rates



Source: SBP

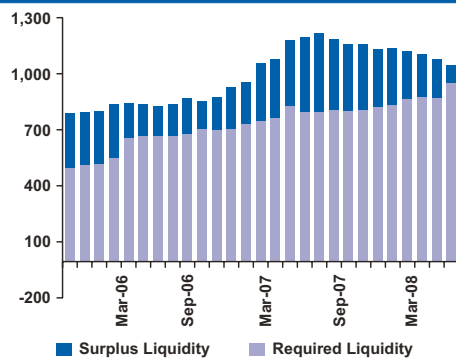
Narrowing gap between liquidity required and liquidity maintained

Key drivers of the drawdown on deposits were deteriorating disposable incomes, high demand for funds during the Eid holiday season and the increasing currency risk triggering dollarization. While the banking sector’s asset base grew in line with expectations by 6% in 1Q FY09, the deposit base saw a decline of 2%. The resultant gap was bridged by banks offloading their stock of government paper in excess of the SLR requirement which increased the banking sector’s refinancing risk and chances of default.

According to the SBP, the banking sector had been offloading their stock of securities in order to plug the gap between a growing asset base and declining deposits. In the last few weeks this reached a critical level with anecdotal evidence suggesting that the Assets to Deposits ratio (ADR) of some individual banks had reached 90% against 70-75% earlier. Short on eligible securities, several banks and NBFCs were resorting to the Call market to supplement liquidity pushing rates to unsustainable levels.

Surplus Liquidity

(PKR bn)



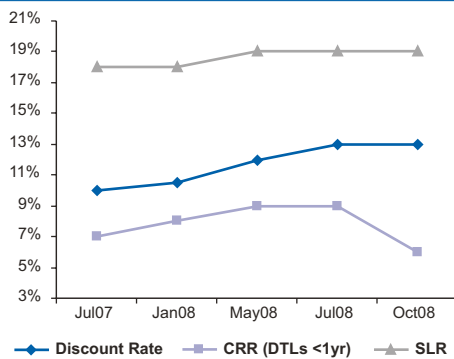
Source: SBP

SBP slashes reserve requirement to ease liquidity constraints

On Oct 13'08 the SBP cut the CRR requirement of 9% on DTLs of less than 1yr by 200bps in a phased manner. In addition the weight of PIBs and TFCs in the SLR requirement was increased to 10% from 5% earlier, making more T-Bills available for use in the Repo Market and easing pressure on the Call/Clean market rates. The use of Held to Maturity (HTM) stock of securities, in excess of the SLR requirement of 19% on all DTLs, was made permissible for the Repo market and Discount Window.

These measures attempted to pump in an estimated PKR 70bn worth of liquidity in the following weeks and eased both Call and Repo rates moving forward. OMO activity in the last month had injected over PKR 270bn of funds as of Oct 17'08. However liquidity pressures persisted and it was obvious more needed to be done.

Monetary Policy



Source: SBP

An overall PKR 250bn to be released into the market

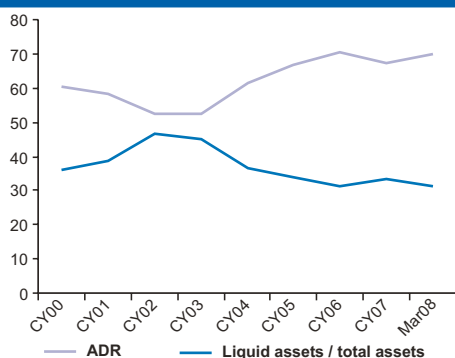
On Oct 18'08 the SBP announced a further cut in CRR to just 6% of DTLs of less than 1yr w.e.f from Oct 18'08 and thereafter to 5% of the same w.e.f from Nov 15'08. In addition SLR requirements of 19% would now only apply to DTLs of less than 1yr whereas earlier it applied to the entire stock of DTLs. The central bank also announced a cap of 70% on the ADR while banks above the limit have 6mo till Mar09 to adhere to this requirement.

Based on a DTL stock of PKR 3.3tn as of Sep 27'08 the cumulative CRR cut of 400bps by Nov 15'08 would release an overall PKR120bn into the system. The SLR exemption meanwhile on DTLs of more than 1yr would pump in additional liquidity of PKR 125bn; earlier the 19% reserve required on all DTLs was amounting to PKR 630bn.

Widening gap between Asset and Deposit base a worrying sign

According to our estimates by 1Q FY09 system-wide advances growth has picked up to 6% while total deposits have declined by 2% broadening the funding gap. Consequently, the system wide net ADR climbed to 75% as compared to 70% in Jun08. For individual banks the ratio may be particularly difficult to manage; anecdotal evidence indicates mid-tier banks had crossed the 90% ADR threshold in recent days. We feel the 70% cap on the ADR ratio is a good move for the time being and will compel banks to raise high cost deposits and shift focus on fee based income.

Liquidity Indicators



Source: SBP

The drawdown on deposits has been exacerbated by the loss of confidence in the sovereign credit rating and the PKR which depreciated by 40% since Jun07. Panic has permeated financial markets with depositors and investors alike hoarding cash and perpetuating a liquidity crisis.

Don't lose sight of inflation

From a monetary policy perspective we feel the SBP has had to make some very tough calls recently and will be prompted to maintain a two-pronged policy to manage both liquidity and inflation. Although the recent reserve cuts will release more than PKR 250bn worth of liquidity into a starved financial system, we do not feel it will adversely affect inflation which remains largely impacted by supply side constraints and the exogenous commodity price spiral. Nevertheless the central bank will continue to monitor inflation otherwise it risks persistent price pressures and possibly hyper-inflation.

In order to address inflation properly the SBP will need to win the confidence of depositors by raising returns in an environment where the real rate of return is negative by almost 7%. In order to develop credibility in the currency and prevent capital flight, base rates will have to provide a hedge against PKR depreciation of 22% in 1Q FY09 and inflation of 20% expected by Jun09. This is certainly a difficult task but unless external liquidity flows from debt, remittances and foreign direct investment can prop up the balance of payments position, policy makers will have to take some tough decisions to stabilize the financial system and the economy. If not the answer is obvious: with a negative real rate of return and a depreciating currency in hand, the rational depositor will sell all their PKR holding till the last unit of USD or other appreciating currency is available in the market.

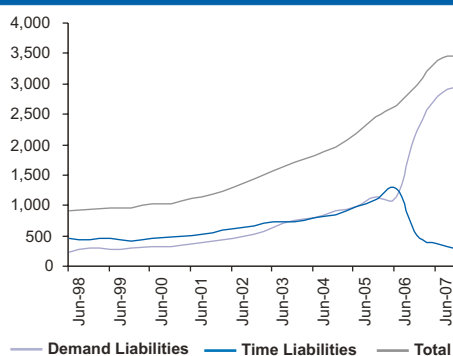
Largest beneficiary HBL and NBP

The cut in CRR (DTLs of less than 1yr) by a total of 400bps to 5% in a phased manner is likely to benefit large Tier-I banks. Within the IGI Universe, the key beneficiaries will be HBL and NBP as they have the highest proportion of DTLs with less than 1yr maturity. According to Dec07 results, based on contractual maturity, HBL and NBP had over 90% of DTLs with maturity of less than 1yr. Meanwhile UBL, MCB and ABL had DTLs less than 1yr in the range of 60-70%.

ABL the key beneficiary of SLR exemption

The SLR requirement, inline with the CRR, will be applicable only on DTLs of less than one year in contrast to total DTLs previously. In terms of impact on IGI Universe banks, ABL will benefit the most followed by MCB and UBL. Based on contractual maturity, ABL has an estimated 67% of DTLs with less than 1yr maturity while MCB & UBL have 77% each. As a result the SLR amendment will free up an estimated 20-30% DTLs from the reserve requirement.

DTLs



Source: SBP

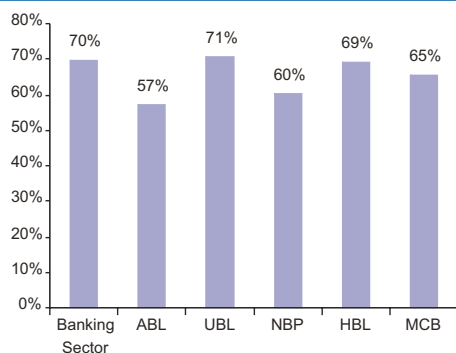
HTM eligibility to boost repo activity

SBP has allowed banks to use Held to Maturity (HTM) securities for participation in open the Repo Market and Discount Window. Previously only securities in the Available for Sale and Trading (AFS and AFT) category were eligible for Repo transactions and the Discount Window. This move will reduce demand for liquidity in the Call Money market and allow banks short on securities in AFS and AFT to revert to the Repo Market easing pressure on Call and Clean rates. In addition, the central bank has increased the weightage of TFCs and PIBs in the SLR pool to 10% from 5% earlier w.e.f. Oct 18'08; however, the incremental 5% applies to PIBs only. This will free up necessary space taken up by T-bills which can also be utilized for liquidity management in the Repo Market by the banking sector.

Funding gap lowering investments to assets ratio

During 3Q CY09, advances growth has picked up by 6.1% aided by rising import demand, bridge financing requirements of energy and power sectors, and private sector credit expansion. However during 3Q FY09, the deposits and other accounts of the banking system reported at decline of 1.5% to PKR 3.78tn as compared to PKR 3.84tn in Jun08. As a result, the net ADR has risen by 500bps to 75% compared to 70% in Jun08. The liquidity crunch forced FIs to liquidate investments; anecdotal evidence suggests significant withdrawals of placements in mutual funds has created downward pressure on deposits. Banking sector investments declined by 23% to PKR 931bn as compared to PKR 1,211bn in Dec-07. Consequently, the investments to total assets ratio declined by 700bps to 18% as compared to 25% in Dec07 indicative of liquidity stress.

Advances to Deposits Ratio - Jun08



Source: SBP

ADR ceiling likely to slow down growth

In terms of impact, the cap on ADR will limit the available leverage on banks balance sheets. Up till now, banks have opted to safeguard low cost CASA and sacrifice growth rather than opt for aggressive high cost deposit mobilization. Going forward with the 70% limit on ADR will compel banks to pursue aggressive deposit mobilization in order to meet the funding shortfall. Coupled with slowing balance sheet growth the ADR cap will result in NIM contraction. Secondly, banks are now required to maintain a minimum capital adequacy ratio (CAR) of 10% versus 8% previously. As a result, banks facing a CAR shortfall will either have to raise Tier I/ Tier II capital to sustain balance sheet growth, or reduce exposure to high risk assets. Moreover, as deposit growth slows we expect a slow down in credit expansion. This will also increase focus on non-interest based fee income going forward.

Underweight' stance on Pakistan banks

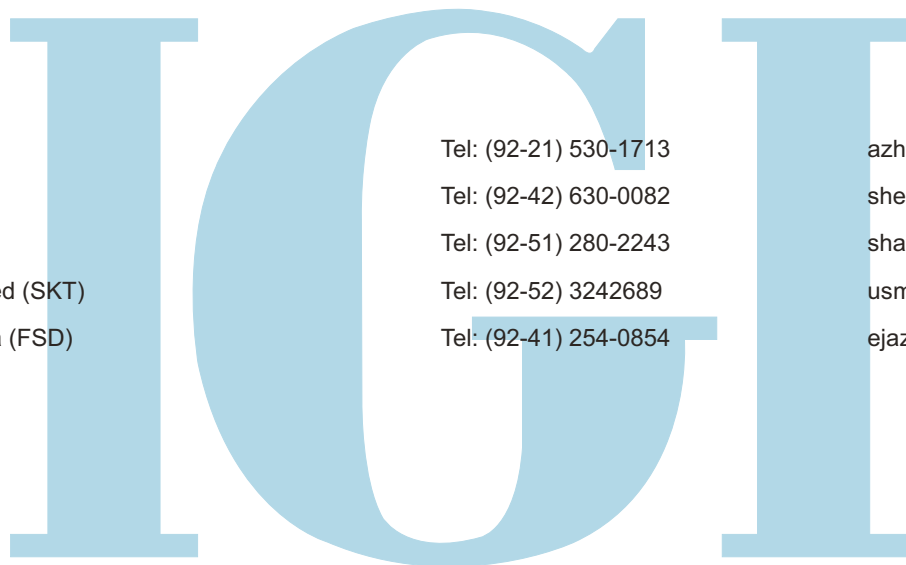
Macro headwinds, including sharp deceleration in GDP growth to 3% range, concerns over rising NPLs, margin contraction, and slowing balance sheet growth among others are the key downside risks facing Pakistan banks. These factors will limit the earning potential in the near to medium term. In view of the prevailing situation, the market has discounted the negatives and banking scrips have lost an estimated 40% during the current bearish spell. At present, in terms of valuations the banking sector is trading at a forward CY08E PB of 1.4x compared to historical average of 3x. That said, owing to the KSE freeze mechanism the current prices have an upward bias and likely to plunge after lifting of the floor. The discount vis-à-vis regional peers is also decreasing and regional counterparts are becoming more attractive. Going forward, the dearth of upside value drivers underpins our 'Neutral to Underweight' stance on Pakistan banks.

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