Pakistan Banks

In his first speech, PM hints at regulations for the banking sector to promote SME and low income lending

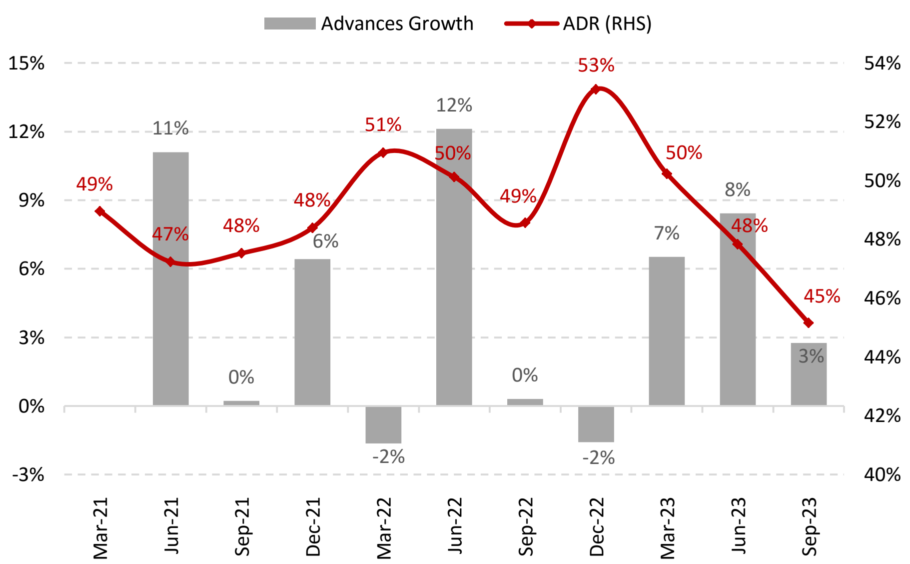
Tuesday, March 5, 2024

- **Since 2022, banks have been encouraged to increase the Advances / Deposits Ratio (ADR) through tax reform.**
- **Banking sector ADR rose from 48% to 53% between December 2021 and 2022, in order to avoid additional taxation. As of September 2023, ADR stands at 45% amid higher government borrowing from banks and reduced lending.**
- **While there is no ADR tax for 2024 yet, additional taxation in the form of punitive measures if SME/low-income lending targets are not met, could be introduced. Similar legislation exists in other countries.**
- **We believe regulators should take lessons from the Community Reinvestment Act 1977 in the US.**

Background on Taxation on Bank Lending: Since 2022, banks have paid an additional tax on profit earned on investing in government securities. The tax has ranged from 49% to 55% if ADR falls below 50%, while banks paid the standard 39% tax if ADR was maintained at or above 50%. The banking sector saw 6% and 12% Q/Q advances growth in December 2021 and June 2022. This resulted in the industry ADR rising from 48% in December 2021 to 53% by December 2022.

The relatively risk free composition of banking sector assets is as much a function of the typical risk-averse nature of banks as it is of the government's growing borrowing needs that are crowding out private sector lending.

Chart 1: Banking Sector Advances Growth & ADR



Source: BMA Research

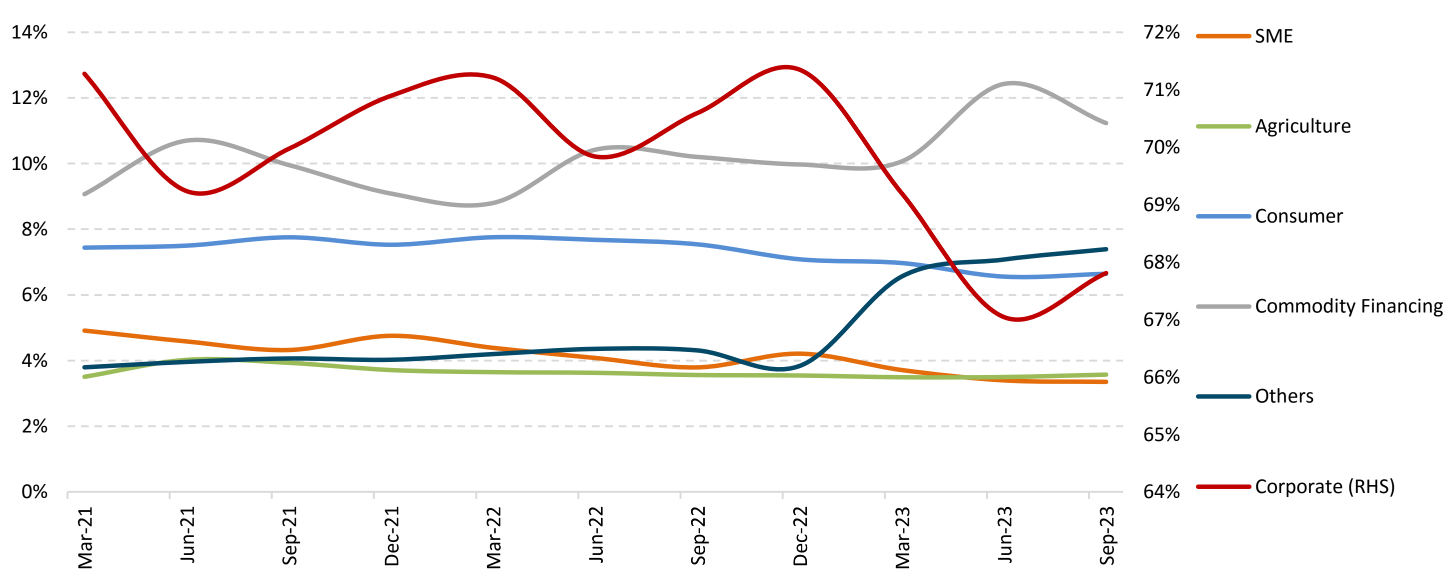
Syavash Pahore
Deputy Head of Research
Tel: +44 7984 992801
E-mail: syavash.pahore@bmacapital.com
BMA Capital Management Ltd.

Composition of Bank Lending: Currently, roughly 68% of bank lending is corporate. Commodity financing follows next at 11%. Consumer and SME lending forms just 7% and 3% of sector advances as of September 2023.

SME lending was 5% of the portfolio in March 2021. The drop in composition to 3% is as a result of an absolute decline in lending of 6%. In contrast, corporate lending has increased 32% during the same three year period.

During this period the CPI Index has increased 70%, from 143.6 to 244.1. Therefore in real terms, SME lending has declined 64% while corporate lending has declined 28%.

Chart 2: Banking sector advances composition



Source: BMA Research

A tax structure similar to the ADR tax is unlikely to be effective: Unlike the ADR tax, a similar structure with minimum thresholds for lending to SMEs and other prioritized sectors is unlikely to generate large tax revenues. This is because the portion of lending to SMEs, for example, is barely 3% and a 1-2% deviation from the threshold is unlikely to be meaningful in terms of overall taxation.

There is also the issue of banks boosting advances growth in December through short term measures to meet ADR thresholds and then reducing lending throughout the next year. This type of management was more evident in December 2021 than December 2022 (when the ADR ratio was already high)

The US Community Reinvestment Act 1977: We believe, a structure similar to the CRA Act in the US, is more likely to be effective in encouraging lending to priority sectors. The CRA Act is enforced by a tri-partite banking regulatory committee that categorizes banks on a four point scale ranging from “Outstanding” to “Substantial Non-Compliance”. Banks that do not comply are subject to restrictions growth through limits on branch expansion, mergers and acquisitions…

… The passing of the CRA has been effective in forcing banks to lend to low-income households and a similar result could be achieved in Pakistan. By implementing qualitative restrictions on growth strategies, banks can be given time to develop strategies to diversify advances growth sustainably. This can also solve the problem of circumventing quantitative thresholds at December end, expressly for the purpose of managing tax liability.

Incentive remains to implement quantitative tax based measures to support the fiscal deficit: However, we highlight that recent banking regulation has been focused on short term tax based measures such as the ADR tax and the Windfall Tax on FX profits. It is debatable whether these are motivated by a genuine motivation to reform banking, support tax collection, or both.

In the current fiscal year, debt servicing is on trend to be PKR 1.0 TN higher than budgets. Going forward, current expenditures excluding debt servicing should rise even as debt servicing costs fall. Therefore, plugging the primary deficit remains a sticky problem.

We believe this increases the possibility of implementing quantitative measures on banks, or implementing regulations on both overall ADR and individual lending areas, in order to raise taxes and simultaneously move towards banking reform.

Disclaimer

This research report is for information purposes only and does not constitute nor is it intended as an offer or solicitation for the purchase or sale of securities or other financial instruments. Neither the information contained in this research report nor any future information made available with the subject matter contained herein will form the basis of any contract. Information and opinions contained herein have been compiled or arrived at by BMA Capital Management Limited from publicly available information and sources that BMA Capital Management Limited believed to be reliable. Whilst every care has been taken in preparing this research report, no research analyst, director, officer, employee, agent or adviser of any member of BMA Capital Management Limited gives or makes any representation, warranty or undertaking, whether express or implied, and accepts no responsibility or liability as to the reliability, accuracy or completeness of the information set out in this research report. Any responsibility or liability for any information contained herein is expressly disclaimed. All information contained herein is subject to change at any time without notice. No member of BMA Capital Management Limited has an obligation to update, modify or amend this research report or to otherwise notify a reader thereof in the event that any matter stated herein, or any opinion, projection, forecast or estimate set forth herein, changes or subsequently becomes inaccurate, or if research on the subject company is withdrawn. Furthermore, past performance is not indicative of future results.

The investments and strategies discussed herein may not be suitable for all investors or any particular class of investor. Investors should make their own investment decisions using their own independent advisors as they believe necessary and based upon their specific financial situations and investment objectives when investing. Investors should consult their independent advisors if they have any doubts as to the applicability to their business or investment objectives of the information and the strategies discussed herein. This research report is being furnished to certain persons as permitted by applicable law, and accordingly may not be reproduced or circulated to any other person without the prior written consent of a member of BMA Capital Management Limited. This research report may not be relied upon by any retail customers or person to whom this research report may not be provided by law. Unauthorized use or disclosure of this research report is strictly prohibited. Members of BMA Capital Management and/or their respective principals, directors, officers and employees may own, have positions or effect transactions in the securities or financial instruments referred herein or in the investments of any issuers discussed herein, may engage in securities transactions in a manner inconsistent with the research contained in this research report and with respect to securities or financial instruments covered by this research report, may sell to or buy from customers on a principal basis and may serve or act as director, placement agent, advisor or lender, or make a market in, or may have been a manager or a co-manager of the most recent public offering in respect of any investments or issuers of such securities or financial instruments referenced in this research report or may perform any other investment banking or other services for, or solicit investment banking or other business from any company mentioned in this research report. Investing in Pakistan involves a high degree of risk and many persons, physical and legal, may be restricted from dealing in the securities market of Pakistan. Investors should perform their own due diligence before investing. No part of the compensation of the authors of this research report was, is or will be directly or indirectly related to the specific recommendations or views contained in the research report. By accepting this research report, you agree to be bound by the foregoing limitations.

BMA Capital Management Limited and / or any of its affiliates, which operate outside Pakistan, do and seek to do business with the company(s) covered in this research document. Investors should consider this research report as only a single factor in making their investment decision. BMA Research Policy prohibits research personnel from disclosing a recommendation, investment rating, or investment thesis for review by an issuer/company prior to the publication of a research report containing such rating, recommendation or investment thesis.

Stock Rating

Investors should carefully read the definitions of all rating used within every research reports. In addition, research reports carry an analyst's independent view and investors should ensure careful reading of the entire research reports and not infer its contents from the rating ascribed by the analyst. Ratings should not be used or relied upon as investment advice. An investor's decision to buy, hold or sell a stock should depend on said individual's circumstances and other considerations. BMA Capital Limited uses a three tier rating system: i) Buy, ii) Neutral and iii) Underperform (new rating system effective Jan 1'18) with our rating being based on total stock returns versus BMA's index target return for the year. A table presenting BMA's rating definitions is given below:

Old rating system

Valuation Methodology

To arrive at our period end target prices, BMA Capital uses different valuation methodologies including

- Discounted cash flow (DCF, DDM)
- Relative Valuation (P/E, P/B, P/S etc.)
- Equity & Asset return based methodologies (EVA, Residual Income etc.)