Day Break

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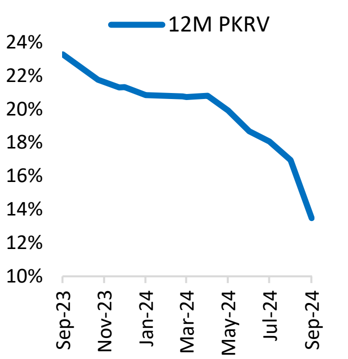
Commercial Banks

ADR Taxation and Debt Buyback: A Strategic Shift and Its Implications for Banks

- In a historical move, the Federal Government initiated its debt buyback program in an auction held on September 30, 2024 in which it bought back short-term Market Treasury Bills (MTBs) worth PKR 351 billion (target: PKR 500 billion) which were set to mature in Dec-24. Moreover, the SBP is set to conduct another MTBs buyback auction on October 9, 2024 with a target of PKR 500 billion.
- Since banks are the largest investors in Government securities, these buybacks will generate excess liquidity which the banks will either place in long-term PIBs or increase lending to the private sector.
- For improving their ADRs the banks are likely to opt for a cost effective approach by increasing lending and reducing deposits. A similar approach was adopted by banks in 2022 when ADR taxation was imposed which was managed by reducing deposits and increasing advances temporarily.

Exhibit: Declining Trend in PKRV yield



Source: MUFAP, IGI Research

Government Initiates Debt Buyback

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To highlight, the Government also rejected all bids in the T-Bills auction held on September 18, 2024. The impetus for this bold move is the recent increase in liquidity, which came on the back of PKR 2.74 trillion share of profits received from the State Bank of Pakistan (SBP).

Impact of buyback decision for Banks

Since banks are the largest investors in Government securities, these buybacks will generate excess liquidity which the banks will either place in long-term PIBs or increase lending to the private sector.

The banks in Pakistan are facing a risk of an additional taxation of up to 16% on investment income prompted by a low ADR ratio, which has declined to 38% in Aug-24 well below the SBP's target of 50% given to the banks for year-end. To avoid this additional tax, the sector would need to expand its loan portfolio by ~PKR 3.6 trillion assuming deposits remain unchanged, representing a growth of ~30%y/y while the historical average growth in the industry's loans stand at ~8%. However, these recent buybacks of MTBs by the Government can prove to be an opportunity for the banks to build up their loan portfolio.

It is important to note that in the year 2022, the banks faced a similar situation when the ADR taxation was imposed for the first time and the sector's ADR increased to ~53% by Dec-22 from 48% at Jun-22, however this tax was later exempted in the budget of 2023 after which the sector's ADR ratio has averaged at 44% till June 2024.

Impact on Bank's Earnings if ADR target not met

If a bank's ADR falls below 40% by December 2024, a 16% additional tax will be imposed on income from investments in government securities whereas banks whose ADR falls between 40%-50% will be charged an additional tax of 10%. However, banks whose ADR exceeds 50% will not be subjected to any incremental tax. As at June 30, 2024, only 3 listed banks: a) Faysal Bank Limited, b) Askari Bank Limited, and c) Samba Bank Limited have a gross ADR above 50%.

We have conducted a sensitivity analysis on listed banks to evaluate the potential impact on earnings if they fail to meet the ADR target by year-end.

Banks	Gross ADR (Jun-24)	EPS Impact
SBL	68%	-
FABL	56%	-
AKBL	53%	-
HBL	38%	(7.88)
UBL	25%	(11.28)
MCB	33%	(11.33)
MEBL	48%	(6.26)
NBP	38%	(1.89)
ABL	42%	(4.46)
BAFL	39%	(5.24)
BAHL	38%	(5.59)
HMB	42%	(2.46)
JS Bank	38%	(1.75)
BIPL	39%	(2.28)
SNBL	38%	(1.26)
BOP	45%	(0.24)
BOK	31%	(0.65)
SCBPL	28%	(2.93)
Sindh Bank	41%	(0.18)
BML	29%	(0.08)

Source: Company Financials, IGI Research

What Banks Can Do?

For improving their ADRs the banks are likely to opt for a cost effective approach by increasing lending and reducing deposits. A similar approach was adopted by banks in 2022 when ADR taxation was imposed which was managed by reducing deposits and increasing advances temporarily.

Increase in short-term lending to meet ADR by Dec-24

Several banks have started offering new short-term financing to businesses at rates below the KIBOR as an effort to bring their ADRs at par with SBP's target. The expectations of continued monetary easing had already kept the KIBOR under pressure which has declined by ~73 bps w/w to 14.70% as at October 4, 2024. It has been noted that in the past few weeks some banks have offered new loans at the spread of minus ~6-12 bps to KIBOR bringing the lending rate down to ~3-4%. However, these low rates will be limited to new short term financing only and will not affect the bank's existing long-term loan portfolio. We believe that by the start of 1QCY25 banks will stop offering new loans at negative spreads and redirect their focus to investments in Government and other securities.

Deposit Reduction

A rather cost-effective measure, apart from resorting to aggressive lending, that banks may choose to adopt for improving their ADR is to reduce their deposit base by eliminating high-cost deposits.

Exhibit: Policy Rate Vs. 6M KIBOR

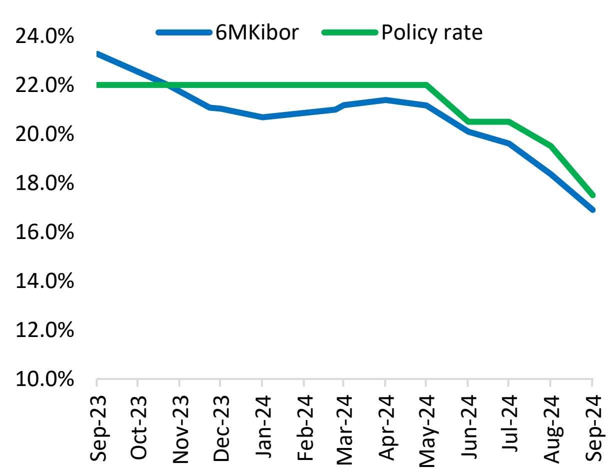
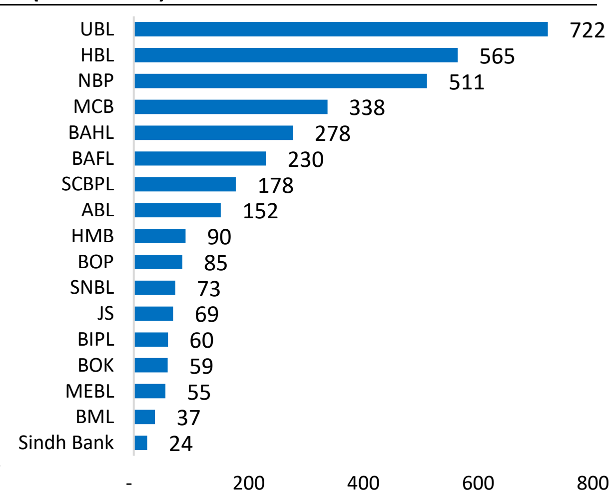


Exhibit: Incremental Advances to meet 50% ADR (PKR Billion)



Source: SBP, Company Financials, Bloomberg, IGI Research

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