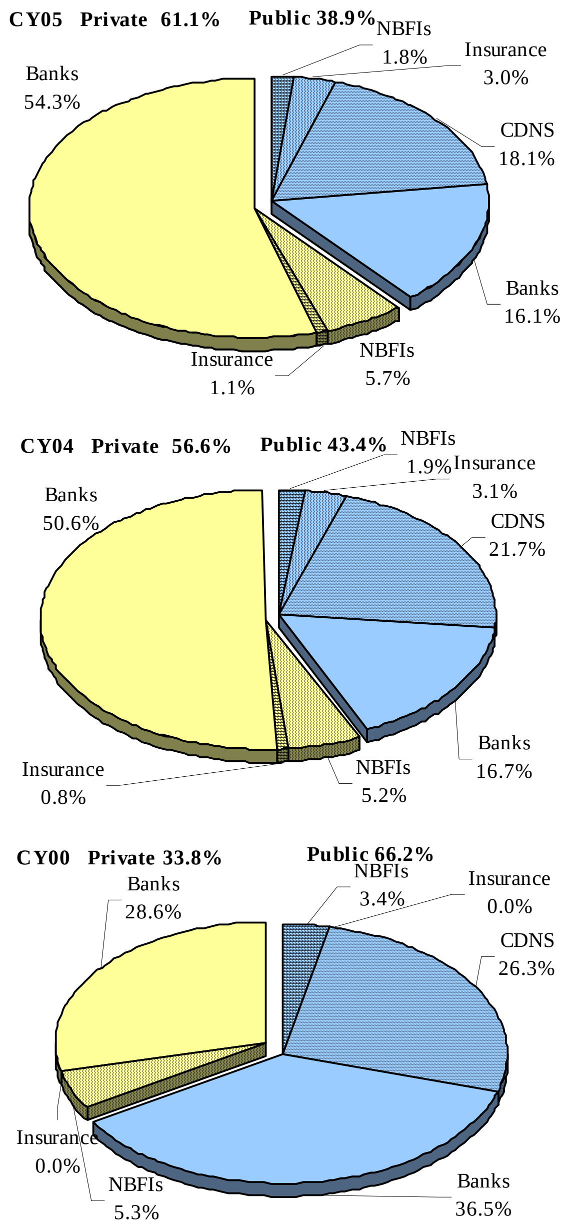
Executive Summary

Macroeconomic Environment and Performance of the Financial Sector

The strengthening macroeconomic fundamentals, sustained economic growth, and strong commitment to continue reforms in the financial sector paved way for the successful implementation of the reforms. As a result, financial sector witnessed rapid growth in assets, positive changes in ownership and balance sheet structure, and substantial improvement in financial health during CY01-CY05. The ownership structure of the financial sector, as shown in **Figure E1**, underwent a rapid shift from public to private sector, as the share of the latter in overall assets of the financial system jumped from 33.8 percent in CY00 to 61.1 percent in CY05. Since the nationalization in 1970s, it was the first time in CY04 when private sector acquired the majority share at 56.6 percent in the overall assets of financial sector. The share of private sector consolidated further and reached 61.1 percent in CY05. Pakistan is among the few developing countries that successfully transferred such a large share of financial sector from public to private ownership in a short span of time. This was primarily achieved through (a) privatization of state-owned financial institutions, including two big-commercial banks and all the state-owned closed-end mutual funds; (b) relatively faster growth in the assets of existing private-owned institutions; and (c) net outflows in Central Directorate for National Savings (CDNS) instruments.

Figure E1: Ownership and Institutional Structure



The overall size of the financial sector, measured by financial assets, increased at a robust average annual growth rate of 14.8 percent reaching Rs 5.2 trillion in CY05 from Rs 2.8 trillion in CY00. As percent of GDP, size of the financial sector improved from 73.2 percent in CY00 to 79.0 percent in CY05. However, the financial sector assets to GDP ratio, after showing the highest level of 81.8 percent in CY03, declined in CY04 and CY05. This fall in relative size of the financial sector was primarily because of net outflows in the CDNS instruments during CY04 and CY05. Excluding CDNS, financial sector assets to GDP ratio showed a continuous uptrend during the period under review.

In terms of institutional composition, the dominance of scheduled banks in the financial sector further strengthened; as their share increased from 63.7 percent in CY01 to 70.4 percent at the end of CY05. Besides rapid growth in profitability and business expansion, transfer of assets from Non-bank Finance Institutions (NBFIs) on account of mergers and acquisitions, has also contributed in raising the share of the banking sector. The restructuring of NBFIs from 2000 onwards and the shift of their assets to banks led to a decline in their share in the financial sector assets from 8.6 percent in CY00 to 6.2 percent in CY02. However, the strong growth by NBFIs from CY03 onwards, in particular by mutual funds, has pushed the share of NBFIs up to 7.5 percent in CY05. The share of insurance companies and microfinance institutions, though remained small, this has been rising during the previous five years. Net outflows in National Savings Schemes (NSS) instruments in CY04 and CY05 led to decline in the share of the CDNS. Among the different financial institutions, CDNS was the only exception that lost it share in the financial sector from CY03 onwards.

The rapid increase in the size and private ownership was also accompanied with improved health of the financial sector. Compared to CY00, in general, financial institutions are now relatively better capitalized, enjoying good quality assets and earning significantly higher profits. The increased minimum capital requirements and handsome profits of financial institutions helped in achieving higher capital ratios. In fact, the rising capital adequacy is even more impressive, as this was accompanied by substantial improvement in asset quality. While Non-Performing Loans (NPLs) to total assets ratio declined from 27.8 percent in CY00 to 8.5 percent in CY05, earning asset to total asset ratio increased from 75.4 percent to 82.2 percent during the same period. As a result, the profitability (ROA after tax) of the financial institutions, which was negative during CY00 and CY01, recorded a continuous uptrend CY02 onwards, reaching 1.8 percent in CY05 – significantly higher than 1.25 percent internationally acceptable benchmark.

The highest profitability was registered during CY05, as ROA (both before and after tax) was the greatest during the last sixteen years. This was achieved on the back of (1) a sharp increase in earning assets relative to total assets during CY05; (2) an increase in deposits to liability ratio (since deposits are a relatively cheaper source of financing); and more importantly (3) the increase in average spread and net interest margin in CY05. In specific terms, the average spread that had been declining CY02 onwards witnessed a trend reversal during CY05 and increased by 110 basis points. In addition, the continued improvements in macroeconomic environment of the country also strengthened the banks' profitability during CY05.

A formal investigation for the determinants of the financial sector's profitability reveals that a combination of low interest rates, high economic growth and low inflation provides a conducive environment for financial sector profitability. Sustained economic growth, rather than sporadic improvement in real GDP, helps the financial institutions to earn higher profits. Besides the aforementioned macroeconomic variables, the better provisioning to advances, lower operating expense to total assets ratios, higher productivity, improved capital adequacy of financial institutions and diluting institutional concentration within financial system underpinned the profitability of the financial sector.

Financial Infrastructure

The reforms in the financial sector 2000 onwards were essentially extension of the reforms that were initiated during 1990s with renewed emphasis on resolving the issue of a large non-performing loans portfolio and privatization of the state-owned financial institutions. High on agenda were also the consolidation of the financial sector, improving legal and regulatory environment, and modernizing the payment systems.

A number of financial institutions were privatized through competitive bidding, while the 23 percent shares of National Bank of Pakistan were offloaded through local stock exchanges. To make these institutions viable entities before sell off, several steps were taken to recapitalize and clean the balance sheets. To this end, the Corporate and Industrial Restructuring Corporation (CIRC) and Committee for the Revival of Sick Industrial Units (CRSIU) were set up to clean the balance sheets of state-owned banks and Development Finance Institutions (DFIs) and to valuate the possibility of restructuring the loans of industrial units.

For institutional strengthening, the SBP started the process of consolidation by progressively raising the minimum paid-up capital requirements for each type of financial institution. In this regard, the SBP also issued guidelines on mergers and acquisitions for banks/financial institutions. The efforts to consolidate the financial sector were complemented by liberalizing Branch Licensing Policy (BLP) to promote the growth of small and medium size banks by increasing their outreach and asset base.

To ensure prudence in banking operations, the SBP had been issuing Prudential Regulations (PRs) for commercial banking. However, 2003 onwards with the onset of new financial products and services, it became increasingly difficult to cover all of the diverse activities of banks under one set of regulations. Therefore, the SBP issued separate PRs for different set of banking operations, including PRs covering, corporate and commercial banking, Small and Medium Enterprises Financing, Consumer Financing and Agriculture financing. In addition, the SBP also introduced PRs for Microfinance Banks (MFBs), keeping in view the difference in the the nature of MFBs activities from those of the commercial banks.

Furthermore, to promote financial discipline and better credit risk management by the financial institutions, the credit information facility at SBP, which has been available since 1992 was upgraded. In April 2003, SBP launched eCIB, an online facility that allows financial institutions to upload and retrieve information online through Virtual Private Network. This has substantially reduced time required for making informed decisions. Previously the CIB contained data of borrowers of more than Rs 0.5 million and above only. However, in the new structure, all fund and non-fund based credit facilities, irrespective of any amount outstanding, are being reported to eCIB with provisions for online amendments and updations.

To resolve the overlapping of regulatory authority over the NBFIs, the SBP and SECP formed a joint taskforce which recommended that there should be a clear division of responsibilities between the two regulators. Consequently, SECP, which was initially concerned with the regulation of corporate sector and capital market, also started supervising all NBFIs, except DFIs. Soon after taking up the responsibility of regulating NBFCs,[1] the SECP issued the detailed rules for the establishment and regulation of NBFCs in the country in April 2003. These rules clearly identified the functions of each of the various types of NBFCs including, leasing, investment banks, housing finance companies, venture capital companies and discount houses. In addition, during 2004, the SECP issued PRs[2] for NBFCs and also revised the existing PRs for modarabas.[3,4]

[1] NBFCs include: Investment Finance Companies (IFCs), Leasing companies, Discount Houses (DHs), Housing Finance Companies (HFCs), Venture Capital Companies (VCC) and Asset Management Companies.
[2] SECP Circular No. 02: Prudential Regulations for Non-Bank Finance Companies dated January 21, 2004.
[3] Even after transfer of the responsibility of regulating the NBFCs from the SBP to SECP, initially the PRs issued by the SBP for NBFIs continued serve the purpose of providing operational guidelines.
[4] SECP Circular No. 04: Prudential Regulations for Modarabas dated January 28, 2004.

With the establishment of SECP, the much-awaited insurance sector reforms were introduced, through promulgation of Insurance Ordinance 2000 that replaced the Insurance Act of 1938. The prime objectives of Insurance Ordinance were: (1) to regulate the insurance business; and (2) to ensure the protection of the interest of insurance policy holders. Specifically, the thrust of insurance sector reforms was to improve the financial standards and efficiency of the insurance companies, which in turn enable the insurance industry to mobilize long-term resources.

Realizing that robust payment and settlement system is the backbone of a stable financial infrastructure and plays a vital role in containing systemic risk, efforts were made to increase the reliability and speed of the transactions by upgrading the payment system. For this purpose, Electronic Clearing House taskforce was set up in 2001 for implementing electronic clearing and e-banking in Pakistan. Electronic Transaction Ordinance was passed in late 2002. SBP is in the process of introducing a Real-Time Gross Settlement (RTGS) system for large value payments; while Globus is under implementation at SBP that would provide a strong back end system for SBP's banking operations. To expedite international transactions, SBP became a member of Society of Worldwide Inter-bank Financial Telecommunications (SWIFT) in June 2000, while all other banks were required to become members of SWIFT by the end of FY01.

CY05 onwards, a number of reform measures were under taken by the regulatory authorities for the development of the financial sector. In particular, the government has constituted a Banking Laws Review Commission (BLRC) so that the banking laws could be amended in accordance with the new challenges faced by the banking industry. The commission has prepared a draft Banking Act 2006 that would replace existing Banking Act once finalized by the concerned authorities.

In addition, SBP has issued several guidelines to the banking institutions as and when the need emerged. For instance, in CY05 the SBP prohibited all banks to finance speculative and non-productive use of their resources. Similarly to accommodate banks aspiring to enter into new but economically viable businesses, the SBP has issued guidelines for infrastructure and for higher education financing schemes. Moreover, during the year 2006, a new SME policy was announced by the government that has made several recommendations to improve the SMEs' access to bank finance. It is expected that following these recommendations, the banking industry would be able to improve financial products and services to SME sector. In addition, ithrough the Finance Bill for 2006, the government has made a few amendments in the MFIs ordinance to expand the business of microfinance banks in the country.

Also, the SECP has issued Prudential Regulations for consumer financing and directed all NBFCs (licensed to undertake the business of Investment Finance, Leasing, Housing Finance, and Discounting Services) to conduct consumer finance business in conformity with the Regulations for Consumer Financing. These Regulations were made effective from January 09, 2006. The objective behind the issuance of these Regulations was to expand the product range of the NBFCs.

Performance of the Banking Sector

Benefiting from the ongoing reform process and strengthening of macroeconomic fundamentals, Pakistan's banking system witnessed visible improvements in the size, structure, outreach and financial health during CY01-CY05. Assets of the banking sector registered almost a three-fold increase to reach at Rs 3.7 trillion in CY05, up from Rs 1.8 trillion in CY00; showing a robust average annual growth rate of 15.2 percent that outpaced the growth in nominal GDP during the period under review.[5] As a result, the banking sector's assets to GDP ratio jumped from 47.2 percent in CY00 to 55.6 percent in CY05.

During CY01-CY05, a significant share in the aggregate assets of the banking sector shifted from public sector to private sector and asset concentration within the banking sector declined substantially. These changes were made possible largely by the privatization of the state-owned banks and the efforts made for consolidation of the weak financial institutions. This changing structure has far-reaching implications for the performance of the banking system. An empirical investigation suggests that the privatization has significantly contributed in improving profitability of privatized banks, though it has made no significant impact in reducing the intermediation spread. The assets concentration has been found as an important determinant of the intermediation spread; implying that improvement in the concentration during the last five years has played a significant role in improving efficiency of the banking sector.

In addition, banks have also witnessed considerable changes in the assets and liability structure during the last five years; including: (a) earning assets constituted a substantially larger part of banks' total assets during CY00-CY05, compared to the second half of the 1990s; (b) Since CY03, it was an upsurge in banks' advances that maintained the earning assets ratio at a higher level; while the share of investment declined substantially; (c) banks' advance and investment portfolios diversified significantly;[6] (d) the share of banks' borrowings in total liabilities declined, as it was the sharp growth in bank deposits and capital that financed the strong asset growth; and (e) the share of fixed-term deposits of six-month and above has witnessed a substantial decline.

These structural changes have strong implications for the financial health and performance of the banking sector. Although the banks have witnessed a substantial rise in profitability and improvement in capital adequacy ratios; the changing financial structure has also increased the risk exposure of the banking sector, especially in the wake of monetary tightening since Q4-FY04. For instance, the rising share of advances in total assets, due to strong credit growth, has raised credit risk of the banking system. However, banks have effectively managed the risk so far. This is evident from improved asset quality as seen from continuing declining trend in NPLs both in absolute and as a ratio of advances and capital.

The strong growth in bank credit has also deteriorated banks' liquidity indicators considerably CY03 onward. This can be seen in a sharp increase in advances to deposit ratio and a decline in liquid assets to total assets ratio during this period. Moreover, the fall in the share of longer-tenor fixed deposits has also led to an emergence of maturity mismatch in banks' balance sheets as the incremental advances and investment had a relative longer maturity compared with the incremental bank deposits during the period. In order to address the liquidity risks and sustain growth momentum, it is essential for banks to put more efforts for mobilizing deposits, especially of longer-tenor.

In this regard, the measures taken by the SBP are expected to force banks to address their liquidity risks. Specifically, the relatively higher cash reserve requirements (CRR) on short term deposits would compel banks to mobilize the longer tenor deposits.[7] Furthermore, since the empirical estimates suggest that the interest rate spread has a negative relationship with the share of time

[5] The strong assets' growth during CY00-CY05 was well supported by a robust 16.2 percent average annual growth in banks' deposits.

[6] In contrast from past practices, during this period banks have extended a significantly larger credit to consumers, agriculture, SME, and project financing to corporate sector. Similarly, banks have invested relatively more in equity and private sector debt markets; as a result share of government securities in banks' investment has declined significantly.

[7] Likewise, the increased minimum capital requirements by the Central Bank would not only help in improving the capital adequacy of banks against uncertainties; but would also aid in lengthening the maturity profile of banks' liabilities.

deposits to the total bank deposits, the relatively lower CRR on long term deposits will also increase the sensitiveness of bank deposits to interest rates and would thus help in narrowing down the interest rate spread.[8] It is important to note that the interest rate spread of the banking sector, after showing a declining trend during CY01-CY04, registered a sharp increase to reach at 5.0 percent in CY05 against 3.5 percent in the previous year. The higher spread in CY05 primarily stemmed from lower response of banks deposit rates to the rising benchmark interest rates than that on banks lending rates.

Performance of Non-Bank Finance Institutions (NBFIs)

The NBFIs sector, which comprises DFIs, modarabas, mutual funds and Non-Banking Finance Companies (NBFCs), has gone through a comprehensive transformation under the increased regulatory and supervisory role of the SECP during the last five years. SECP's regulatory policies, which focused on consolidating weak institutions by strengthening their capital base, have led to a large number of mergers and acquisitions within and across sectors. For instance, three DFIs, and four investment banks were merged into scheduled banks that shifted the asset base of these institutions from NBFIs to scheduled banks during FY01-FY05. Similarly a number of leasing companies, investment banks and modarabas opted for voluntary liquidation during the period under review. As a result, the number of institutions in the sector declined significantly to 114 by end June 2005 from 156 at end June 2000. In sharp contrast to 1990s, NBFIs sector is now represented by institutions that are standing on relatively strong capital footing and are better placed to compete for a sizable share given the increasing demand for financial products and services as a result of the growing economy.

The institutions remaining in business have encouragingly over-performed both in terms of asset growth and earnings as evident from a compound annual growth (CAGR) of 11.9 percent in assets during FY01-FY05. The strong growth of mutual funds, DFIs and leasing companies mainly contributed in the overall expansion of the NBFIs' business. Macroeconomic stability and high economic growth in low interest rate environment during FY01-FY05 played a vital role in achieving this robust growth by NBFIs as validated by quantitative analysis.

It is important to note that despite the strenuous competition with commercial banks, during FY05 the advances of NBFIs grew by 35 percent compared with 16 percent in FY04. This was mainly on the back of growing financing needs of the economy, especially the growth in project finance reflected in the sharp growth of machinery imports in recent years. As a result, the share of advances in total assets has increased during 2005 after declining during preceding five years. Going forward, keeping in view the diversification that these institutions are bringing in their businesses and a number of new entrants during the year 2005, it is expected that the NBFIs will continue their present performance. SECP has issued license to seven new NBFCs during the year and interestingly all of these NBFCs are asset management companies or mutual funds. In addition, three new Modaraba management companies were also registered during CY05.

As far as the ownership structure of the NBFI sector is concerned, the share of private sector increased considerably to 77.7 percent at end FY05 compared with 69.5 percent at end FY01. Besides the asset growth of the private sector NBFIs, the liquidation or mergers of all public sector DFIs with the banking institutions and the change of ownership of all public sector closed-end mutual funds to private asset management companies are the main factors which increased the share of private sector by 8.2 percentage points during the period under review.

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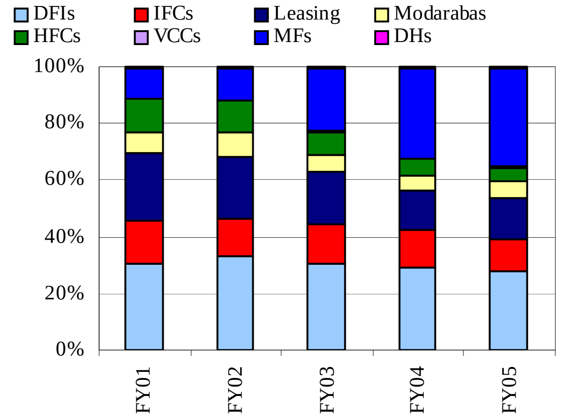
[8] It is important to note that there is no unique definition of interest rate spread. For example, the difference between banks weighted average lending and deposits rates, though widely being used, is the narrowest definition to proxy the intermediation spread or efficiency of a banking system. Here, we have computed interest rate spread as a wedge between interest rate charged on interest earning assets and interest rate paid on interest bearing liabilities.

Figure E.2: Asset Structure of NBFIs



Within NBFIs sector, mutual funds benefited from the buoyant stock market and took over the leading position in NBFIs from FY04 at the expense of DFIs which conceded their position due to liquidation and mergers of numbers of DFIs with the banking institutions (see **Figure E.2**). Compared to FY01, share of all the remaining groups registered a decline in FY05 with venture capital companies as the only exception. The changes in the relative size of the NBFIs' sub-categories emanate from both the pace of expansion in their business activities and the consolidation process within and across sectors.

DFIs assets, despite the liquidation and mergers across sector of four institutions, registered 3.3 percent CAGR during the last five years. More importantly, the assets of existing DFIs registered a relatively sharp growth of 20.6 percent on average during the same period. As shown by empirical analysis, this robust growth was driven by, in addition to other macro economic factors, an increase in the development expenditures and import of plants and machinery. During FY05, though the capital base of DFIs registered a robust growth of 18.6 percent, the capital adequacy ratio (CAR) has declined slightly. Apparently the decline in CAR is reflective of the weakening risk absorption capacity of these institutions; however, it should be noted that the ratio is still significantly higher than the required level of 9 percent. Further, it is important to see that this decline in CAR is a natural outcome of the changing asset mix of these institutions which is in conformity with the DFIs' core objective. In specific terms, the advances to earning assets ratio has increased during FY05 due to the growing financing needs of the economy which has resulted in an increase in risk weighted assets of these institutions.

Similar factors shaped the financial performance of the investment finance companies (IFCs). Specifically, the activities of investment finance companies increased as reflected in a 10.5 percent CAGR during FY01-FY05; despite a sharp decline in number of institutions from 16 to 9 during the period. The profitability of IFCs has remained stable throughout the period. Going forward, it is expected that the business of IFCs would grow further given the fact that the existing companies are undertaking a number of corporate finance activities, including securities underwriting, private placements, and financial advisory services for acquisitions, restructuring, etc, in line with the international practices. In addition, IFCs have also sped up brokerage activities either through obtaining brokerage licenses or through acquiring independent brokerage houses. The asset management company of one IFC will become operational in FY05-06 and will focus upon introducing a range of mutual funds. Moreover, another IFC has also launched its housing finance services during FY05. In addition to product diversification, the existing IFCs have also focused on geographical diversification of their products and services.

Leasing was another sector that recorded a considerable asset growth of 7.0 percent CAGR during FY01-FY05 despite a sharp decline in number of institutions. Improved customer services and shift in business strategies mainly helped leasing companies to maintain some niche in the growing leasing business despite an aggressive take up of leasing business by commercial banks. However, leasing companies will have to bring in further diversification in both financing products as well as avenues of resource mobilization to compete with commercial banks. In this regard, it is encouraging to see that one leasing company has already secured the license of investment finance services; two companies have received licenses for housing finance services; and one company has secured license of discounting services from SECP up till the end of FY05.

Though modarabas have recorded a robust 7.0 percent CAGR during 2001-2005, the composition of assets has largely remained unchanged as the lease finance continued to hold the largest share at 47 percent in total assets. Given the concentration of modarabas in leasing business, this sector is required to bring in diversification in financing products. In this regard, it is encouraging that a number of modarabas have recently consulted the Religious Board for taking up new shariah compliant businesses. During FY05 the profitability of modarabas though has remained robust, the high amortization and depreciation charges have dampened the net profit margins to Rs 794 millions in FY05 against Rs 932 millions in the previous year. Correspondingly, the return on assets and on equity also deteriorated slightly. This was attributed to three factors: (1) while the funding cost of modarabas increased significantly amid tight monetary posture, the returns on advances did not increase proportionately due to stiff competition; (2) bulk of FY04 profit was constituted of the non-recurring income like capital gains on investments that were absent during FY05 and (3) the expanding business has also increased the operating expenses, which have squeezed the net income margins.

Housing finance sector registered a negative asset growth during FY01-FY05 despite a booming real estate and increase in construction related activities in the country. However, the composition of assets shows that adjusting for provisioning and suspended income against NPLs; the financing activities of HFCs have registered a positive growth rate of 3.2 percent during the period. This growth was driven mainly by the expanding outreach of HBFC and the growing popularity of its two recently launched shariah compliant schemes. It is encouraging to note that HBFC is about to launch the first ever Real Estate Investment Trusts (REITs) in the country that will provide a mode to small investors for participating in the real estate activities.

Mutual funds sector was the star performer within the NBFIs with CAGR of 40 percent during FY01-FY05. During FY05, the total net assets of mutual funds registered a growth of 30.5 percent and reached Rs 134.5 billion. As a result of this tremendous growth, mutual funds have attained the largest share in NBFIs assets at end June 2005. Furthermore, the share of publicly owned mutual funds in aggregate assets of overall sector has declined significantly; from above 90 percent in FY01 to close to 50 percent in FY05. This sharp decline in public-ownership was primarily a result of privatization of ICP funds to private asset management companies during FY03. Similarly, the nature of funds has also seen significant changes as the share of closed-end mutual funds has increased almost five times during FY05 compared with FY00. While open-end funds continued to hold larger share in total mutual funds assets; the share of closed-end funds has increased sharply during FY01-FY05 depicting a growing confidence of investors in the sector. Finally, in terms of investment strategies, the proportion of equity funds in the overall sector is still the largest at the end of FY05; but has declined slightly to the share of bond and balanced funds.

The expectations of healthy corporate sectors' profitability, the expedited process of privatization of public-owned units; and the heavy influx of foreign portfolio investment, further strengthened investors' confidence in mutual funds. In addition, it is expected that the launch of REITs would broaden the horizon of mutual funds in Pakistan.

During the FY05, seven new asset management companies were given license and the public offering of ten funds was approved. It is for the first time that the index tracker fund and the fund of funds were launched in Pakistan and therefore it is expected that the depth and diversification in the mutual fund industry would improve further.

In sharp contrast to this, the activities of discount houses have largely remained limited throughout FY01-FY05. The assets of discount houses have declined by 3.6 percent mainly due to the liquidation of three companies during the period. At present, there is only one company in the sector that has been granted NBFC status and the license was given by SECP to conduct leasing business.

Finally, the smallest group in NBFI sector, i.e., Venture Capital Companies (VCCs) has registered a sharp growth of 25.5 percent CAGR during 2001-2005. At present, all the three VCC in the sector are involved in the business process outsourcing (BPO). Given the growing BPO-market around the world and the strong prospects of domestic IT professionals; VCCs have a strong potential to expand and support the local companies in product development and marketing of their IT-enabled services abroad.

Financial Deepening: Role of Islamic and Microfinance Institutions

The establishment of Islamic banking and microfinance institutions is one of the major highlights in Pakistan's financial sector development in recent years. These specialized institutions are expected to enhance deepening of financial services in the country through offering services to two major segments of the society that had remained outside the coverage of the existing financial system. First, those who are not using the existing system due to its non-conformity with the Islamic rules of law; and second, the poor people, who do not have access to the conventional financial system. Both the Islamic banking and microfinance institutions have registered rapid growth during the last couple of years, though they have covered only a small segment of the available market.

Since 2002, the Islamic financial sector, in particular Islamic banking, has made rapid progress in Pakistan. The network of Islamic banking has increased manifold. Compared to only one full-fledged bank with total six branches in June 2002; by the end of June 2006, four full-fledged Islamic banks, with a network of 60 branches, and, 40 stand-alone branches of commercial banks were providing Islamic banking services in the country. Moreover, recently licenses have been issued to two more banks,[9] which are expected to start their business soon. The rapid growth in Islamic bank network allowed this sector to register above 100 percent average annual growth in assets during CY02-CY05. As a result, share of the Islamic Banking System (IBS) in overall assets of banking sector increased to 2.0 percent at end CY05 against 1.5 percent in CY04 and only 0.3 percent in CY02.

Similar to the conventional banking system, *financing* has the largest share in overall assets of IBS. However, in sharp contrast, *investment* share is miniscule. At end CY05, investment comprised of only 2.6 percent of total assets of IBS, while it shared around 22 percent of total assets of scheduled banks. This difference can be explained by the lack of Shariah compliant investment avenues in the country. In fact, lack of investment opportunities for IBS put these institutions at a relative disadvantageous position compared to the other commercial banks in fulfilling the Statutory Liquidity Requirement (SLR). Specifically, until the issuance of WAPDA-Sukuk bond in November 2005, there was no approved security for meeting SLR and IBS was required to hold the entire SLR in cash (at zero return) with SBP. However, despite this disadvantage, Islamic Banks were enjoying a relatively better financial health compared to overall banking sector. At the end CY05, Islamic Banks were relatively better capitalized, enjoying high quality assets and earning better returns than the overall banking sector.

[9] Namely Emirates Global Islamic Bank & First Dawood Islamic Bank Limited.

Microfinance is another area that expanded quite significantly ever since the Microfinance Institutions Ordinance 2001 was promulgated. By the end of CY05, the network consists of five institutions[10] consisting of 130 branches. The expanded network is also evident from the increase of 0.23 million in number of borrowers from 2002 to 2005. With average annual growth rate of around 80 percent over the last four years, microfinance assets now comprise 0.22 percent of the assets of the whole commercial banking industry. Though the share is still very small, the rising trend may be indicative of the favorable environment that can result in making MF as one of the essential part of the financial sector of the country.

Although the Microfinance Banks (MFBs) have recently started business in Pakistan, their rapid growth and high performing assets has confirmed the fact that the low income group do have the ability to meet their debt obligations and can save a part of their income, as well. However, at present, focus in Pakistan is only on extending credit facilities, as MFB, in particular the Khushhali Bank, is solely relying on credit line from ADB and has not yet started mobilizing deposits. However, in order to sustain growth in future and to optimize the social benefits, it is important for MFBs to increase focus on deposit mobilization as well. Further, there is a need that microfinance institutions should provide insurance services to the poor segment of the society, which is more prone to adverse shocks and often has limited capability to mitigate negative fallouts. Also, at present, the operations of MFBs are largely concentrated in rural areas and the most of the loans (above 70 percent) are being extended to agriculture and live-stock sectors. Moreover, the distribution of loans of MFBs is highly skewed towards male borrowers. It is important for MFBs to diversify their loan portfolio professionally, regionally and gender wise.

It is encouraging to note that recently the commercial banks have also been allowed to start microfinance operations. Moreover, in order to provide flexibility to the SBP at the regulatory cum supervisory level, recently, Microfinance Institutions Ordinance 2001 was amended and refined through Finance Bill 2006. These developments would not only accelerate the development of this sector but also improve the efficiency of MFBs through increased competition.

Developments in the Insurance Sector

Like many developing countries, the insurance sector in Pakistan has remained dormant. This is reflected in very low level of insurance density at around US$ 5.0 per capita and insurance penetration at only 0.8 percent in the country in CY05.[11] In fact, both these indicators suggest that the relative size of the insurance industry is significantly smaller in Pakistan than in other regional countries such as India and Sri Lanka. However, on the back of macroeconomic stability, higher economic growth and continuation of reform process, the insurance industry in Pakistan showed some improvement from CY01 onward. Assets and gross premium of the insurance industry registered a compound annual growth rate (CAGR) of 15.5 and 20.4 percent during CY01-CY05.

The market structure of insurance industry though dominated by few players also witnessed some improvement during 2001-2005. The life insurance sector continued to dominate the insurance industry; however, relatively higher CAGR of 19.3 percent in assets of non-life insurance sector compared to 14. 0 percent in CAGR of life insurance assets increased the share of non-life insurance sector from 23.4 percent to 26.6 percent during 2001-2005 (see **Figure E3**). Within life insurance sector, share of State Life Insurance Corporation (SLIC) declined from 87 percent in 2001 to 75 percent in 2005. Similarly, in non-life insurance sector, the share of top 5 companies in total non-life

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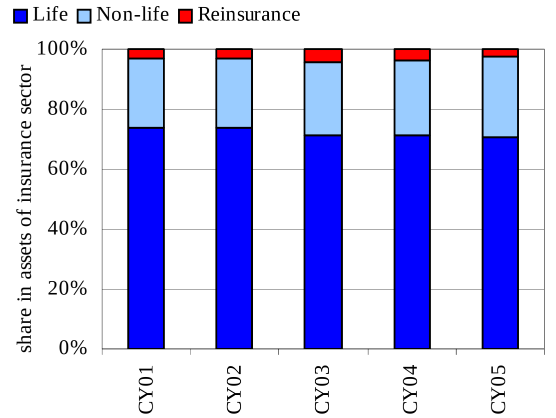
[10] Three MFBs (Khushali Microfinance Bank Limited, First Microfinance Bank Limited, Tameer Microfinance Bank Limited,) are working at national level while two MFBs (Rozgar Micro Finance Bank Ltd. & Network Micro Finance Bank Limited) are operational at district level.

[11] Insurance density is defined as gross premium per capita and insurance penetration as gross premium as percent of GDP.

insurance assets declined from 76.0 percent in 2002 to 71.1 percent in 2005. These changes in structure are welcome signs for the development of insurance industry in Pakistan. However, there is a considerable room for further improvement in structure through consolidation of small sized, private non-life insurance companies and encouragement of banc assurance channel, particularly for life insurance companies. In this regard, further enhancement in paid up capital requirement of both life and non-life insurance companies may not only improve the structure of insurance industry but would also act as a buffer against any potential shock to insurance industry. It is important to note that paid-up capital requirement for insurance companies, both in life and non-life businesses, is significantly lower than that of the other developing countries.[12]

Figure E.3: Structure of Insurance Industry



Financial health of the insurance industry has improved considerably during the period under review. Increased capital requirement and higher profitability improved the capital adequacy of insurance companies. In specific terms, capital to assets ratio increased from 12.1 percent in CY01 to 13.7 percent by the end of CY05. Moreover, the underwriting practice by the insurance industry became more prudent, as claim ratio registered a substantial fall from 61.0 percent in CY01 to 52.0 percent in CY05. As a result, profitability of the insurance sector improved as ROA increased from 1.7 percent in CY01 to 3.4 percent in CY05.

It is important to note that compared to CY04, both growth and financial health of the insurance companies has improved significantly in CY05. Specifically, in CY05 gross premium and assets of the insurance sector grew at 20.1 and 15.6 percent, respectively, against corresponding values of 12.5 and 15.4 percent in the previous year. Similarly, indicators for financial health including profitability, capital adequacy, and retention and claim ratios suggest improvement during CY05. In fact, during the CY01-CY05, profitability and capital adequacy indicators registered the highest values in CY05. However, lack of long-term investment avenues forced the insurance companies to opt for relatively risky avenue such as stock market. Specifically, the scarcity of PIB securities and also low return on these securities tilted the interest of insurance industry towards bullish stocks and shares market. Although, growing investment in stock market helped the insurance industry to post healthy yield on assets and in turn profitability; potential risks in the face of volatile stock market have also increased.

The continued progress in the surveillance and monitoring efforts is another factor that may help in the development of insurance industry in Pakistan. While substantial progress has been made in formulating the regulatory framework and subsequently developing off-site inspection of insurers; comprehensive enforcement of regulations demands more in-depth surveillance in the form of on-site inspection of insurers as well as intermediaries. Moreover, it is imperative for insurers and SECP to harness public confidence by strengthening the consumer protection infrastructure. The recent appointment of insurance ombudsman would subscribe insurers to high ethical and standard moral values through greater sales accountability and consumer redress. Moreover, the promotion of

[12] For instance in India, both life and non-life insurance companies are required to have paid-up capital of Indian Rs 1.0 billion (or around US$ 22 million); whereas in Pakistan, the paid-up capital requirement is Rs 100 million (or US$ 1.7 million) and Rs 80 million (or US$ 1.3 million) for life and non-life insurance companies, respectively.

consumer awareness and education would also be needed to safeguard consumers from unfair practices in the insurance industry. Similarly, dissemination of information related to insurance sector would also highlight the integrity of insurance companies. In this regard, SECP needs to build comprehensive database of financial positions of insurers so that effective policies can be formulated to provide enabling environment for development of insurance industry.

Performance of Financial Markets

In line with the phenomenal progress made by the overall financial sector, financial markets, including money, forex, and capital market further developed during FY01-FY06. The money market witnessed (a) increase in depth of both primary and secondary markets; (b) improvement in the efficiency; and (c) fall in volatility in short-term interest rates. In the long-term government bond market, however, the situation was mixed. Initially, introduction of Pakistan Investment Bonds (PIB) led to development of a relatively vibrant long-term government bond market. However, supply constraints in later years, eventually resulted in diminutive activity in both primary and secondary market of PIBs making the longer-end of yield-curve non-representative of true long-term interest rates.

The foreign exchange market also witnessed some major structural changes during FY01-FY06 that transformed foreign exchange market from a volatile, segmented and thin market in FY00 to a stable, unified and relatively deep market in FY06. The international efforts against the informal fund transfers diverted the foreign exchange flows to the formal channels that resulted in collapse of the kerb market and virtual unification of exchange rates. The increased inflows of funds from formal channel provided SBP an opportunity to streamline the businesses of the money changers by corporatizing them into exchange companies. Thus, the market segmentation, which was a major distortion in the foreign exchange market, was eliminated. The sharp increase in forex liquidity in the interbank market also allowed SBP to build up its foreign exchange reserves to unprecedented level. The stability in the exchange rate along with improved macroeconomic environment has led to substantial improvement in external account. Further, the foreign currency loans have strengthened the linkage between the foreign exchange market and the money market.

The improvement in major macroeconomic and geopolitical factors coupled with a low interest rate environment positively affected the equity markets during FY01-06. The increased investor's confidence together with strong improvements in the corporate earnings is reflected in the remarkable performance of the equity markets, especially since 2003. Although the market encountered some major corrections, it remained among one of the best performing markets in the world. In terms of the size of the market, and growth of indices, all the three stock exchanges of Pakistan showed phenomenal growth. The Karachi Stock Exchange (KSE) registered more than 700 percent increase in market capitalization and over 600 percent increase in the index over the period of last five years.

The corporate debt market has also made some progress during FY01-FY06, especially during FY01-FY03. However, like most developing countries, the market is still in the initial stages of development. By the end of FY06, outstanding issues totaled Rs 49.3 billion, which was only 0.64 percent of GDP. The growth prospects for the debt market are improving due to number of recent developments. On the supply side, rising interest rates have led corporate to lock-in funding costs, even as the demand profile is improving due to two main reasons: first, the increasing number of mutual funds; and second, the increasing role of professional fund managers in pension & provident funds, trusts, etc. However, the recent decision by the government to re-allow institutional investors in NSS may reduce the demand for TFCs. In this regard, it is essential to keep NSS rates in line with overall interest rate structure in the economy.

Financial Sector Development

Pakistan has achieved a remarkable financial sector development during the last five years as shown by improving financial sector deepening and intermediation indicators such as M2 to GDP ratio, money multiplier, currency to deposits ratio, etc. As a result of financial sector development, the share of national saving captured by financial sector (financial saving as percent of national saving) increased. The decline in the credit concentration is particularly a welcome development as it has widened the clientele of the banking sector not only in the traditional sectors but also in financially underserved sectors of the economy including the consumer, small and medium enterprise and the agriculture sector. Specifically, with the active and strong support of SBP in identifying various untapped sectors and providing guidelines for their financing, the number of borrowers registered a significant growth in recent years in almost all the major sectors of the economy. In particular, within consumer finance alone, 1.7 million borrowers were added within the last two years to reach 2.4 million borrowers at end December 2005 from just 0.7 million at end December 2003. This was followed by the SME sector where more than 69,000 additional enterprises have got access to banking services in the preceding two years.

However, despite the financial sector development during the last five years, Pakistan is still well behind the peer countries in terms of financial deepening and intermediation. Therefore, for further financial sector development in Pakistan, it is imperative to sustain the continuing strong growth path with low inflation; increasing documentation of the large undocumented sector; expanding outreach of formal financial sector; improving literacy; etc.