



# BSR

## **Banking System Review**

**For the year ended December 31, 2003**

***State Bank of Pakistan***  
***Banking Supervision Department***

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## **Preface**

The promotion of financial stability has been the main theme governing operations of central banks in recent times. In its capacity as the guardian of monetary and financial stability, the State Bank of Pakistan is fully alive to the importance of this issue, and its potential consequences for the overall economy. To achieve the goal of financial stability, the SBP has launched an over-arching campaign which focuses on institutional strengthening, development of necessary infrastructure and ensures the smooth functioning of markets.

Transparency and disclosure are essential traits that the SBP has prescribed - not only for market players but upon itself as well. This is done to keep stakeholders fully abreast with the strengths and weaknesses of the banking system. Through its various publications, the SBP is disseminating information on trends and developments in the economy and the banking system. The Banking System Review for the year 2003, produced consecutively for the second year running under the guidance of Dr. Ishrat Husain, the Governor of the State Bank of Pakistan, is one such endeavor.

Considering the overwhelming size of banks in the financial system, the review focuses mainly on the assessment of the financial health of the banking system. Separate chapters cover the performance of Development Finance Institutions (DFIs) and Micro Finance Institutions (MFIs), which also come under the regulatory ambit of the SBP. This analysis is based primarily on data from the annual audited accounts of banks and DFIs for the year 2003. However, some data from other sources have also been used to supplement the analysis. Macro-prudential indicators-aggregated micro-prudential indicators and macroeconomic indicators- are the leading benchmarks used for the purpose of analysis.

In addition to the assessment of the financial health of the banking system, the review also highlights various policy developments that took place during the year, both in the banking system as well as within the SBP. The purpose is to highlight the efforts being made to address issues confronted by the banking system and also to prepare it to face emerging realities.

The Banking Supervision Department is indeed indebted to other departments for their invaluable help in preparing this document. In this regard, the support provided by the Islamic Banking Department for the section on Islamic banking in Pakistan, the Banking Policy Department for a brief on policy developments, the Research Department for the data on macroeconomic indicators, the Payment System Department for RTGS, the Exchange & Debt Management Department for data on market risk and Vital Information Services, a private concern, for providing data on the corporate sector, is highly appreciated.

Since evaluation of the banking system's financial health is a continuous process, the SBP would appreciate comments/views for further improvement of the future reviews.

**June 04, 2004**

**JAMEEL AHMAD  
DIRECTOR  
Banking Supervision Department**



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## 1 Overview

The year under review added further strength to the soundness of the banking system. This is in line with trends witnessed over the past couple of years. Indicators of financial soundness have shown significant improvement and the industry structure presents a robust picture. The major developments during the year are summarized as follows:

- A few more banks with low capital base, which could have posed a systemic risk to the sector, merged and became part of more resilient and consolidated institutions, better placed to withstand any adverse shocks.
- Profitability and earnings showed a remarkable improvement, thereby contributing significantly towards strengthening the capital base and resilience of the banking system.
- Credit to the private sector picked up significantly, after showing years of sluggishness.
- The flow of non-performing loans has been stemmed and their stock came down substantially during the year, as did the NPL indicators. Along with the creation of additional provisions, this led to a considerable reduction in the burden of the infected portfolio on capital base.
- The system continued to have abundant liquidity. The recent upward movement in the interest rates, however, has increased the market risk.
- The average intermediation cost came down as a result of cost controls and expanding business volumes. This reflected an increased efficiency in financial intermediation.
- The privatization of Habib Bank Limited, a post-review development, has increased the share of private sector in the banking system to around 80 percent. This will further promote competition and efficiency in the system.

While these improvements owe much to financial sector reforms and improved corporate governance in banks, the regulatory and macro-economic environment have also contributed towards this:

- The economy preformed well and remained on the projected growth trajectory. The demand for bank credit by the private sector picked up. The key indicators of the corporate sector showed robust earnings and debt servicing capacity.
- Workers' remittances, though decelerated as compared to the last year, remained in the projected growth brackets. Consequently, the flow of funds to the banking sector remained intact and was sufficient to maintain a comfortable liquidity position in the market.
- Fiscal position of the government as well as inflationary trends was in favorable shape, thus enabling the easy monetary regime during the year.
- To support a vibrant financial system, the State Bank took a number of policy initiatives. This included issuing guidelines on corporate governance to strengthen the culture of accountability and transparency, change of ownership and consolidation of weak institutions, encouragement of consumer financing, and cleaning up of balance sheets through incentive-based recovery drives. Guidelines were also issued to banks

on risk management to provide the banks a broader framework to identify, measure, monitor and control/mitigate various risks in their business. The State Bank also took a major leap forward shifting from a “one-size-fits-all” approach of regulation to more risk-focused supervision by categorizing and instituting separate sets of prudential regulations for corporate/commercial banking, SME financing and consumer financing. Realizing the importance of much needed expansion in the scope of business and the due risk management thereof, the SBP issued guidelines in various areas and liberalized its exchange policy in respect of trade financing.

The banking sector is sensitive to developments in the economic and political sphere. The country’s political scene saw the resolution of some key issues, which had a salutary impact on its economic condition. Improvement in relations with India also helped restore investor confidence and as the process continues, prospects of boosting regional trade become bright. Despite these improvements, some irritants continue to haunt the geo-political environment. The western border continues to pose problems and, despite some progress, will remain in the limelight considering its potential impact on the state of law and order in the country. However, the government’s resolve to address the issue generates hope for better days ahead.

The results for the first half of the fiscal year paint a positive economic outlook and promise achievement of major growth targets. Strong and robust growth in the manufacturing sector and consistent surge in credit demand further support this belief.

There are, however, some subtle concerns that may increase stress both on the economy as well as the banking system. Higher level of economic activity is placing pressures on the external account, despite satisfactory export performance, in form of higher increase in imports, while there is a slowdown in capital repatriation and official inflows, prepayments are being made on external debt. Its intensity will depend upon the future terms of trade - oil prices have witnessed a sharp increase recently. The comfort of substantially large foreign exchange reserves and an under-pressure US Dollar (barring sporadic moments of strength) presents the SBP with some significant maneuvering space.

Creeping inflation, along with an anticipated global rate hike, is generating sentiments for a similar response in the local market. The magnitude and impact of such a rate hike (as and when it comes) is likely to remain modest as much of the prevalent liquidity is likely to remain in the system. This contributes to the continued strength of the corporate sector over banks, which have already built up significant cushions on the back of robust performance over a couple of years. The debt and liquidity related indicators for corporates have continued their upward trend, giving it the essential robustness for sustaining an upward march even in a changed interest rate environment. This said, the recent string of anti dumping measures taken against Pakistani exports, formation of new trade alliances and a continued influx of cheap foreign imports in the local market have the potential of stalling the recent corporate performance. The household paying capacity could come under strain in the changed rate scenario but given the present leverage margins, it is unlikely to result in growing defaults in the short run.

The banking sector’s persistent robust operating performance over the last couple of years is a healthy sign. But, the overwhelming portion of trading gains presents a caveat, and this may not be sustainable on long-run basis. The recent upturn in credit demand, if it is to sustain, has the potential of making up much of the lost gains. Another caveat is the continuous drain



on depositors' wealth; they are at present in a disadvantageous position as they have to settle at a negative real rate of return.

Other than the depressing yields, the specter of massive liquidity has not had any adverse impact on the system. Banks' adventures in the booming stock market has been capped at twenty percent of their equity. Along with upcoming margin rules for stock trading (as against a highly leveraged badla trade, in which the banking system is an important player) is likely to further solidify the banking system's inherent strength.

Credit disbursement at an exponential rate has, at last, broken the protracted spell of sluggishness. However, it has also at the same time, increased the level of credit risk for the banking system. Crucially important is the substantial increase in loans to SMEs, agriculture and consumer finance. This may have helped in diversification of loan portfolios of the banking system but at the same time have enhanced the risk profile, as banks are still going through an evolutionary phase in developing risk appraisals and mitigating techniques in these areas. The future expansion of credit to these new sectors will largely depend upon the extent to which the banks are able to develop internal procedures and controls in risk appraisals and mitigation.

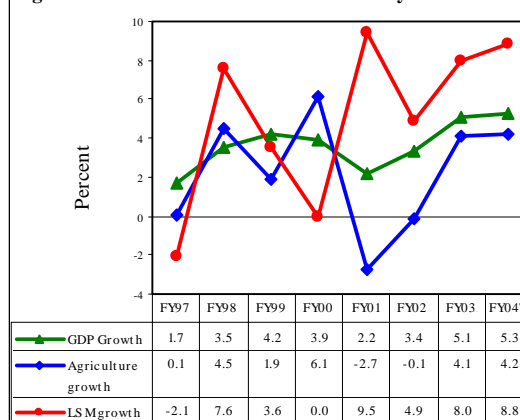
## 2. Macroeconomic Environment

The mutual dependence of real and financial sectors is an essential feature of any economy. Problems arising in one can easily seep through to the other and this may have dire consequences for the entire system. A judicious mix of fiscal, monetary and exchange rate policies pursued in recent years as well as other favorable circumstances seem to have put the economy on the persistent recovery path. This augurs well for overall financial stability.

The data for 2003 and the first two quarters of FY04 shows that the key macroeconomic indicators are well on course to meet their annual targets, with the exception of the inflation target. Rapid expansion in credit, mainly to the manufacturing sector, may have provided the much-needed impetus to aggregate output. Resultantly, the large scale manufacturing sector is set to surpass the target of 8.8 percent growth by the year-end.

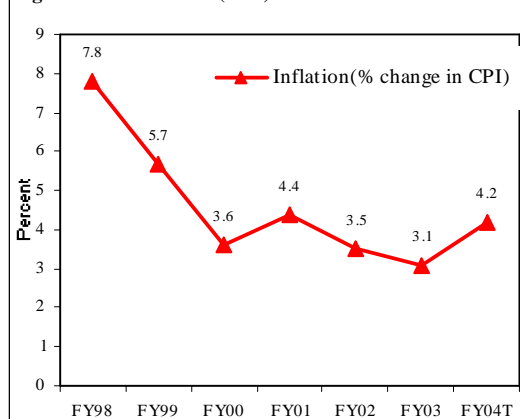
Despite favorable factors, including attractive agriculture product prices and growing emphasis towards lending to agriculture, it is unlikely that the agriculture growth targets will be achieved. However, a higher than expected growth in industrial sector along with stable growth in the services sector, promises to translate into a GDP growth exceeding its target (see **Figure-2.1**).

**Figure-2.1: Growth of Pakistan Economy**



Inflationary pressures have risen primarily due to supply shocks and are expected to rise further by the year-end (See **Figure-2.2**). These inflationary tendencies along with other factors gave rise to expectations among market players of a rise in interest rates. Interest rates did take an upward tilt but have not assumed any threatening proportions which may undermine nascent investment activities in the economy. The SBP is keeping a close watch on inflation numbers and is pursuing a policy to maintain interest rates at a level that would not jeopardize the long-term growth prospects of the economy while at the same time subdue inflationary expectations.

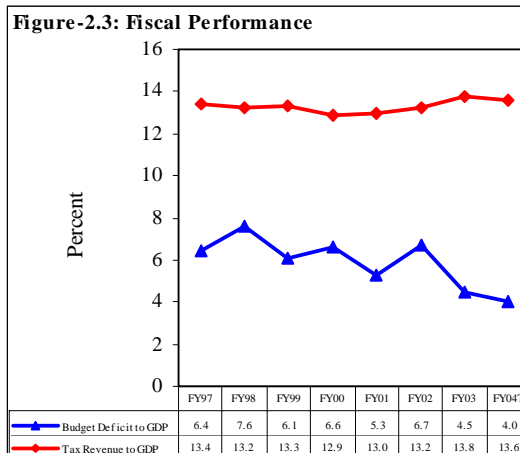
**Figure-2.2: Inflation (CPI)**



Low budgetary deficit, as a consequence of larger than targeted revenue collection and contained expenditure, is also a welcome sign. This would substantially reduce the burden on the financial system. The budget deficit as a percentage of GDP is targeted to decline further by the year-end (see **Figure-2.3**). It will release greater resources for utilization in more productive areas. This would help promote growth and financial stability. Moreover, the Government's resolve to the pre-mature repayment of expensive external debt as well as the

prevailing low interest rate scenario, would facilitate considerably in reducing the debt-servicing burden.

Despite deceleration in foreign exchange reserve accumulation, the total foreign exchange reserves are sufficient to meet approximately 50 weeks of imports (see **Figure-2.4**). The strengthened reserve position would not only enhance the country's ability to meet its obligations but would go a long way in improving its credit standing. In this context, the up-gradation of the country's rating is a good signal to foreign investors. The recent fall in foreign direct investment has more to do with geo-political conditions than with the economic fundamentals.



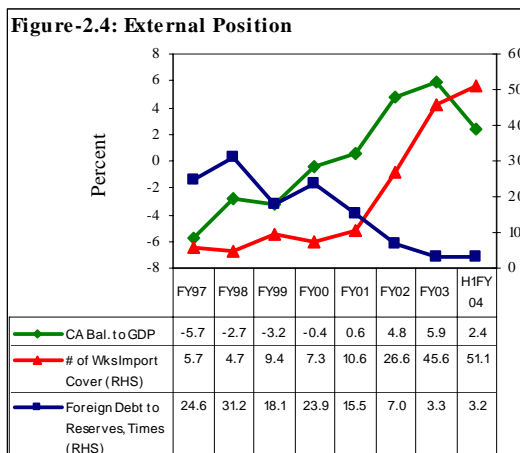
The external account position of the country remains satisfactory despite a decline in surplus in the balance of payments position in the first half of the FY04. The current account surplus diminished as a result of moderation in workers remittances, termination of Saudi Oil facility, rising oil prices and higher outflows with regard to service-related transactions. This led to a fall in the ratio of the current account balance to GDP in the first half of the current fiscal year (see **Figure-2.4**). More than proportionate increase in imports, mainly due to machinery and raw material purchases to complement increased economic activity, widened the trade deficit. The export performance, in spite of an increase in cotton prices, remained on track. The major challenge ahead will be to maintain export competitiveness in view of increasing competition abroad and also because of cessation of the quota regime in textiles.

The exchange rate remained stable with only a mild appreciation against the US dollar because of the SBP's policy to reduce inter bank forex purchases in view of a surplus on the external account. The stability of the exchange rate for quite some time has helped curb speculative behavior, providing a buffer against any currency and banking crises.

The remarkable performance of capital markets with an unprecedented rise in the Karachi Stock Exchange (KSE) index is largely on account of domestic investors. The vulnerability to short-term foreign capital movement, therefore, is negligible considering the low level of foreign portfolio investment in the market.

In short, the overall macroeconomic environment is very congenial to financial stability with consistent improvement in all the relevant indicators. However, there is also a need to guard against over expansion in credit and lending against collaterals like real estate and equity, which have experienced considerable appreciation in their prices and to manage the market risks that may arise due to likely change in the behaviour of key prices.

Any undesirable twist of events might have an unpalatable impact on the financial system.



### 3. Corporate Sector

For the second year running, the corporate sector posted very strong results. Profits for the year have well surpassed last year's level. Strong demand both at home and abroad enabled the corporate sector to further build on its previous year's successes. This was due not only to increased demand but also some cost saving, largely on the back of a strong bargaining position for the corporate sector over banks (that are flooded with excess liquidity). Financial charges eased off by more than one-third over the previous year's level.

The impetus of these factors was so strong that it pushed the combined return on assets (ROA) of companies listed on the Karachi Stock Exchange to over 1.9 percent, a jump of about 50 basis points over last year's ROA. Although net margin also improved substantially - 5.2 percent from 4.7 percent a year ago - this came largely through financial savings, as gross margin tapered off to 17.5 percent from 19.8 percent in the previous year. In fact this is being registered for at least the last three years as continuous financial cost savings are translating into hefty net margins for the corporate sector. This is an encouraging development and could not have come at a better time. The only caveat here is that these gains are largely of a financial nature, leaving room for productivity increases on the operational side.

Nonetheless, it is not just profitability that is improving. Equally healthy developments are also taking place on other fronts.

Pakistan's corporate sector used to have a leverage structure that made it vulnerable to business cycles. Recent years, however, have witnessed a steady decline in its indebtedness. Capital gearing has further improved and is getting close to 0.5, almost half of the 1998 level (the more conventional ratio of debt: equity also came off substantially to 45 percent from 59 percent a year ago). The sustainability of this trend might be difficult as the capacity utilization rate has significantly increased over the year. Some large-scale manufacturing industries are already running at full capacity. The need for expansion/ BMR is likely to spur

fresh investment and on the assumption that own funds largely tied up in the business, new funds will most likely come from the financial sector. The reliance of the corporate sector on banks though is not to the extent as it used to be. A string of new issues in the capital market (6 in 2003, and 6 up till April 04) along with new found enthusiasm in TFCs (8 over the same period) suggest gathering momentum of utilizing the capital markets for long term needs.

Figure-3.1: Operating Performance

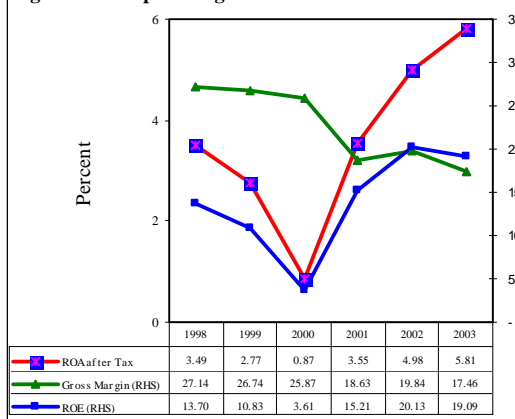
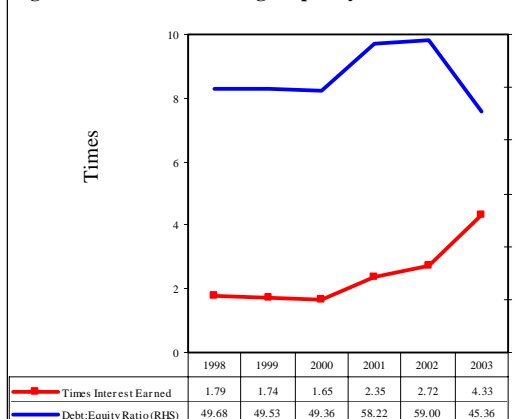


Figure-3.2: Debt Servicing Capacity



Nonetheless, the tax benefits for using debt over equity would continue to enthrall corporate sector and might pull back some of the recent gains made at capital gearing.

Interest coverage ratio is also at its record best, the EBIT/ financial charges indicator that has been continuously improving, edged up in a big way over the year and stands at 4.33 times. This gives much more resilience to the corporate sector, providing it with enough room to cope with any sudden interest rate shocks. A much better picture can be obtained if principal payments were also incorporated in the above equation; however, data constraints limit undertaking such an exercise. Nonetheless, trends in NPLs and the robustness of fresh lending over recent years can be proxies of the increasing corporate houses' ability to honor their debts.

The corporate sector has never been so liquid in the past, which can be gauged from the fact that cash generated from its operations is enough to liquidate almost three-fourth of long term debt. This stands despite the hefty rise in dividend payments which showed an appreciation of almost 70 percent over the previous year. The borrowing mode is also not a cause of concern as most of the debt contracted is in local currency.

These developing trends are pervasive and run across almost all sectors. The few exceptions are cement, for instance, that is in negative because of poor results by some heavyweights which have either not yet converted to coal/gas or are suffering because of unfavorable loan arrangements. Nonetheless, the outlook for the sector is bright and quarter-end March-04 results tend to confirm this upturn even in the loss making units. Similarly, the textile sector which showed some improvement in dividend payouts again tapered off in this year. This may, however, be indicative of a move of tapping more into the internal resource generation, as the sector has undertaken huge investments in view of the post-WTO scenario. The peculiar ownership structure (mostly family controlled) might also have facilitated this move. Contrary to this is the cement sector which continued to make huge dividend payments even in the face of losses and a leveraged structure. Even after some improvement (with the debt equity ratio 57:43 in 2003 as against 60:40 a year ago), the cement sector lags far behind the overall corporate average of 45:55.

Apart from textiles, oil & gas and to some extent, the communication sector, there is still a lot of room for improvement for Pakistan's corporate sector to bring it on an even keel with its counterparts in other economies. For instance, the current bonanza in the automobile sector owes much to a highly protective environment. Some recent developments such as imposition of anti dumping measures by the EU against Pakistani exports could undermine the expected profitability in value-added textiles, which has already committed sizeable investments in BMR. Further, the emerging constellation of Free Trade Agreements/ trade blocs worldwide could yet prove another impediment in sustaining this corporate run. On the home front, there have been reports on the fast marginalization of certain sections of the local industry (mostly in the informal sector) in the wake of recent flooding of cheap goods from a neighboring country. While this is a welcome news for consumers of these goods, these imports impose an adjustment cost on the domestic producers.

#### **4. Household Sector**

The current asset price boom owes much to increased consumer spending which has resulted from large capital inflows (remittances) and gradual up take in domestic economic performance. The phenomenon is a pervasive one and permeates through the financial as well as real estate markets. There is also a change in household relationship with the financial sector transforming its role from a mere resource provider to that of a user of its funds. Recent forays by banks into consumer finance have helped in reducing this imbalance somewhat. At the same time, the higher consumer lending has given rise to questions about the sustainability of this trend and resultant risks the banking industry may exposed itself to. Of particular importance is the household's capacity to service their debts as well as future liquidity conditions.

For strategic and operational reasons, prospects of the sustainability as well as the further reinforcement of this trend are high. Since 1999, consumer net worth has increased by a rapid 14.6 percent. As calculation of net worth is restricted to financial wealth alone (because of data constraints on capturing house wealth) the robustness of the sector is much higher than the one captured by this data. Nonetheless this build up in net worth, along with the prevailing low interest rate regime on household debt in the vicinity of Rs65.6 billion, provides the strategic reason for the continuation of this trend.

The flush of liquidity during the year was the fundamental driver of an increase in consumer financing. The future liquidity scenario also appears comfortable and suggests the continuation of the current momentum. Further, relatively high yields on consumer loans and ongoing investment in infrastructure by banks are also strong reasons which are likely to keep the banking system engaged in the consumer finance business.

To minimize the risk of default, the banking system, so far, has targeted customers in the relatively higher income brackets with a minimum of Rs 200,000 per annum. The income to debt servicing capacity ratio is also about 3 times. All these make consumer finance a very viable option.

As of December 2003, the banking sector had Rs65.6 billion outstanding in consumer loans, around 60 percent or Rs37.6 billion of this consisted of credit cards and personal loans, which are generally considered as riskier. Market intelligence suggests that appetite for such loans is high as they come with relatively less hassle and are not tied to any particular purpose. The charm for the banks is the high rates on such loans. However, this very factor makes these loans most susceptible to interest rate swings and could prompt serious difficulties for banks if rates were to change rapidly. Mortgage loans have grown rapidly considering their base but their volume still is quite low at Rs 4.1 billion- less than one percent of total loans. Considering the current level of banks' expertise in this field, the low level of exposure at this stage is, perhaps, propitious. Further, liquidity has already skewed the loan to value ratio considerably which can be stressful once the boom is over (especially so, as the allowable debt to equity ratio is at 80 percent). The banks, therefore, need to be more vigilant in managing the risks associated with such loans.

The contours of risk, one feels, manifest more the operational or micro side than the macro. The risk management techniques in the field of consumer finance are still evolving. Banks are faced with maturity mismatches, as so far they have not been able to tap the longer-term funds (insurance, pension and mutual funds etc.) to their liability side of the balance sheet, highlighting failure at development of appropriate product class to fend off the ensuing yield

risk. Expertise needed to develop a secondary market and to carry out sophisticated transactions such as securitization is also in the nascent stage and will take time to reach maturity. Nonetheless, the resolution of these weaknesses will be helpful in creating a conducive environment necessary for giving impetus to consumer finance.

## 5. Financial Soundness of the Banking System

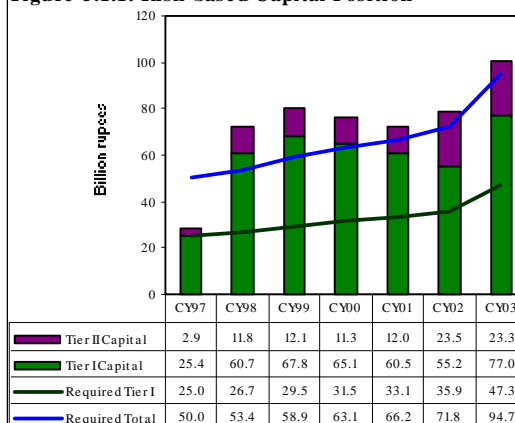
### 5.1 Solvency of the Banking System

The solvency of the banking system stems from its capitalization. To fortify the capital base of banks, the SBP enhanced the minimum capital requirements to Rs1 billion in 2000 giving them two years time to meet the requirement in a phased manner. This led to mergers and acquisitions within banks and NBFIs. Banks also raised fresh capital through right or bonus issues. The strong earnings for CY03 also supported the capital of banks. As a result, the overall qualifying risk-based capital of the banking system recorded a significant growth of 27 percent to Rs100.3 billion over the previous year (see **Figure 5.1.1**). However, the required level of risk-based capital also went up due to a surge in risk-weighted assets. The strong growth of credit to the private sector, the slow down in the investment in government papers and the reduction in the credit exposure to the public sector are some of the factors responsible for the change in risk profile of banks. Resultantly, the ratio of RWA to total assets soared to 46.5 percent from 40.3 percent (see **Figure 5.1.2**).

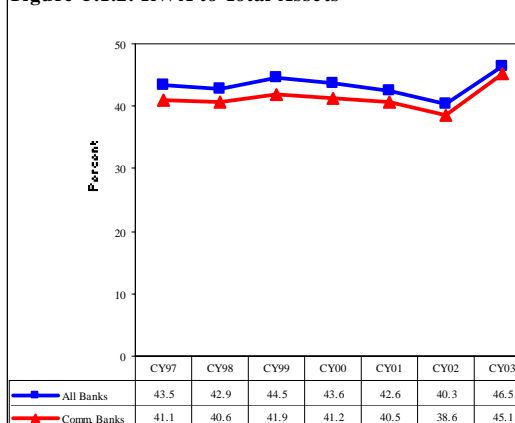
Unlike the previous year, the improvement in the risk-based capital was achieved through increase in core capital, as supplementary capital contracted over the last year. The decline in supplementary capital is mainly ascribed to the shrinkage in revaluation reserves. The increase in core capital is an important development as it had been on declining course for a number of years.

Despite considerable growth in the capital, the capital adequacy indicators showed a mixed picture. Because of relatively greater increase in the risk-weighted assets, the capital adequacy ratio of the banking system dropped by 0.3 percentage point to 8.5 percent in CY03 (See **Table 5.1.1**). Almost all the groups experienced a decline in their capital adequacy ratio. However, the core capital to risk-weighted assets ratio improved to 6.5 percent from 6.2 percent in CY02. Local private banks

**Figure-5.1.1: Risk-based Capital Position**



**Figure-5.1.2: RWA to Total Assets**



Percent	CY97	CY98	CY99	CY00	CY01	CY02	CY03
<b>CAR</b>							
PSCBs	-1.3	11.6	10.6	10.4	9.6	12.3	11.0
LPBs	11.9	11.4	10.7	9.2	9.5	9.7	9.0
FBs	14.6	15.6	18.6	18.0	18.6	23.2	23.0
Comm. Banks	6.0	12.5	12.2	11.4	11.3	12.6	11.1
SBs	-6.2	-1.4	0.3	-3.3	-13.9	-31.7	-28.2
All banks	4.5	10.9	10.9	9.7	8.8	8.8	8.5
<b>Tier I Capital to RWA</b>							
PSCBs	-2.0	8.3	7.7	7.7	7.1	8.6	8.2
LPBs	11.4	10.2	9.3	8.1	8.4	6.6	7.1
FBs	14.4	15.4	18.4	17.9	18.6	23.0	23.0
Comm. Banks	5.5	10.5	10.3	9.8	9.7	9.7	9.1
SBs	-6.3	-1.6	0.3	-3.4	-13.9	-31.7	-28.7
All banks	4.1	9.1	9.2	8.3	7.3	6.2	6.5
<b>Capital to Total Assets</b>							
PSCBs	0.3	4.9	3.8	4.6	3.7	5.6	6.1
LPBs	4.9	4.9	4.9	3.5	3.8	5.2	5.1
FBs	7.9	8.8	9.7	8.8	8.5	10.6	10.0
Comm. Banks	3.1	5.6	5.0	4.9	4.6	6.1	6.0
SBs	8.8	0.2	1.7	-1.1	-10.3	-23.0	-9.5
All banks	3.5	5.3	4.8	4.6	3.8	4.8	5.4



made the highest increase in their core capital to risk-weighted assets ratio as they outperformed other groups in terms of profitability and fresh capital injection. They were also the acquirers of foreign and investment banks under the merger and acquisition process. The improvement in the ratio of local private banks holds more significance as their share in the banking industry is rising.

Like core capital ratio, the overall balance sheet capital to total assets ratio also went up by 0.6 percentage points to 5.4 percent. Here again, local private banks made the highest increase. Public sector commercial banks followed them by 0.5 percentage point improvement. All the three ratios of the banking system are above their respective internationally accepted benchmarks.

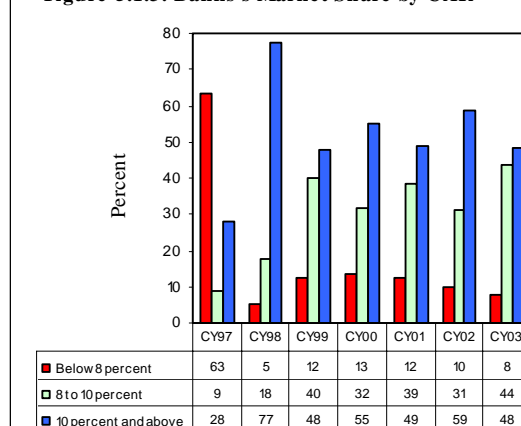
The disproportionately large size of five banks, and hence their systemic importance, makes the behavior of their solvency ratios very significant for the banking system. The consolidated capital adequacy indicators of these banks are the mirror image of the banking system. Their core capital to risk-weighted assets ratio and total capital to total assets ratio improved to 6.1 percent and 4.8 percent respectively from 6.0 percent and 4.6 percent in the previous year. At the same time, their overall capital adequacy ratio dropped by 1.2 percentage points to 8.7 percent. Nevertheless, their ratio is above the internationally accepted benchmark.

So far, we have focused mainly on aggregate analysis of the key solvency indicators. A glance on individual performance would provide greater insight. Most of the banks have strengthened their capital base. As a result, the banks, meeting the enhanced minimum capital requirement of Rs1 billion, now stand at 34 as against 28 in the previous year. At the same time, almost all the banks experienced a rise in their risk-weighted assets. The relatively greater increase in the risk-weighted assets led to a decline in the capital adequacy ratio of most of the banks. Consequently, the number of well capitalized banks<sup>1</sup> fell to 26 from 32 in the last year (see **Table-5.1.2**). Accordingly, the market share of well-capitalized banks also dropped to 48 percent from 59 percent (see **Figure-5.1.3**).

In short, significant growth in RWAs during the year influenced the growth of key capital ratios. The increase in loan portfolio is an encouraging development as it has not only revitalized economic activities in the country but at the same time provided banks an opportunity to channel their liquidity in more profitable avenues. Enhanced profits, in turn, will help further strengthen the capital base of banks. The improving loans appraisal standards and low level of fresh infection are already manifesting themselves through a

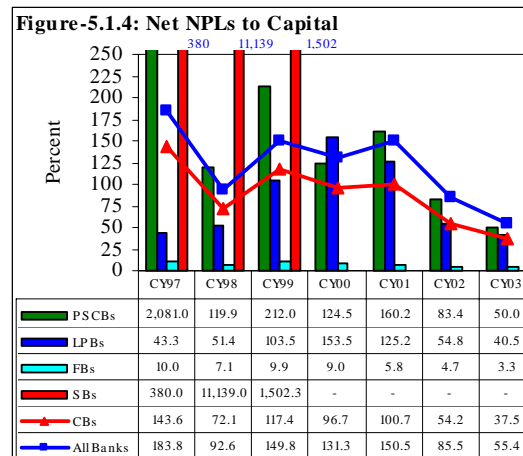
	Total No. of Banks	Below 8%	8 to 10 %	10 to 15 %	Over 15 %
CY97	46	7	5	12	22
CY98	46	2	4	17	23
CY99	44	3	6	16	19
CY00	44	5	6	16	17
CY01	43	5	5	11	22
CY02	40	4	4	9	23
CY03	40	4	10	5	21

**Figure-5.1.3: Banks's Market Share by CAR**



<sup>1</sup> Well-capitalized means banks with Capital Adequacy ratio greater than 10 percent.

persistent fall in non-performing loans. This will reduce the burden on banks' capital. Fall in net NPLs to capital ratio from 85.5 percent to 55.4 percent, further substantiates this point (See **Figure 5.1.4**). The improved performance can also be gauged from the credit ratings of the banks (See **Box-I**).



Box-I								
CREDIT RATINGS OF BANKS / DFIs								
Sr. No.	Name of Bank / DFI	Rating Agency	Previous Credit Rating			Latest Credit Rating		
			Short Term	Long Term	Date of Rating	Short Term	Long Term	Date of Rating
Public Sector Commercial Banks (PSCBs)								
1	National Bank of Pakistan	JCR-VIS	A-1+	AAA	Sept. 2002	A-1+	AAA	April, 2003
2	Habib Bank Limited	JCR-VIS	A-1+	AAA	Dec, 2002	A-1+	AAA	Apr. 2003
3	First Women Bank Limited.	PACRA	A2	BBB	Aug, 2002	A2	BBB+	Aug. 2003
4	The Bank of Khyber	JCR-VIS	A-2	BBB	May, 2002	A-2	BBB	April, 2003
5	The Bank of Punjab	PACRA	A1	A	June, 2002	A1	A	June, 2003
Local Private Banks (LPBs)								
6	Muslim Commercial Bank Limited	JCR-VIS / PACRA	A1+	AA	Sep., 2002	A1+	AA	May, 2003
7	United Bank Limited	JCR-VIS	A-1	A	Jan, 2003	A-1	A	June, 2003
8	Askari Commercial Bank Limited	PACRA	A1+	AA	June, 2002	A1+	AA	June, 2003
9	Bank Alfalah Limited	PACRA	A1+	AA-	June, 2002	A1+	AA-	June, 2003
10	Bank Al-Habib Limited	PACRA	A1+	AA	July, 2002	A1+	AA	June, 2003
11	Bolan Bank Limited	JCR-VIS	A3	BB+	June, 2002	A3	BB+	April, 2003
12	Faysal Bank Limited	JCR-VIS	A-1	AA-	Aug, 2002	A-1	AA-	Feb, 2003
13	Metropolitan Bank Limited	PACRA	A1+	AA+	June, 2002	A1+	AA+	June, 2003
14	PICIC Commercial Bank Limited	JCR-VIS	A-1	A-	Nov, 2002	A-1	A	Feb, 2003
15	KASB Bank Ltd.	JCR-VIS	B	BB+	July, 2002	A-3	BB+	April, 2003
16	Prime Commercial Bank Limited	PACRA	A1	A	July, 2002	A1	A	June, 2003
17	Soneri Bank Limited	PACRA	A1+	AA-	June, 2002	A1+	AA-	June, 2003
18	Union Bank Limited	PACRA, JCR-VIS	A2	A-	July, 2002	A-1	A+	June, 2003
19	Meezan Bank Limited	JCR-VIS	NIL	NIL	NIL	A-1+	A+	Jan, 2003
Foreign Banks (FBs)								
20	ABN-AMRO Bank	Standard & Poor's	A-1+	AA-	Previous	A-1+	AA-	Latest
		Moody's	P-1	Aa3		P-1	Aa3	
		Fitch-IBCA	F1+	AA-		F1+	AA-	
21	Al-Baraka Islamic Bank	PACRA	A1	A	July, 2002	A1	A	June, 2003
22	American Express Bank	Moody's	P-1	A2	Dec., 2001	P1	A2	Dec, 2002
		Fitch-IBCA	F-1	A+		F1	A+	
23	Bank of Ceylon (Now Dawood Bank)	JCR-VIS	A-3	BBB-	June, 2001	A-3	BBB-	July, 2002
24	Bank of Tokyo-Mitsubishi Limited	Standard & Poor's	A-2	BBB+	March, 2002	A-2	BBB+	April, 2003
		Moody's	P-1	A2		P-1	A2	
		Fitch IBCA	F1	A		F1	A-	
25	Citibank N.A.	Standard & Poor's	A-1+	AA	Previous	A-1+	AA	Latest
		Moody's	P-1	Aa1		P-1	Aa1	
		Fitch IBCA	F1+	AA		F1+	AA+	
26	Credit Agricole Indosuez	Standard & Poor's	A-1+	AA		A1+	AA	FY 2002
		Moody's	P-1	Aa2		P-1	Aa3	
		Fitch IBCA	F1+	AA+		F1+	AA+	
27	Deutsche Bank AG	Standard & Poor's	NIL	NIL	Nov, 2001	A-1+	AA-	Sep, 2002
		Moody's	P-1	Aa3		NIL	NIL	
28	IFIC Bank Ltd. (Now NIB)	JCR-VIS	A-2	BBB+	July, 2002	A-2	BBB+	April, 2003
29	Habib Bank AG Zurich	JCR-VIS	A-1+	AA+	July, 2002	A-1+	AA+	April, 2003
30	Mashreq Bank Pakistan Ltd. (Now Crescent)	JCR-VIS	A-2	BBB+	April, 2003	A-2	BBB+	Dec, 2003
31	Oman International Bank	JCR-VIS	A-2	BBB	April, 2002	A-2	BBB	April, 2003
32	Standard Chartered	Standard & Poor's	A-1	A		A-1	A	2002 Final Results
		Moody's	P-1	A2		P-1	A2	
		Fitch-IBCA	F1	A+		F1	A+	
33	Hong-Kong Shanghai Banking Corp. (Non HKS)	Standard & Poor's		A+	Jan, 2003		A+	Mar, 2004
		Moody's	A1	Aa3		A1	Aa3	
		Fitch-IBCA		AA-			AA-	
Specialized Banks (SBs)								
34	Punjab Provincial Cooperative Bank	JCR-VIS	A-3	BB+	June, 2003	A-3	BB+	Feb, 2004
35	Zarai Taraqiati Bank Ltd.	JCR-VIS	NIL	NIL	NIL	A-1+	AAA	April, 2004
Development Financial Institutions (DFIs)								
36	Pak Kuwait Investment Co. (Pvt.) Ltd.	PACRA	N/A	N/A	N/A	A1+	AAA	Nov, 2003
		JCR-VIS	A-1+	AAA	May, 2002	A-1+	AAA	May, 2003
37	Pak Libya Holding Company	JCR-VIS, PACRA	A-1+	AA-	Mar. 2003	A1+	AA-	Sept, 2003
38	Pak-Oman Investment Company	JCR-VIS	N/A	N/A	N/A	A-1+	AA+	June, 2003
39	Pakistan Industrial Credit & Investment Corp.	PACRA	A1	A+	Mar, 2003	A1+	AA-	Nov, 2003
40	Saudi Pak Industrial & Agricultural Inv. Co.	JCR-VIS	A-1+	AA+	May, 2002	A-1+	AA+	April, 2003
Micro Finance Institutions (MFIs)								
41	The First Microfinance Bank Ltd.	JCR-VIS	N/A	N/A	N/A	A-1+	A+	Sept, 2003

## 5.2 Profitability

The year 2003 proved to be very positive for the Pakistani banking sector as it made exceptional profits. After tax profits of commercial banks almost doubled to Rs 28.4 billion over the previous year (see Table-5.2.1). The specialized banks, which used to affect the overall profitability of the banking sector in the past few years, also managed to reduce their losses significantly. Consequently, the after-tax profit of the entire banking system surged to Rs 25.1 billion from Rs 2.9 billion in the previous year.

Profitability indicators accordingly registered a significant improvement. The return on assets (ROA) of commercial banks jumped up to 1.24 percent, which is almost equal to the internationally accepted benchmark of 1.25 percent. Similarly, their return on equity went up to 20.5 percent from 14.3 percent in the previous year (see Table-5.2.2).

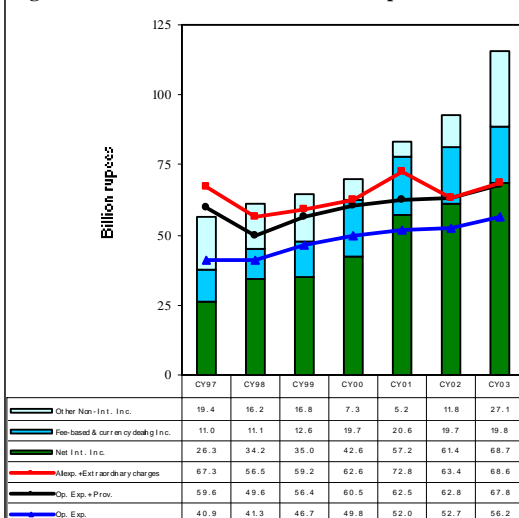
Like the previous year, the improvement in the profitability of commercial banks, amidst squeezing margins, was achieved on the back of huge gains on the sale of securities coupled with an increased volume of business. **Figure-5.2.1** and **-5.2.2** give a brief account of the commercial and specialized banks' operating performance over the last few years.

(Billion Rs)	CY97	CY98	CY99	CY00	CY01	CY02	CY03
<b>Profit before tax</b>							
PSCBs	(22.9)	(3.0)	(3.3)	3.9	0.2	10.9	16.1
LPBs	4.9	3.3	3.9	(0.6)	5.0	11.9	23.8
FBs	7.4	4.6	4.6	3.7	5.0	6.6	7.1
Comm. Banks	(10.6)	4.9	5.2	7.0	10.3	29.4	47.1
SBs	(0.2)	(9.2)	1.8	(2.5)	(9.2)	(10.4)	(2.5)
All Banks	(10.8)	(4.2)	7.0	4.5	1.1	19.0	44.6

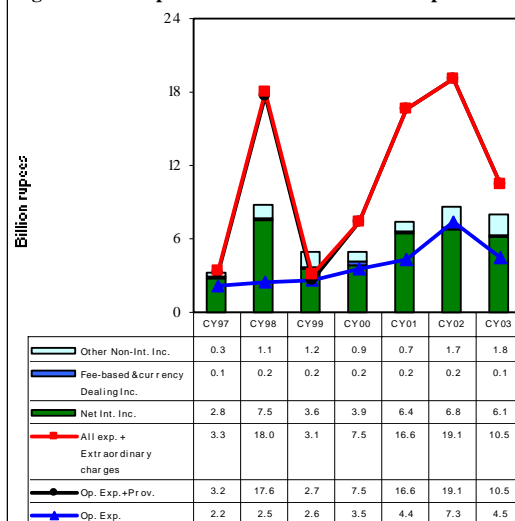
<b>Profit after tax</b>							
PSCBs	(21.4)	4.9	(8.3)	1.8	(4.6)	4.8	9.4
LPBs	1.8	1.4	1.7	(3.5)	2.0	6.4	14.8
FBs	3.4	1.1	1.7	1.4	2.4	4.2	4.2
Comm. Banks	(16.2)	7.4	(4.9)	(0.2)	(0.2)	15.3	28.4
SBs	(0.2)	(9.2)	1.8	(2.6)	(9.5)	(12.4)	(3.2)
All Banks	(16.4)	(1.8)	(3.1)	(2.8)	(9.8)	2.9	25.1

(Percent)	CY97	CY98	CY99	CY00	CY01	CY02	CY03
<b>Before Tax ROA</b>							
PSCBs	-3.4	-0.4	-0.4	0.5	0.02	1.3	1.8
LPBs	1.4	0.9	0.9	-0.1	0.9	1.4	2.2
FBs	3.0	1.7	1.8	1.4	1.7	2.3	2.6
Comm. Banks	-0.8	0.4	0.3	0.4	0.6	1.5	2.1
SBs	-0.2	-9.4	1.8	-2.3	-8.4	-10.2	-2.5
All Banks	-0.8	-0.3	0.4	0.3	0.1	0.9	1.9
<b>Before Tax ROE (based on Equity plus Surplus on Revaluation)</b>							
PSCBs	-272.7	-14.6	-9.6	10.9	0.5	26.3	29.9
LPBs	29.0	17.5	18.5	-3.2	25.4	32.3	42.2
FBs	37.7	20.5	19.3	15.6	19.3	24.2	25.2
Comm. Banks	-23.8	8.0	6.5	8.8	12.2	27.5	33.9
SBs	-1.8	-211.0	182.8	-	-	-	-
All Banks	-20.2	-6.4	8.7	5.7	1.4	21.1	36.4
<b>After Tax ROA</b>							
PSCBs	-3.1	0.7	-1.0	0.2	-0.5	0.6	1.0
LPBs	0.5	0.4	0.4	-0.7	0.4	0.8	1.4
FBs	1.4	0.4	0.7	0.6	0.8	1.5	1.5
Comm. Banks	-1.3	0.5	-0.3	-0.01	-0.01	0.8	1.2
SBs	-0.2	-9.4	1.7	-2.3	-8.8	-12.1	-3.2
All Banks	-1.2	-0.1	-0.2	-0.2	-0.5	0.1	1.1
<b>After Tax ROE (based on Equity plus Surplus on Revaluation)</b>							
PSCBs	-255.0	24.0	-24.0	4.9	-12.2	11.5	17.3
LPBs	10.9	7.3	8.1	-17.4	10.3	17.3	26.2
FBs	17.2	5.1	7.1	6.1	9.1	15.2	14.9
Comm. Banks	-36.2	12.0	-6.2	-0.3	-0.3	14.3	20.5
SBs	-2.0	-211.6	179.1	-	-	-	-
All Banks	-30.7	-2.7	-3.9	-3.5	-12.6	3.2	20.5

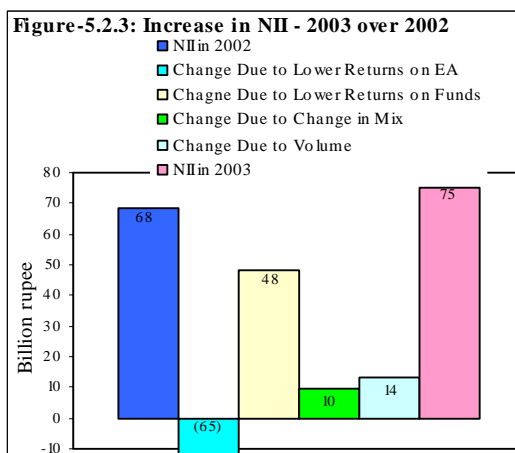
**Figure-5.2.1: Comm. Banks' P&L Composition**



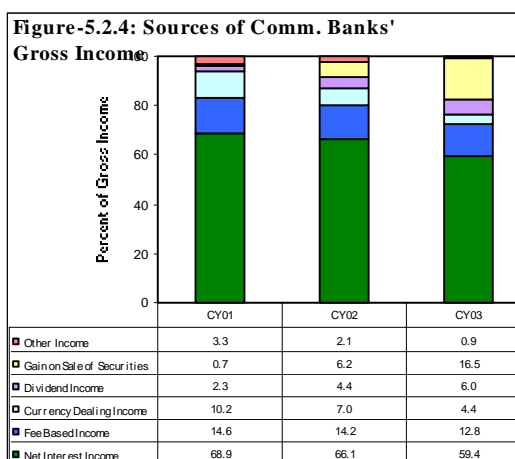
**Figure-5.2.2: Specialized Banks' P&L Composition**



The declining interest rate scenario that started to emerge in 2002 continued into the year under review. The returns reached to their historical low levels. Even the stabilization in returns that started to take place in the latter part of the year 2003 did not have any noticeable effect by the end of year. This decline in returns had a considerable contracting effect on the bank's interest income. The corresponding reduction in interest expense due to decline in interest rates coupled with re-profiling of deposits off-set the loss of interest income to a great extent. The increased volume of business, however, not only made up the remaining loss of interest income but also helped the banking system record an increase of Rs6.7 billion in net interest income (see **Figure-5.2.3**). However, in relative terms the banking system had to experience a decline in the net interest margin from 4.0 percent in the last year to 3.7 percent in 2003 as banks could not pass on the effects of decline in lending and treasury rates fully to their depositors, who were already being paid quite low returns.



The non-interest income of the banking system recorded an exceptional growth of 46.4 percent over the year. All the components of non-interest income registered increase except income from dealing in foreign currencies. The major contribution, however, came from gains on sale of securities which originated from the declining interest rates. These gains of non-recurring nature contributed 42.8 percent of the entire banking sector's pre-tax profits (as compared to 30.1 percent in 2002) and formed 15.5 percent of the gross income (5.6 percent in 2002). Another component of non-interest income, which recorded a major increase during the year, was dividend income. The improved performance of the corporate sector in general and the positive outlook of the capital market coupled with the improved performance of National Investment Trust, a leading mutual fund, in particular, yielded handsome dividend incomes for the banks contributing 15.5 percent to their pre-tax profits.



**Figure-5.2.4** shows sources of commercial banks' gross income for the last few years.

For the last couple of years, banks have maintained a cap on the growth of administrative expenses. During the year under review, total administrative expenses of the banks declined by 3.6 percent. But this reduction was not widely shared among the banks, as it was posted by two large PSCBs and one specialized bank, which provided extraordinary charges in last year. The combined effect of this reduction, i.e. Rs6.8 billion, was large enough to cover the increase of Rs3.8 billion by local private banks, which were following an expansionary strategy through acquisitions and increasing their branch network. The reduction in administrative expenses coupled with the remarkable growth in the fund base led to a

considerable reduction in the banking sector's intermediation cost (see **Figure-5.2.5**). Similarly, cost-income ratio (operating expense to gross income) of all the groups improved and stood below the internationally accepted maximum limit of 60 percent (see **Figure-5.2.6**).

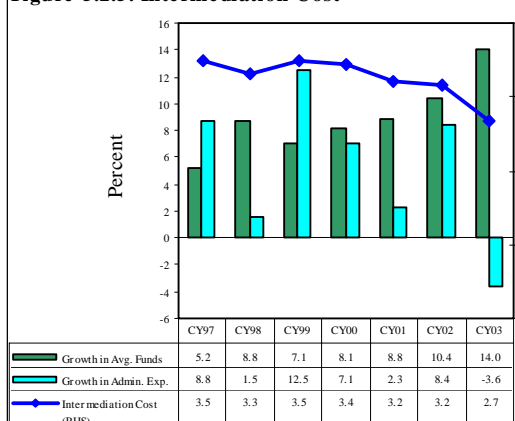
The assets quality of the banking sector has been showing signs of consistent improvement over the last few years. This year also witnessed significant decline in NPLs, and a parallel reduction in the charge for non-performing loans. This charge was lower by 19.7 percent for the year CY03 as against 21.6 percent in last year and took 14.2 percent of the banking sector's gross income. Consequently, incidence of NPLs for the whole banking sector came down by 180 basis points to 2.8 percent and by 90 basis points to 2.1 percent for commercial banks. This improvement was shared by all the groups.

Lastly, the tax charge, the rate of which is relatively higher for the banking sector vis-à-vis the rest of the corporate sector, worked out to 43.6 percent of the industry's pre-tax profit.

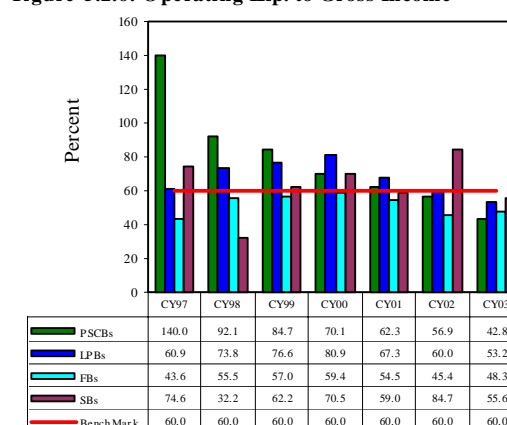
The government has initiated a policy to gradually phase out this difference in tax rates, which in the case of banks would be gradually reduced from existing 44 percent to 35 percent by FY07 to bring it at par with the tax rate applicable to non-bank public limited companies. The impact of this reduction in tax rates on banks is evident from gradually reducing burden of current year's tax charge as percentage of their pretax profits i.e. 52.1 percent, 35.1 percent, and 31.5 percent in 2001, 2002, and 2003, respectively.

The relatively higher tax rates for banks were not only at odds with principle of equity but they were also creating moral hazard problems – stifling creativity and innovation and providing impetus to indulge in riskier ventures, as excessive tax rates provide high tax shields on business losses – and were one of the contributing factors for higher lending rates to the borrower. This was not an ideal situation both for the economy at large and the banks and, therefore, needed correction. The recent cuts on the tax rates for banks have not only corrected the incentive structure but also contributed towards the rationalization of the

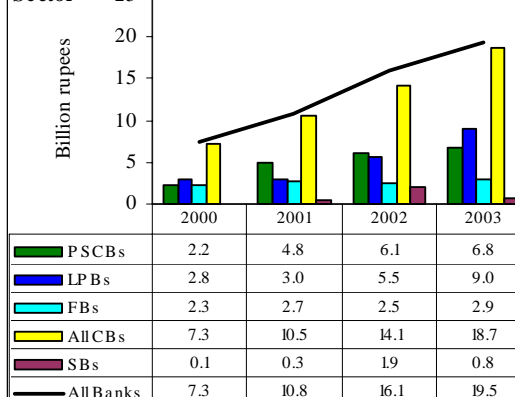
**Figure-5.2.5: Intermediation Cost**



**Figure-5.2.6: Operating Exp. to Gross Income**



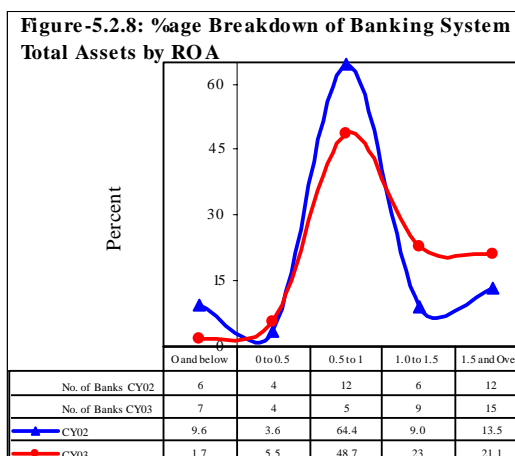
**Figure-5.2.7: Annual Tax Contribution by Banking Sector**



borrowing cost to the economy. The encouraging thing is that this rationalization of tax rates has not adversely affected the banks' contribution towards national exchequer; in fact, it increased to over two and half times since 2000 when the rate cuts were introduced (see **Figure-5.2.7**). These rate cuts have also contributed towards the financial stability by strengthening solvency of the banking sector through increased retention of profits.

### Individual Banks

The improvement in overall profitability of the system was widely shared by individual banks as well. This is well reflected in **Figure-5.2.8** which represents the percentage breakdown of banking sector assets by different categories of ROA. Shift in the curve as well as the number of banks towards right, higher brackets ROA, and rise in the higher ranges show this development. Number of loss making banks though increased; however, most of these banks were small banks; a few were going through the merger and acquisition process and suffered losses because of this transitory phase.



### Profitability Outlook

The performance of the banking sector in the current year depends on the general economic condition and monetary regime. An optimistic future economic outlook bodes well for the banking sector. The demand for bank credit that started to take pace in the latter part of the year 2003 is likely to continue into 2004. Though recent stabilization in returns on government papers entails a slack down in trading gains, the expected growth in the scale of business along with allied growth in fee-based incomes would, at least, make good the likely reduction in trading gains, if not elevate the level of earnings. The results for the first quarter of CY04 show that commercial banks' profits are on track to touch last year's levels, pre-tax profit for the quarter was 23 percent of the previous year's figure. Loans also showed an increase of 3 percent which is unusual, for the banking sector generally experienced retirement of seasonal lending during this quarter. This upturn in demand for bank credit, in the wake of improving returns, is likely to boost the profitability of the banking sector more substantially in the following quarters. However, the banks will have to take extra care of their expanding exposures, for a rapid growth in lending if accompanied by lax controls may take its toll on the earnings through deterioration in asset quality.



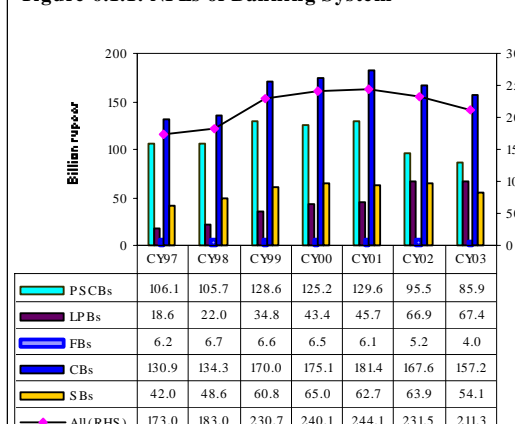
## 6 Risk Assessment of Banking System

### 6.1 Credit Risk

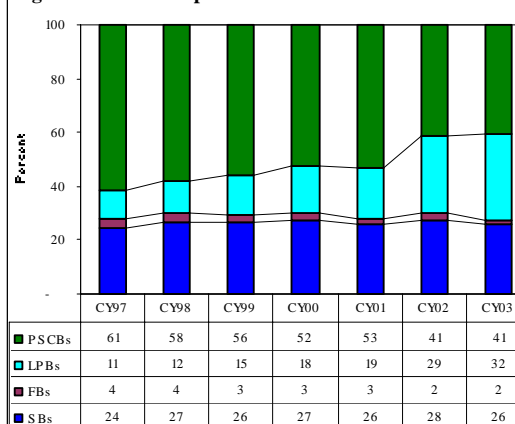
The phenomenal acceleration in loans during the year has, undoubtedly, been a stimulus for the resurgence of economic activity in the country. At the same time, it holds special connotations for the banking system's credit risk because of the comparatively higher level of risk involved. Particularly important are banks venturing into, until now, under-explored areas of SMEs, consumer finance and housing finance. There are concerns that the banking system does not enjoy the same degree of skills, expertise and loans appraisal systems in these sectors as compared to lending in the corporate sector. However, one must also acknowledge that the banking system has come of age as a result of significant in-house capacity enhancement and reforms and policies of the regulator in recent years. The banking system is expected to be robust enough to counter unforeseen contingencies more effectively now. The success of consolidation measures and reforms is visible by the fact that the haunting pace of accumulation of Non Performing Loans (NPLs) has been contained. NPLs of the banking system have come down significantly from what they used to be a few years back. Moreover, the low interest rate regime has also reduced significantly the burden on debt repayment capacity of borrowers. This, coupled with the substantial increase in liquidity and the profitability indicators of corporates as well as rising income levels, have reduced the chances of large scale loan defaults, as witnessed in the past.

The ensuing paragraphs will focus, in some detail, on various aspects of the credit risk of the banking system in Pakistan. Firstly, the absolute figures of gross NPLs have been showing a consistent downward turn since the last two years after following an ever upward trend in the past. During the year under review, the NPLs of the banking system declined by around Rs22.9 billion or 9.8 percent (see **Figure-6.1.1**). This improvement is attributed to the acquisition of NPLs by the CIRC, the introduction of the SBP's Incentive Scheme, the focused recovery drives by banks and the promulgation of new recovery laws. Moreover, banks have strengthened their internal controls and risk management practices which stemmed the flow of new NPLs. All the groups within the banking sector experienced a reduction in the NPLs from last year. Major reduction was

**Figure 6.1.1: NPLs of Banking System**



**Figure-6.1.2: Group-wise Share in NPLs**





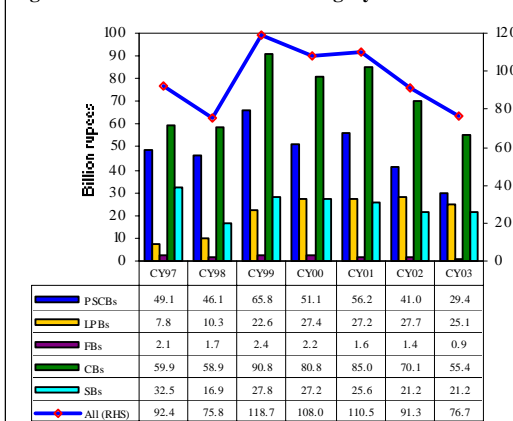
made by the Public Sector Commercial Banks and Specialized Banks<sup>2</sup>. The comparatively lesser decline recorded by the local private banks was due to the fact that they acquired some relatively weaker (foreign and investment) banks as a part of the ongoing consolidation process of the financial system. The group-wise share in NPLs, however, remained almost unchanged (see **Figure-6.1.2**).

A more appropriate measure of infection in the credit quality of the banking system is the level of net NPLs. However, net NPLs have also been steadily declining over the last couple of years. This has been achieved through reduction in gross NPLs while at the same time increasing provisions against bad loans. This signifies a more prudent approach adopted by the industry in recognizing banking risk, in line with the SBP's provisioning guidelines. The net NPLs of the banking system decreased by Rs.15.5 billion – a 17 percent reduction from the previous year. PSCBs and LPBs managed to bring down their net NPLs by Rs.11.6 billion and Rs.3.5 billion respectively whereas FBs decreased their NPLs by Rs.0.5 billion (see **Figure-6.1.3**). The NPLs coverage ratio has also, for quite a few years, been improving except for CY99. From just 47 percent in CY97 it has now reached 64 percent as of end of CY03 (see **Figure-6.1.4**).

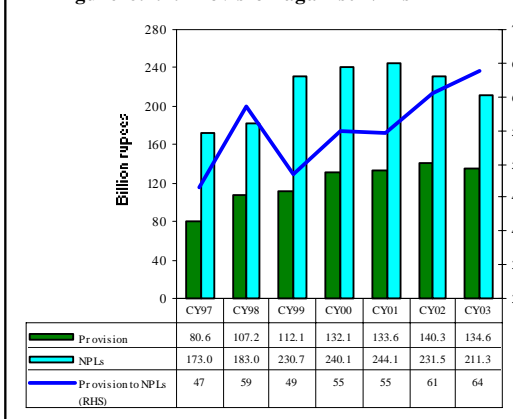
Similarly, the gross NPLs to gross loans ratios showed an improvement for all the sectors barring SBs whose ratio somewhat deteriorated, though not significantly, to adversely impact the overall ratio of the banking system. Overall, the NPLs to gross loans ratio improved to 17 percent from 22 percent last year (see **Figure-6.1.5**). By the same token, net NPLs to net loans ratios has now come in single digit, at 7 percent from 10 percent in the previous year (see **Figure-6.1.6**). For CBs, net NPLs to net Loans ratio looks more impressive at about 5 percent with LPBs and FBs making the largest contribution at a mere 4.5 percent and 0.7 percent respectively.

The NPLs not only affect the solvency of a bank negatively, they also upset the bank's

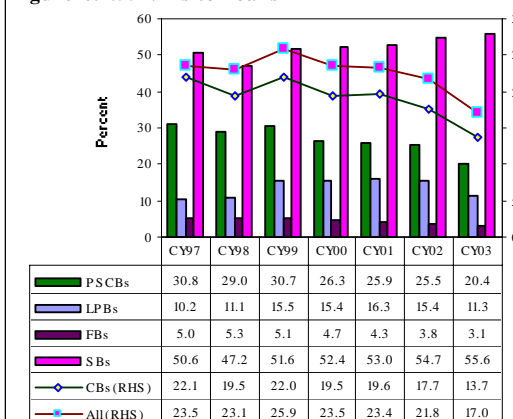
**Figure 6.1.3: Net NPLs of Banking System**



**Figure-6.1.4: Provision against NPLs**



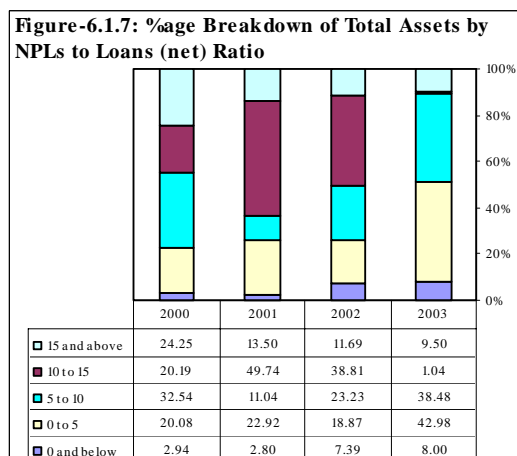
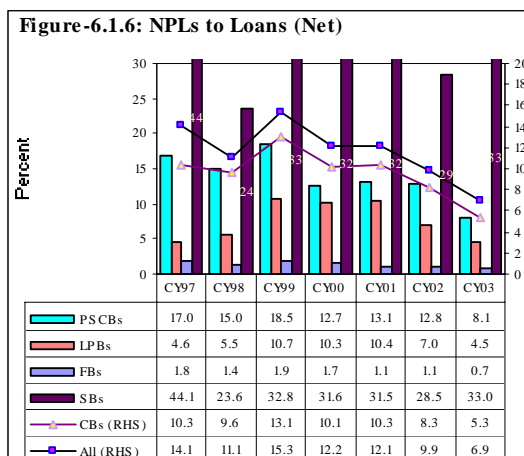
**Figure-6.1.5: NPLs to Loans**



<sup>2</sup> The reduction in the NPLs of Specialized Banks was mainly due to change in the NPLs methodology, which requires mark-up on NPLs to be kept in memorandum account.

earning potential by keeping bank funds blocked in non-earning avenues. The incidence of NPLs is a good measure to uncover what portion of bank income has been lost due to the NPLs. The incidence of NPLs for the whole banking system has come down to 2.9 percent from 4.6 percent last year which in turn had decreased from 5.9 percent in CY01.

The position of individual banks has also improved in terms of credit risk management. At present, 30 banks representing more than 89 percent of banking assets have NPLs to Loans (net) ratios in single digit, as compared to 26 banks representing only 49.5 percent of banking assets in the same category a year ago (see **Figure-6.1.7**).



Change in margin on securities retained by the banks against loans is an indicator of change in perceived risk profile of borrowers in general. The perceived risk profile of the banking system by the system participants does not seem to have changed much as margin on securities retained by banks against loans has not moved much in the recent past. With abolition of margin restrictions by the SBP in early 2004, change in margin retained will be a better reflection of change in risk profile of borrowers in the future.

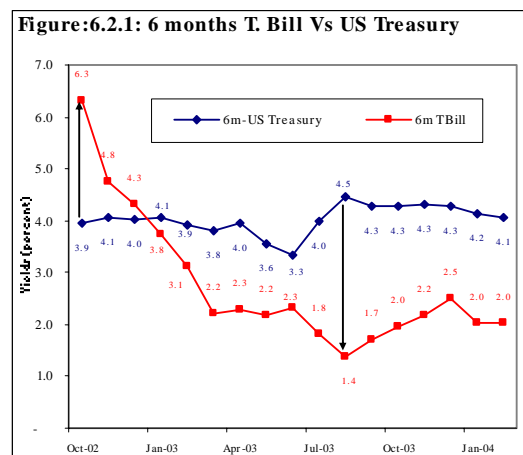
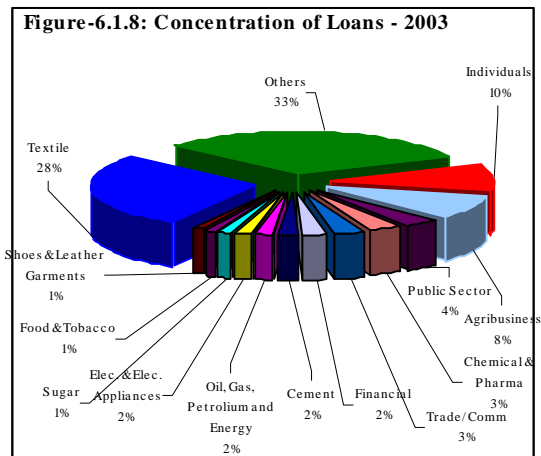
Risk concentration can be viewed as any exposure with the potential to produce losses that are substantial enough to threaten a bank's capital strength or earnings, or otherwise undermine public confidence in the bank. It can take many forms, including exposures to particular types of assets, individual counterparties, groups of related counterparties and counterparties in specific geographical locations, economic or industry sectors. Diversification of risk is essential in banking. Many bank failures in the past have been due to risk concentrations of some kind. It is essential for banks to prevent undue risk concentration from excessive exposures to particular counterparties, industries, economic sectors, countries or regions. Looking at the concentration of credits in different sectors of the economy, the textile sector stands out as the most concentrated sector (see **Figure-6.1.8**). Nevertheless, contribution of the sector in the GDP of the economy and the fact that textile itself consists of various different sectors (i.e. spinning, weaving, composite etc.) which distinctly remain quite unperturbed by problems in each other, fairly justify concentration in this broad sector. Besides sectoral concentration, the advances in Pakistani banking sector are somewhat concentrated in the hands of a limited number of corporates who form less than one percent of total borrowers but have a share of more than 70 percent of total outstanding advances. This phenomenon is, however, due to the fact that the borrower base in the banking

industry mainly comprises small agriculture and consumer borrowers. These may be quite large in number yet their individual borrowings are too small to form a sizeable portion in the total outstanding loans. To achieve more diversification, both industry-wise and geographically, banks have recently ventured rigorously into consumers and SMEs financing and these two sectors have shown an impressive growth. However, the relatively riskier nature of these new avenues necessitate adoption of robust risk management policies and matching human resource expertise to cater to the needs of these sectors while at the same time protecting the banks' interest. With the onset of a proper risk management regime and unrelenting supervisory review by the Central Bank, it is expected that the banking system will continue with the decreasing trend in their overall net NPLs. The data for the first quarter of CY04 reinforces this expectation as the net NPL ratio has further come down to 6.1 percent.

## 6.2 Market Risk

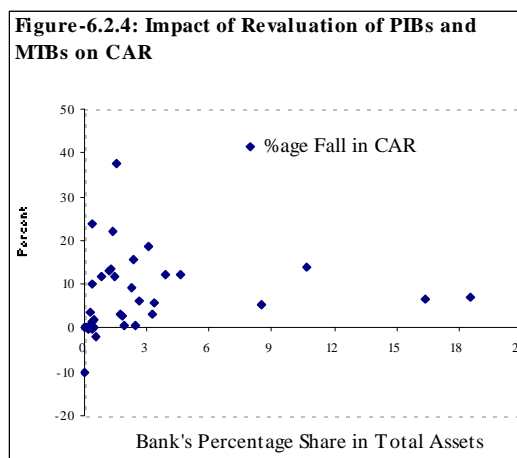
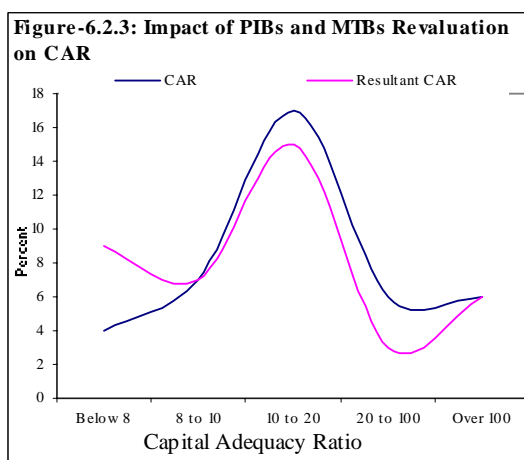
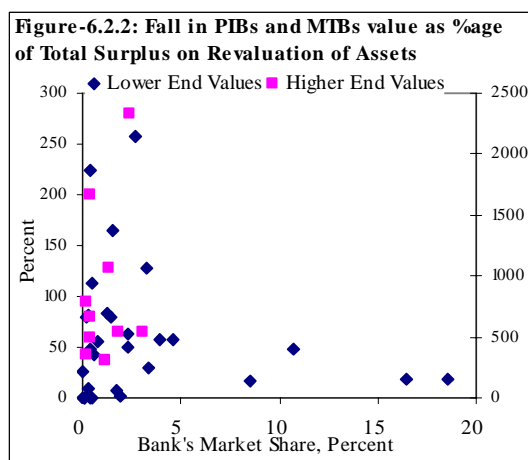
Market risk tends to rise given the increasing threat of interest rate and equity price volatility. The international dynamics depict a rising interest rate trend after the US economy started recovering. All-time low interest rates on rupee denominated instruments coupled with low or negative real returns on deposits, are likely to receive an upward pressure to avoid dollarization of the economy (See **Figure-6.2.1**). This magnifies interest rate exposures for the banks especially those with a big chunk of fixed income securities.

**Interest rate risk** remains unattended with out considering the yield risk. Duration of longer tenor fixed income bonds, a measure of yield risk exposure, remained quite high during first three quarters of CY03. However, from last quarter onward, a slight upturn in the interest rates has been ended up with comparatively lower value of duration. Consequently, the weighted average duration of PIBs comes to 5.2 by the end of the CY03, which is still very high. When measured as percentage of the tenor of the bond scrip-wise, the position shows that 10 year bonds tend to have higher duration at 71 percent of their tenor whereas 5 year and 3 year maturity bonds duration remained at 64 percent and 50 percent of their respective base tenors.



Accordingly, price volatility of these fixed income longer tenor securities tends to be higher with any change in interest rates. Its impact is well seen in the price sensitivity measure of these fixed income bonds, which presents that with a rise of interest rate by one percentage point, the revaluation would cause the prices of 10-year bonds to fall by around 5.7 percent. The weighted average impact of all the three bonds could possibly be a 4.5 percent fall in the value of overall PIBs portfolio. However, for the market treasury bills (MTBs), the impact is not that significant as the same rise in interest rate would cause a 0.44 percent fall in these shorter tenors fixed income securities. Though for the last couple of years the liquidity influx and falling rate scenario have helped banks in increasing their balance sheet footings, while investing heavily in fixed income securities and piling up surplus on their revaluation, the upward movement of the interest rates could deplete this fickle increase of surplus.

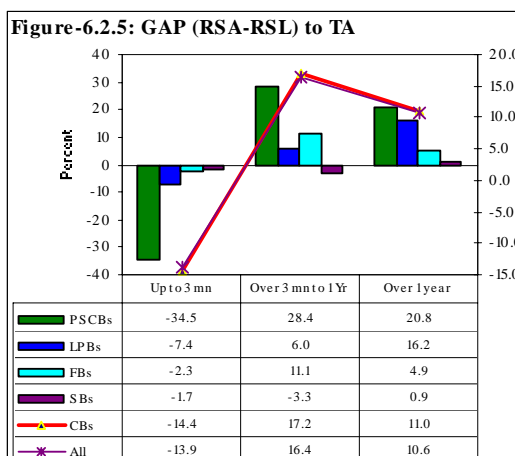
The analysis reveals that if risks associated with investment in these fixed income securities are not managed properly, a 100 basis points rise in the interest rates would cause around 30 percent fall in the total surplus on the revaluation of assets. Bank-wise, 15 out of 40 banks, with market share of around 20 percent, may face negative surplus (See **Figure-6.2.2**). When the impact is realized on capital, a downward shift of five banks may deteriorate their CAR to below the 8 percent benchmark (See **Figure-6.2.3 & 6.2.4**). As concentration itself poses a risk, the banks need to rationalize the mammoth holdings of fixed income securities by secondary market activity.



The other measure of sensitivity of net worth of the bank to fluctuation in interest rates is the economic value perspective. The economic value of an instrument presents an assessment of the present value of its expected net cash flow, discounted to reflect change in market rates. As weighted average maturity of rate sensitive assets and liabilities, with an increasing trend, remained at 8.9 months and 6 months respectively, the maturity GAP stayed positive at 2.9 months. This in fact signifies positive duration GAP, which shows that an increase in interest rate would effectively cause a greater fall in the economic value of assets, hence net worth of

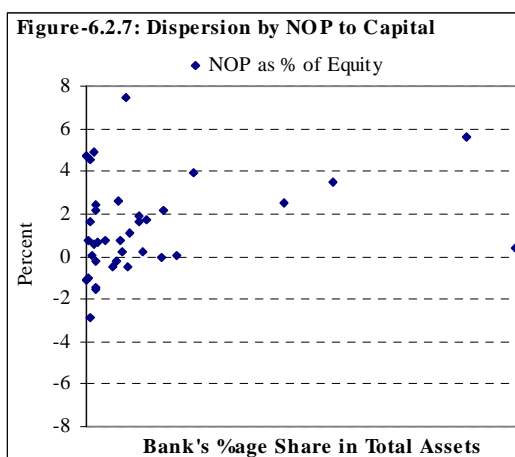
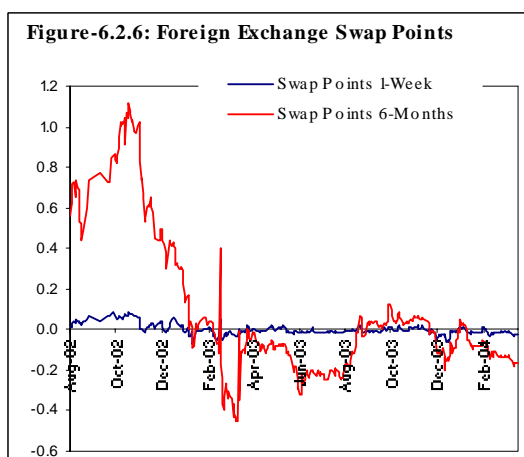
the banks. Quantifying its impact, a 100 basis points rise in interest rates would cause a fall of around 60 basis points on CAR of the banking system.

In the maturity method, long or short positions called GAPs between rate sensitive assets and rate sensitive liabilities, the sources of interest rate exposures have been slotted into maturity ladders comprising three bands. When measured as a percentage of total assets and compared with the acceptable benchmark of +/- 10 percent, our banking system shows greater exposures. For the shorter tenor of three months maturity ladder, the liabilities far exceed assets maintained in the same category. However, for the next two buckets, namely 3-12 months and onward, the GAPs maintained are positive (See **Figure-6.2.5**). Group-wise, public sector commercial banks are very aggressive in maintaining large GAPs for all the three buckets and their overall GAP partially normalizes to 15 percent of the total assets. Local private banks, though, with the same level of overall exposure, are well within the acceptable bands up to the one-year bucket.

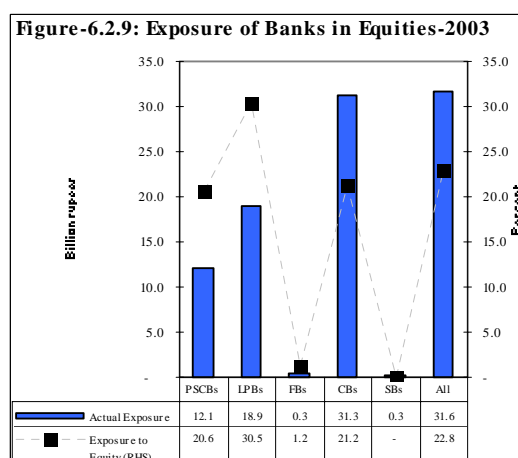
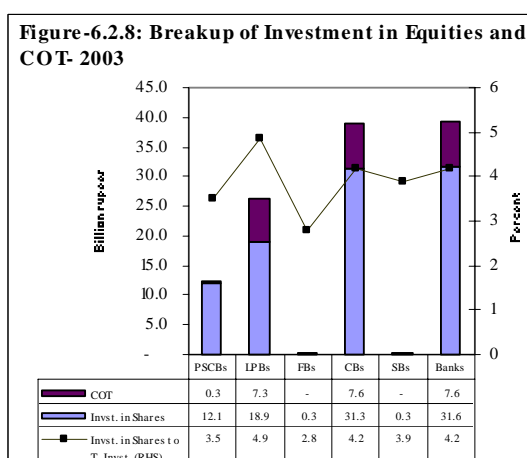


As for **exchange rate risk**, the improved foreign exchange liquidity due to surplus in current account, increasing FE-25 deposits and lesser purchases of foreign exchange by the SBP from the open market gave further gains to the Rupee against the USD. The negative swap points since the start of CY03 encouraged the banks to take a riskier stance by holding an aggregate oversold net open position (See **Figure-6.2.6**).

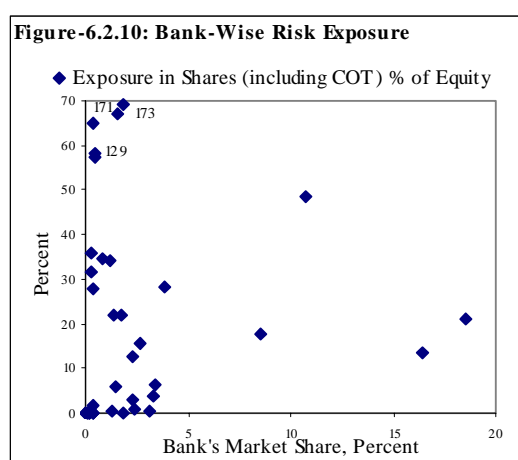
The level of net open position (NOP) as a percentage of capital is well within the acceptable range of  $\pm 10$  percent. However, bank-wise analysis shows that around 10 banks holding the share of 63 percent in the total assets are running negative NOP (See **Figure-6.2.7**). Now, if the lower yields on rupee instruments are not addressed, the rising returns on USD may exert an upward pressure on the exchange rate and if banks continue to have oversold positions, they would have to face exchange rate risk.



The **equity price risk** of banks increased over the last year. The massive influx of funds during the last two or three years mainly went into government papers. Though the banks' exposure in equities increased over the last year in absolute terms, its share in overall investment remained moderate at 4 percent (see **Figure-6.2.8**). However, the banks' average equity exposure as a percentage of their capital comes to 23 percent (see **Figure-6.2.9**). Taking into account the indirect exposure (i.e. COT financing) as well, the overall exposure as a percentage of capital rose to 28 percent.



The group-wise position shows that LPBs carry the highest exposure in equities, which represents 30 percent of their capital. The focal point is that a few banks have invested huge funds in the stock market which is disproportionate to their slender capital base. Besides, there is wide dispersion among banks in terms of their individual risk exposure and their relative size in the banking sector (see **Figure-6.2.10**). Majority of the banks have remained cautious while investing in shares as well as the COT. Only a couple of banks have excessive exposure, which makes these banks vulnerable to any adverse movement in the stock market. The recent investment figures reflect that hyperactivity persisted in the 1<sup>st</sup> quarter of CY04 on the backdrop of strong stock market position. One of the reasons for the high exposure of a few banks is their Islamic banking operations, where other investment modes are not allowed as per Shariah compliance. Despite this, carrying a risk exposure in equities around double the capital base is not prudent by any standards. Although this does not pose a systemic risk owing to the small asset size of these banks and their insignificant share in the overall banking sector, any downturn will, however, have a direct hit on the capital of these banks. Moreover, barely 25 to 30 stocks account for around 75 percent of the trading volume in the stock market. This makes the banks' investments highly susceptible to any decline in these stocks.



If the current economic scenario remains favorable, with the interest rates intact and corporate profitability on the rise, the chances that the market will face a sudden downturn remain dim. However, despite all the positive trends, the banks need to take into consideration the alarming increase in volumes in the stock market and the fact that the improvement in the bottom line of the corporate sector has been primarily led by the reduction in financial charges. Empirical evidence shows that the maximum downturn in the stock market since CY99 has been around 13 percent. Assuming the possibility of adverse

surprises, investment holding of the banks in equities has been discounted by 20 percent. As any dip in the market is likely to affect their capital base, therefore, it is imperative to see the relative strength of the surplus on shares available with banks as a shield against the adverse movement in the stock market (see **Figure-6.2.11**). The surplus of all the groups is sufficiently higher than the expected decrease in the value of investment, barring the LPBs, which have excessive exposure in the stock market due to a few banks. On a bank-wise basis, surplus of 22 banks with market share of 39 percent in terms of total assets will be eroded and turn negative, given a 20 percent fall in the index.

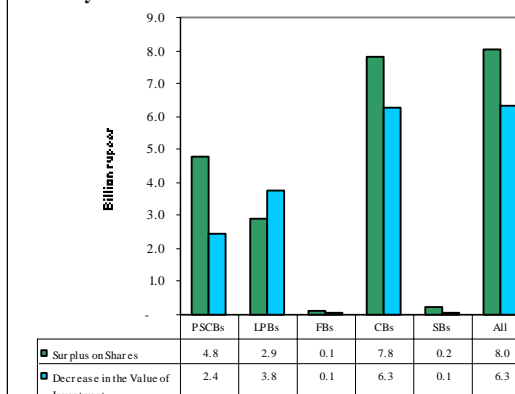
Cognizant of the banks' activity in the equity market and its inherent risks, the State Bank has introduced guidelines regarding the investment exposure in the stock market, requiring banks to maintain their exposure in equities up to a maximum of 20 percent<sup>3</sup> of their capital. As the deadline of 31<sup>st</sup> December 2004 for the banks to regularize their exposures is approaching, the banks might come under pressure if they keep their exposures beyond the stipulated levels. However exposure of most of the banks is within the stipulated limits. Moreover, margin financing is likely to be introduced as the mode of trade in the stock market by middle of this year, and to ensure its smooth transition from COT, the SBP and the SECP would finalize the rules for margin financing by that time so that activities are undertaken in a prudent manner. This step will not only encourage active participation of the banks but also contain the risks associated with such transactions.

### 6.3 Liquidity Risk

An easy monetary policy following the liquidity influx after 9/11, the strengthening of the rupee and improved financials rarely emanates a liquidity concern for the banks. However, managing the liquidity to get optimum returns in a lower yield scenario has remained an issue.

Funding liquidity risks, one of the integral part of liquidity risk, does not pose a threat as banks have remained flooded with core funding due to high liquidity inflows in the form of remittances. M2 grew by 17.6 percent during CY03 as money supply has been picking up considerably since 9/11. Almost all the increase in M2 during the year has led to a

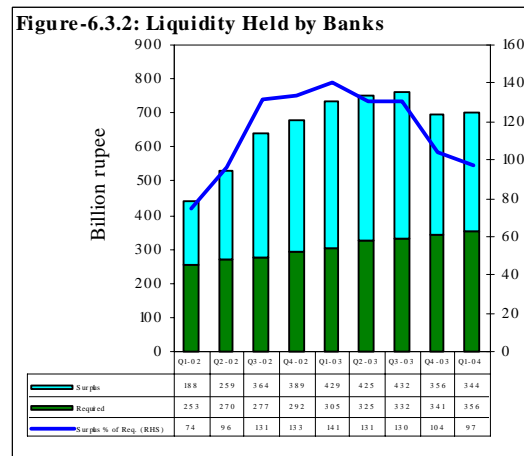
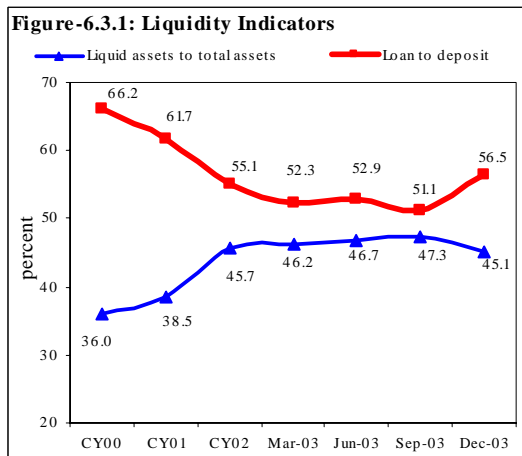
**Figure-6.2.11: Impact of Adverse Movement in KSE Index by 20%**



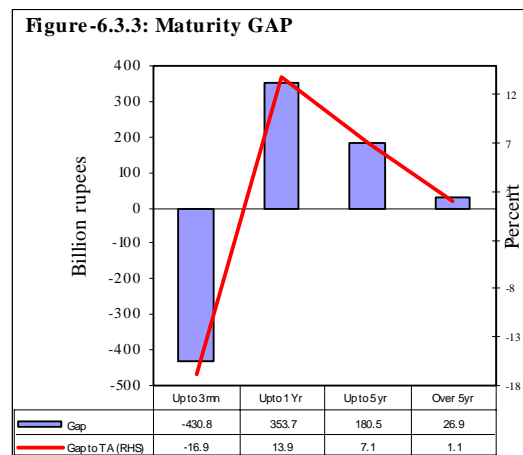
<sup>3</sup> The exposure is calculated after subtracting investments of banks in their subsidiaries and their strategic investments. For Islamic banks the limit is 35%.



proportionate growth in deposits maintaining almost the same level of M2 to Deposit ratio, one of the measures of intermediation of the banks. Loan to deposits ratio, one of the liquidity indicators, at 45.1 percent though increased from last year due to an upsurge in loans, yet the level is comfortable (See **Figure-6.3.1**). If rising interest rates and the theory of demand hold true in our scenario, the ratio will improve further, adding up in the liquidity of the banks. The comfortable liquidity position is also obvious from the fact that bank's liquid statutory reserves far exceed the required level (See **Figure-6.3.2**). Moreover banks paid very few visits to the SBP's discount window.

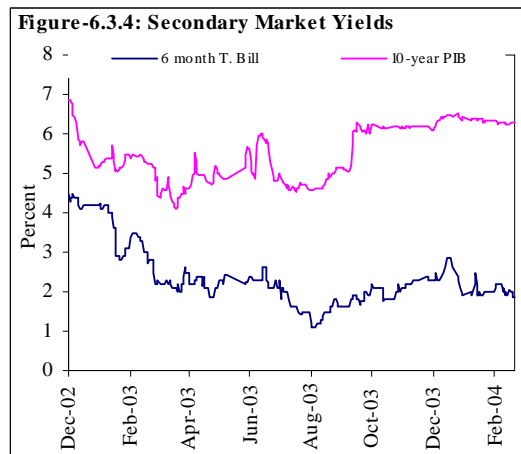


However, as the banks have more short-term liabilities for funding reflected in the negative liquidity cushion in shorter tenor, the banks need to have more asset base liquidity (See **Figure-6.3.3**). On the contrary, liquidity coverage ratio (amount of cushion as percentage of projected cash inflows) is largely positive for the more than three months buckets. This shows the bank's heavy investment in fixed income securities to get easy returns and book large capital gains, which raises the issue of offsetting the large exposures. There stems the risk of liquidation of assets when the banks cannot easily unwind the large exposures without significantly lowering the market prices. This has been obvious in the higher liquidity spreads of off-the-run securities such as PIBs, making the secondary market as a thinly traded securities market. However, the jumbo issue of PIBs in the last quarter of the CY03 fueled the secondary market activity that added to the trading volumes of long term papers. With this issue the total holdings of the PIBs constitutes 28 percent of the total investment of the banks (CY02: 21 percent). The newly issued longer tenor bonds of 15 and 20 years maturity, during the first quarter of CY04 may increase the secondary market activity and help reduce these liquidity spreads. These spreads are lower for the MTBs as these securities are freely traded in the secondary market.

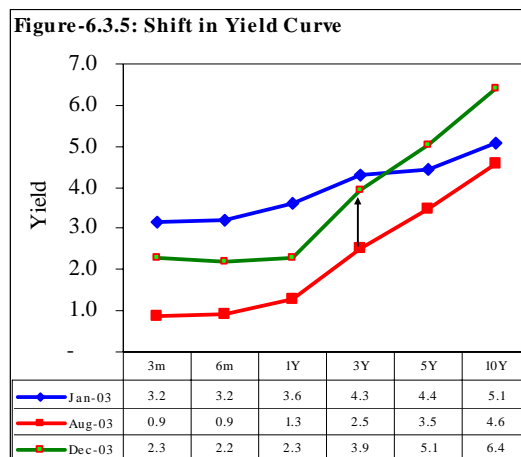




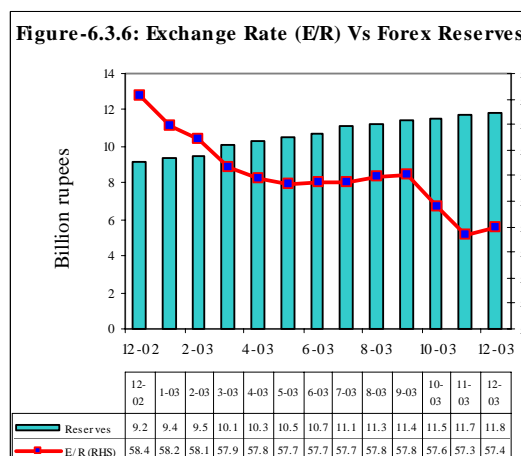
The concern aggravates taking into account the upturn in the ever-falling yields across all the tenors. Given the fall in the liquidity inflows coupled with the rising rates in the international front when the prevailing interest rates have already bottomed out, the expectation of an increase in interest rates is not unrealistic. The prevalent falling rate scenario resumed for the first three quarters of the CY03 but since August 03, an upsurge is seen in the market interest rates (See **Figure-6.3.4**). While higher demand due to sharp credit off-take was one of the influencing factors, more strongly it was the anticipation of higher yields on the jumbo issue of PIBs announced by the SBP that boosted interest rate rise expectations. While the market was expecting a steep rise in the rates that was translated into higher bids, by opting the strategy of having a cut off on interest rate rather than volume in PIBs auction, the SBP kept a check on this market move. However, yields on the new issue of PIBs were comparatively higher.



Consequently, when the discount rate remained intact after a couple of adjustments in CY02, weighted average yields on 3y, 5y, and 10-year bonds gained 125, 192 and 222 basis points since March 03. This development grounds the shift in the yield curves as interest rate started rising across all the tenors (see **Figure-6.3.5**). If not heeded properly, this upward shift in the yield curve could affect the asset-based liquidity. Positive yield spreads whereby yield curve slopes upward, however, signal a future economic surge.



The Rupee persisted in its gains against the USD in the face of an external account surplus and improved foreign exchange market liquidity. The exchange rate quoted was at Rs57.4 per USD as of 31<sup>st</sup> December 2003, witnessing a 1.7 percent appreciation during CY03. Though net inflows decelerated its pace as compared to the last year growth, lower market interventions on the part of the SBP, especially during last quarter of CY03 marked this appreciation (see **Figure-6.3.6**). The cozy exposure of banks in both on balance sheet and off balance sheet and comfortable inter bank dollar liquidity rationalized the foreign exchange liquidity.

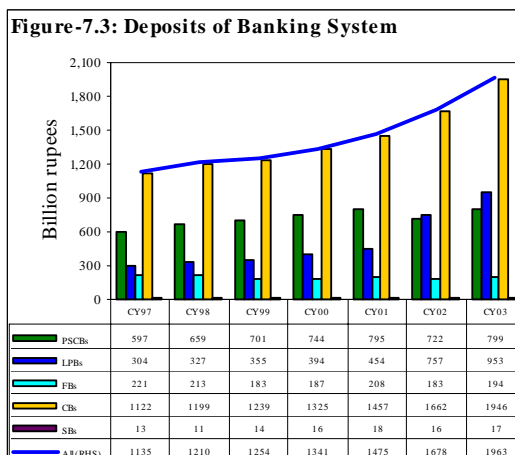
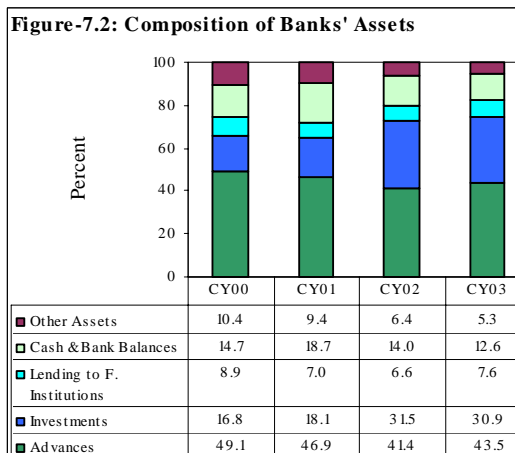
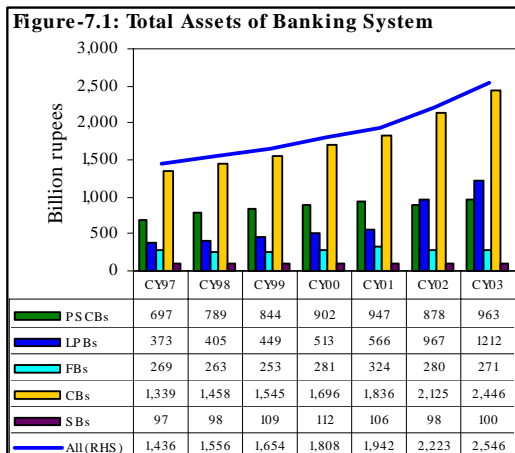


## 7 Assets and Funding Structure

Like the previous year, total assets of the banking system registered an almost identical growth of around 15 percent (See **Figure-7.1**). Deposits expansion once again remained the main stimulant. However, one significant deviation this year was the substantially increased focus on loans. While investments continued to rise, a considerably large portion of funds flowed towards loans. This happened not only because opportunities to make capital gains diminished as interest rates touched rock bottom, but also because of an increased credit demand from corporate and consumer sectors as economic activities started to pick up momentum. Consequently, the share of loans in total assets also increased (See **Figure-7.2**)

A number of factors including privatization, mergers and acquisitions, expanding branch network, launching innovative products, aggressive marketing etc. have given rise to an increased market share of Local Private Banks (LPBs) in the total assets of the banking system in recent years. With a share of 47.6 percent, LPBs now dominate the banking scene of the country. Their share has increased from 43.5 percent last year. Another significant development that has further enhanced the share of LPBs is the government's divestiture of 51 percent shares of Habib Bank at the fag end of the year 2003 through competitive bidding<sup>4</sup>. Further analysis shows that the five largest banks have lost their share by around 2 percent to 59 percent during the year. This shows stiffening competition in the market as second-string banks are vying to increase their market share through aggressive marketing. However, large growth by some of these banks has also raised asset quality concerns. The phenomenal growth in assets would require proper risk management to effectively and efficiently manage greater resources.

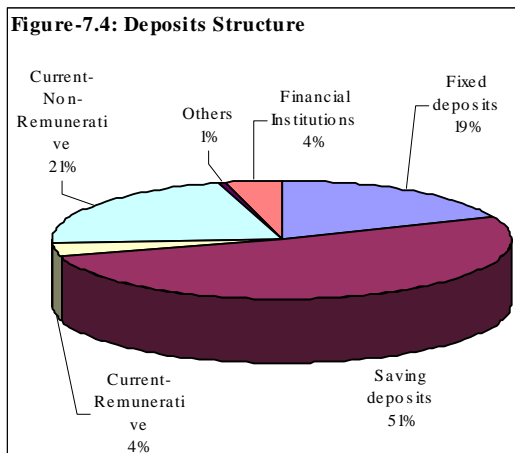
**Deposit** growth accelerated with a 17 percent rise during CY03 as compared to 14 percent growth last year. This happened despite the gradual moderation in overseas workers remittances, which were mainly responsible for



<sup>4</sup> Since ownership of the bank was transferred during the first quarter of the year 2004, therefore, HBL is still categorized among the public sector commercial banks (PSCBs) in this review. PSCBs will be left with a mere 21.4 percent share if we exclude HBL from their fold.

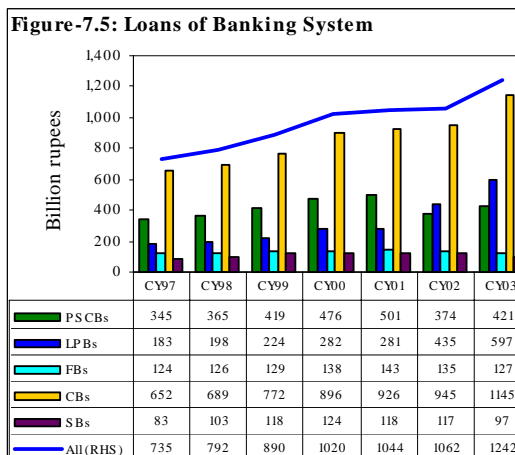
last year's significant deposits expansion. This year, the rapid credit expansion through multiplier effect might also have induced greater deposits proliferation. Significant cuts on NSS returns could well be another factor for funds diversion to the banking system. LPBs with a share of 48.5 percent in total deposits, contributed 68.8 percent in deposit growth during the year. Despite their dwindling share, PSCBs also contributed 27.1 percent to the deposits increase (See **Figure-7.3**).

Deposits structure indicates preponderance of saving deposits at 51.7 percent of total deposits against 49.1 percent last year (See **Figure-7.4**). Current account non-remunerative deposits registered the fastest increase of 42.5 percent among the major deposits categories displacing fixed deposits from the second position. Gradual decline in fixed deposits may find its explanation in the prevailing low interest rates. Foreign currency deposits shrank by around 7 percent largely because of rise in expectations of appreciation in Pak rupee.



**Borrowings** appetite of the banking system remained volatile throughout the year and may be attributed to changing perceptions about future behavior of interest rates, PIBs jumbo issue, improving exports performance etc. In aggregate terms, borrowings increased by Rs21.2 billion from Rs278.2 billion last year to Rs299.4 billion in the year 2003. In fact, the last quarter of the year was the most important which observed the maximum increase of Rs66.3 billion. This coincided with the phenomenal growth in loans as well as an increase in the borrowings against export refinance by Rs31.5 billion, which is also indicative of improving export performance. The remaining major types of borrowings declined during the year.

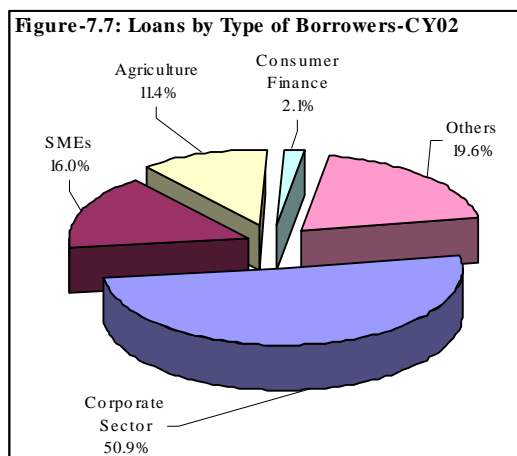
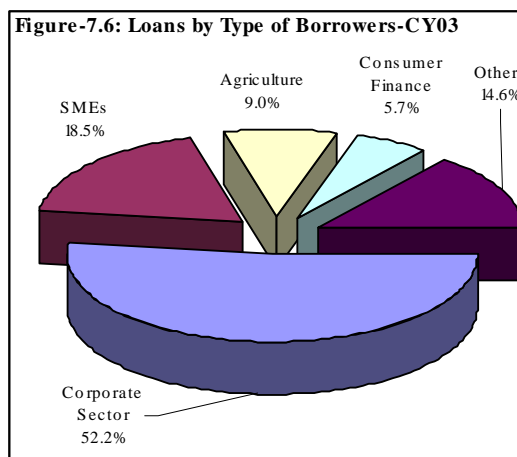
Significant growth in **loans** was the hallmark of the year 2003. Loans portfolio of the banking system recorded 17.1 percent growth, which is unparalleled for the last many years (see **Figure-7.5**). Heavy credit demand on the back of improving economic prospects, low returns on investments and uncertainty governing the future behavior of interest rates as well as the steep fall in weighted average lending rates by all the groups etc are some of the factors which contributed largely towards this phenomenal growth. The second quarter of the year also observed significant growth-mainly due to arbitrage lending to benefit from higher returns on NSS instruments. It was the last quarter, which recorded the fastest growth. Apart from the seasonal impulse, greater demand from the corporate sector following the historically low interest rates and strengthening macroeconomic indicators provided the real impetus.



LPBs once again had the lion share of increase in total loans i.e. 89.8 percent followed by PSCBs. Foreign banks and specialized banks on the other hand faced further decline in their loan portfolios. The declining share of foreign banks is attributed mainly to the shrinkage of their business activities as local banks are giving them tough competition. In recent years, local banks have invested substantially in technology and human resources to match the long-enjoyed advantage of foreign banks. Another factor, which restricts loans growth of foreign banks, is their focus on the top tier clients. On the other hand, local banks are not only coming head to head with foreign banks in terms of increasing their top-tier clientele but also have concentrated on increasing their retail business. All these factors, combined with their deeper outreach, have constantly helped drive up the loan portfolios of local banks.

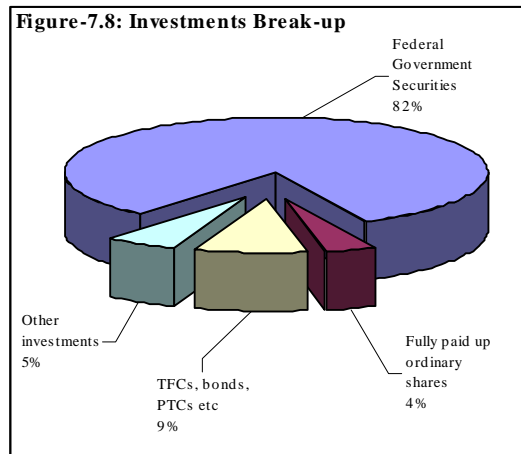
Textiles, being the backbone of the industrial structure of the economy and also because of its gigantic share in total exports, managed to attract the larger chunk of loan growth. Better export performance during the year also signifies higher demand for loans. This led to increase in the textile sector's share in loans to around 28 percent from 25 percent last year. Flow of funds to other sectors largely remained diversified.

Lending by type of borrowers reveals that growth was also broad-based. Loans in terms of consumer finance snowballed, registering a rise of 190 percent since December 2002. Major increase transpired in auto loans followed by mortgage loans. However, housing finance, despite being more than twice its size last year, has been below its potential. Complex legal issues, lack of experience, insufficient matching funds to finance long-term assets etc., are some of the reasons, which make banks wary of engaging actively in housing finance. The consumer finance market is dominated mainly by a few emerging local private banks and two large foreign banks. In fact, four banks, two each from LPBs and FBs, account for around 50 percent of total consumer finance exposure of the banking system. Lending to SMEs is also rising gradually and during this year this sector witnessed increase of around 26 percent. The **Figure-7.6** depicts shares of major types of businesses in total loans. Because of rapid expansion during the year 2003, the respective shares of Corporate, SMEs, and Consumers finance have increased.



In a sharp contrast to the previous year **investments** exhibited extremely subdued growth during the year 2003. Low enthusiasm this year may be attributed to market expectations of a rise in interest rate, low acceptances by the SBP in OMOs to stabilize the rate, extraordinary growth in loan demand etc. Consequently, growth rate of investments was 12.4 percent as compared to 100 percent last year. Majority

of investments continue to be locked in government securities, which saw an increase of 9.9 percent (see **Figure-7.8**). The upbeat mood of capital markets also succeeded in attracting relatively greater attention in the year 2003 with investments in shares and TFCs/ bonds/ PTCs recording a growth of 36.5 percent and 25.4 percent respectively. However, with the imposition of restriction on maximum equity investment, their level is expected to fall in coming days. LPBs hold around 49 percent of total investments of the banking system followed by PSCBs, at 44 percent share. The structure of government securities indicates greater PIBs holding over the last year. The Jumbo issue during the last quarter of CY03 played an important part in enhancing the PIBs holding of the banking system. On the other hand, investments in MTBs declined mainly because of expectations of a hike in interest rates.



The banking system has witnessed a remarkable growth in its total assets over the last few years. This growth and diversification of assets portfolio has helped the banks to substantially increase their profitability. However, there is a need to strengthen internal controls and risk management practices to ensure sustainability in growth patterns on a more long term basis.

## 8. Overseas Operations of Pakistani Banks

Most of the Pakistani banks are operating within the country. Some of them, particularly big banks, also have their presence internationally either through their overseas branches or subsidiaries. Here the discussion is focused on the operations of overseas branches only. These branches represent 7.6 percent of the overall assets base of the banking system, including foreign banks.

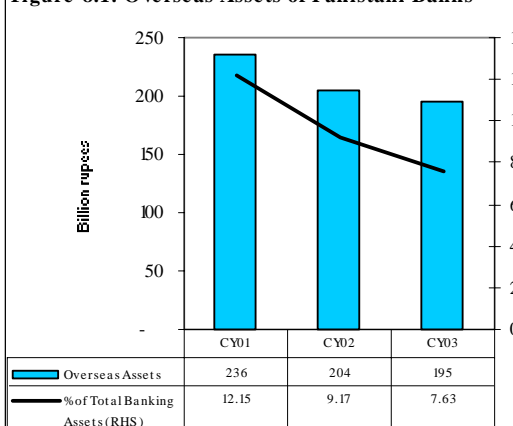
During the year under review, the number of Pakistani banks with overseas branch networks increased to five from four, but the overseas assets base declined by 4.6 percent. Nevertheless, this decline amidst strong growth in domestic operations caused significant erosion in the share of overseas assets in the overall assets of the banking system (see **Figure-8.1**).

The geographical distribution of overseas assets of the Pakistani banks shows their presence in almost all global regions. The major portion of their international operations is concentrated in the Middle East (see **Figure-8.2**). The region has historically remained an epicenter of the country's foreign remittances as it hosts a large number of overseas Pakistani workers and is also one of the major trade areas for the country. Pakistani banks in the region cater to the needs of these overseas Pakistani workers and also to facilitate trade activities.

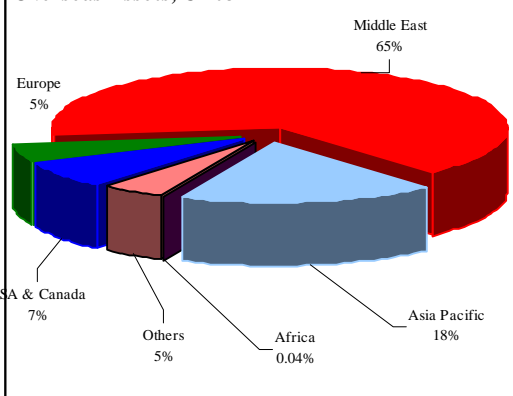
The composition of overseas assets shows that overseas branches of the Pakistani banks are risk averse, as just below two third of their assets composition comprises cash and bank balances and investment in government papers. These branches do not seem to have good lending experiences as the infection ratio at 24.9 percent is quite high. As a result, their lending activities are limited and loans contribute to around one third of their total assets portfolio.

The operating performance of these overseas operations has witnessed a significant improvement during the year. Although the total overseas assets registered a decline, pre-tax profit from these operations increased by 60 percent to Rs3.5 billion. This improvement was mainly contributed by non-interest income. Accordingly, pre tax ROA, with an improvement of 80 basis points, rose to 1.8 percent. The Middle East region being the major player, contributed 50 percent of total profit. **Figure-8.3** shows the region-wise pre-tax profits of the overseas operations of Pakistani Banks.

**Figure-8.1: Overseas Assets of Pakistani Banks**

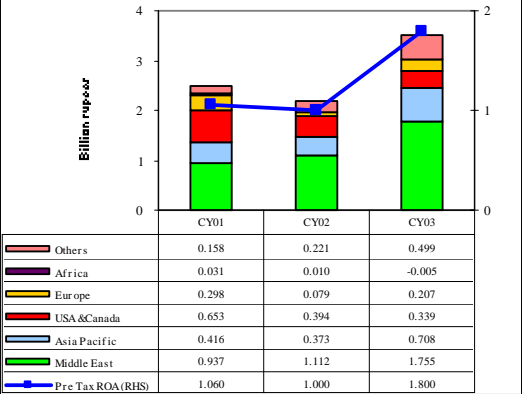


**Figure-8.2: Geographical Distribution of Banks' Overseas Assets, CY03**



The overseas arena presents bright prospects and there is a wide scope for improvement of Pakistani banks as well. Presently, these branches are mainly focusing on conventional, risk free bank placements for their earnings. Fee based income and retail lending are emerging as promising avenues and they hold encouraging prospects for the Pakistani banks as well. Keeping this in view, some of the local private banks are also exploring the possibilities of opening their branches overseas.

**Figure-8.3: Profit from Overseas Operations**





## 9. Development Finance Institutions

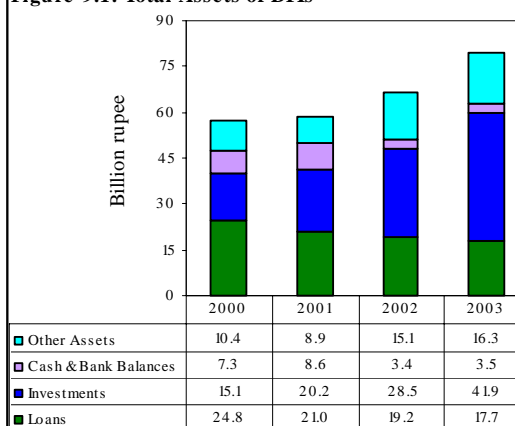
The year under review saw substantial improvement in the overall performance of DFIs. They not only managed to contain the NPLs portfolio but also benefited extremely from the conducive market conditions and reaped heavy gains by engaging in money and capital market operations. The persistent decline in demand for their loans forced DFIs to change their business strategies with increased focus on investments and the leasing business. The fall in loans portfolio reduces credit risk but over-activity in investments portfolio at the same time exposes them to market risk. This brings into question the adequacy of their internal risk management techniques. However, considering the DFIs' total size vis-à-vis the banking system i.e. 3 percent; the chances of a systemic risk appear very slim.

In the period under review, DFIs expanded their balance sheet footing by around 20 percent. This caused a fractional increase in their total assets as a percentage of total assets of the banking system. Rapid increase in deposits and total equity mainly influenced this impressive growth (see **Figure-9.1**). Except for one, all DFIs registered an increase in their total assets. However, contribution of the largest DFI was substantial as it recorded extraordinary growth in its total assets. Majority of funds were channeled in investments, whereas loans portfolio witnessed further decline. Heavy borrowings from financial institutions offset the fall in borrowings from other sources, which indicate increased orientation towards exploiting opportunities offered by market in view of easy monetary conditions (see **Figure-9.2**).

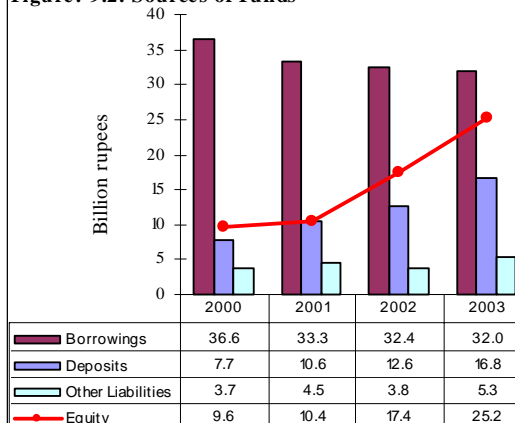
Upsurge in capital by around 44 percent is very impressive. Significant earnings and revaluation of assets mainly accounted for the strengthened capital position. Increase in capital to total assets ratio to 31.8 percent from 26.3 percent in the last year amply demonstrates this fact. No doubt, DFIs have succeeded in capitalizing on easy monetary conditions by making heavy capital gains and increasing value of their investments. However, this has significantly enhanced their market risk and any adverse twist of events may have negative repercussions for capital.

The low proportion of loans in the total assets portfolio i.e. 22 percent, is quite abnormal for DFIs as their core business is medium to long-term lending. However, it also signifies low exposure to credit risk. Apart from the disagreeable past experience, dwindling demand for project financing by the corporate sector with increasing financial innovation, prevalence of excess capacity, encroachment by banks upon traditional business of DFIs, drying up of matching funds to finance longer term projects etc., may be presented as possible

**Figure-9.1: Total Assets of DFIs**



**Figure-9.2: Sources of Funds**



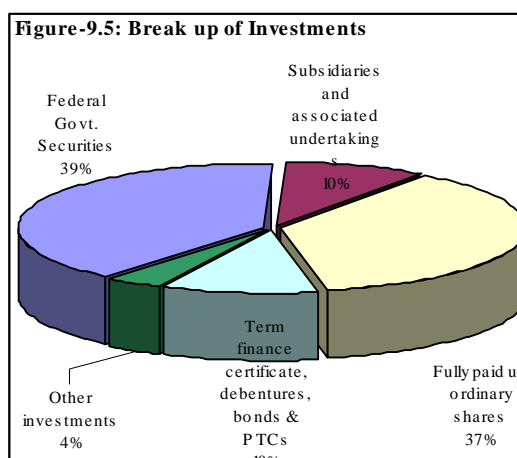
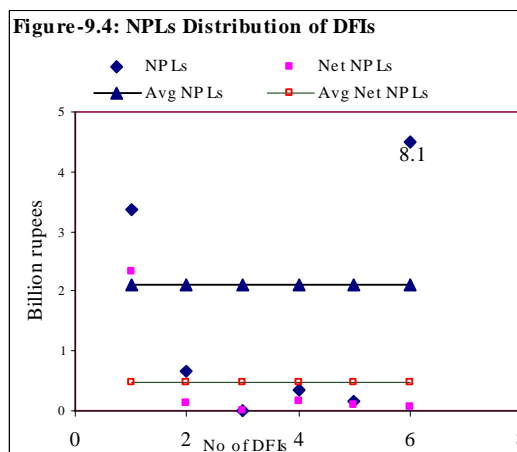
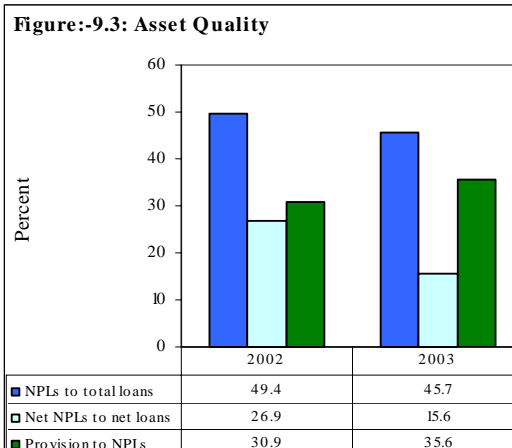


explanations for the continuous reduction in loans portfolio of DFIs. The decline in NPLs is a welcome development and NPLs in absolute terms stand at Rs12.6 billion as against Rs13.8 billion last year. Net NPLs to net loans ratio on the other hand witnessed an even more appreciable improvement to 15.6 percent from 26.9 percent last year. Better cash recovery along-with increased provisions mainly accounted for this amelioration (see **Figure-9.3**).

One DFI, in the public sector, holds around 64 percent of total NPLs of the DFIs. However, for net NPLs its share is very insignificant at 3 percent. That means the DFI is holding very high provisions against NPLs (see **Figure-9.4**).

Finding low demand for their loans, DFIs naturally headed towards investment in order to utilize excess liquidity. Consequently, the share of investments in total assets climbed to a figure of 53 percent from 43 percent in the last year. Federal Government securities absorbed the majority of funds, followed by shares and other securities (see **Figure-9.5**). However, investment in shares recorded an unprecedented acceleration as it increased by Rs5.7 billion - that is 53 percent of total increase in investments. The favorable environment proved very auspicious and significantly enhanced the market value of total investments. The congenial market conditions resulted in substantial surpluses against investment portfolio of DFIs but any adverse movement in interest rates may turn the surplus into deficit. Such a heavy exposure of DFIs in equity investments renders them prone to market risk and increases their vulnerability.

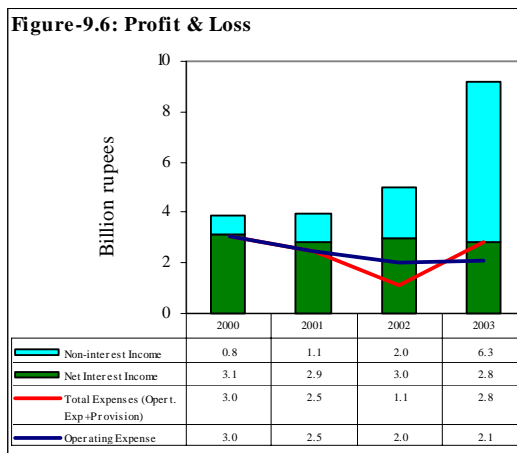
The year also saw profits of DFIs shooting up to new highs with a disproportionately large contribution from non-interest income. This was natural considering the size of investments in total assets portfolio. Consequently, ROA surged to 7.4 percent from 5.6 percent last year. A very large share of non-interest income is reflected by extra-ordinary high non-interest income to total assets ratio of 8 percent as against 3.6 percent for interest income to total assets ratio. The latter ratio in fact declined during the year owing to fall in loans as well as prevailing low interest rate regime. The buoyant Karachi Stock Exchange helped the DFIs realize massive capital gains, which



significantly increased their non-interest income (see **Figure-9.6**). Sustainability of these gains, however, is questionable and such a heavy reliance on them may easily turn their earnings into negative in case of adverse market developments. This calls for diversification of operations with increase in focus on core functions.

Abundant liquidity was the hallmark of the year 2003 and DFIs were no exception to that. The majority of DFIs' funds consist of borrowings, which need to be taken into account while calculating their credit – deposit ratio. The credit – deposit ratio of DFIs so calculated was 54.1 percent as compared to 57.7 percent last year. Substantial deposits growth of 32.5 percent remained the key factor behind this improvement in the ratio.

In spite of significant improvement in the DFIs performance over the last two years, there are still issues which raise concerns about their long-term viability. Most important is the shrinkage in their core business and its replacement by a more short-term nature of investment activities. Heavy reliance on short-term funds presents them with a challenge to ensure constant and smooth flow of relatively longer term funds to finance their activities. The diversification of their service thereby focusing on traditional investment banks' activities, and at the same time increasing the focus on lease financing, consumer financing etc. demonstrate their resolve to survive despite facing heavy odds.



## 10. Microfinance Institutions

Microfinance is a relatively new and emerging discipline in Pakistan as compared to other countries in the region. The NGOs and Rural Support Programs have been the major players in the sector since early 1980s, covering about 5 percent of more than 6.5 million poor households in the country. Recognizing microfinance as an important poverty alleviation tool, the Federal Government formulated a policy and enacted a separate legal framework for MFIs to stimulate growth in the sector. The policy mainstreams the concept of sustainable microfinance, recognizes private sector's role in poverty reduction and encourages its entry into banking with the poor.

The MFIs legal framework provides institutional diversity and allows both formal microfinance banks licensed under the framework and informal NGO-MFIs to provide microfinance services to the poor people. Presently two formal microfinance banks viz. Khushhali Bank and The First Microfinance Bank Limited and a number of NGOs and RSPs are delivering microfinance services in the country. Two commercial banks i.e. First Women Bank and The Bank of Khyber are also focusing on microfinance. The discussion here however focuses on the performance of the licensed MFIs.

During the year under review the operational success of both the MFIs is obvious. They have increased their outreach by expanding their branch network from 39 to 56. Since inception, both the MFIs have extended 207,120 loans, disbursing an amount of Rs 2,258.0 million almost across 145,000 borrowers till Dec-03. Number of active borrowers at 96,420 was 69 percent higher than at the close of last year. The average loan size was Rs 8,020.

The aggregate balance sheet of MFIs underwent significant changes during CY03. The asset base of MFIs grew by 43.8 percent to Rs 4,424.7 million as of December 2003. The expansion in asset base was funded mainly through borrowings. The major portion of these additional funds mainly resided in cash and bank balances, hence could not result in proportionate increase in core income. Investment, though declined over the last year, still dominated the asset mix coming to about 43 percent of total assets (see **Table-10.1**). Despite growing by about 50 percent, the share of advances in total assets remained almost flat at 17 percent. The low base of advances is attributable to initial years of operations of the two MFIs with KB completing just three years of operations and First Microfinance Bank Limited in the business for about one and half years, as well as small loan sizes and their short-term nature. With growing branch network and the MFIs gaining maturities, the ratio is likely to improve substantially in the medium term.

The major funding source of the MFIs remained shareholders' funds followed by borrowings. The share of deposits is still quite low. The low deposit base is mainly due to the fact that one of the MFIs is yet to undertake the deposit mobilization.

<b>Table-10.1: Sources and Uses of Funds</b>				
(Million rupees)	<b>2002</b>		<b>2003</b>	
SOURCES:	Amount	Percent	Amount	Percent
Deposits	64.4	2.1	392	8.8
Borrowings	401.6	13	1,402.6	31.7
Capital & other funds	2,546.9	82.7	2,560.6	57.9
Other liabilities	65.5	2.1	69.5	1.6
	<b>3,078.4</b>	<b>100</b>	<b>4,424.7</b>	<b>100</b>
USES:				
Advances	493.1	16	736	16.6
Investments	1,960.8	63.7	1,905.5	43.1
Cash, bank balance, placements	319	10.4	1,350.3	30.5
Other assets	305.5	9.9	432.9	9.8
	<b>3,078.4</b>	<b>100</b>	<b>4,424.7</b>	<b>100</b>

The non-performing loans of the sector stood at Rs 57.3 million, forming 7.8 percent of outstanding advances as of 31<sup>st</sup> December 2003. The NPLs though adequately provided for, which gives comfort to the MFIs against the potential losses, however the ratio is not in line with international standards for sustainable MFIs and may have repercussions on sustainability of the institutions.

Despite higher level of provisioning together with declining return on government papers, MFIs during the year under review generated reasonable amount of after tax profit of Rs 24.6 million as compared to Rs 0.6 million in the last year. However, the reimbursement of three years' accumulated social mobilization cost from Microfinance Social Development Fund, accounted for the major portion of profit. The cost from 2004 onwards would be reimbursed on annual basis.

Net interest income to total assets ratio has shrunk by 1.9 percentage points, which is attributable to predominantly short term nature of investments of the MFIs, returns on which remained historically low during the year; the yield on investments also dropped to 5.2 percent from 6.9 percent a year ago Further most of the increased borrowings of Rs 1,001 million have ended up in relatively low yielding assets. Nevertheless, return on assets improved to 0.7 percent.

During the year total non-interest expenses have gone up from Rs 205.3 million to Rs290.7 million, which form almost 79 percent of total revenues (see **Table-10.2**). The peculiar nature of MFIs credit portfolios e.g. delivery of credit at the borrowers' doorstep, small tickets but large volumes, large number of small disbursements and recoveries, dispersion over wide geographic areas etc is primarily responsible for the higher administrative and operational cost. The cost structure however, would improve once the MFIs achieve scales and all branches operate at optimum capacity.

The microfinance sector in Pakistan though at evolutionary stage, however, with increased awareness about the policy framework and continuously increasing trust between the policy makers and practitioners coupled with sustained commitment by government and policy makers to promote the sector, it is likely to mature and grow substantially in the medium to long term.

**Table-10.2: Key performance indicators**

	2002	2003
Capital to total assets	82.7%	57.9%
Capital growth	45.0%	0.5%
NPLs to total loans	1.1%	7.4%
Net NPLs to net loans	2.9%	2.7%
Net interest income to total assets	7.5%	5.6%
Growth in advances	346.6%	49.3%
ROA (average assets)	0.0%	0.7%
ROE (average capital)	0.0%	1%
No of active clients	57,037	96,420

## 11. New Initiatives towards Financial Stability

### 11.1 Privatization, Mergers and Consolidation

The structure of the financial system of Pakistan was confronted with two basic problems. First, it was overly dominated by public sector banks, which were largely inefficient in terms of overhead costs and delivery of service. Second, it was fragmented and consisted of a number of small banks and NBFIs. These smaller institutions were at a competitive disadvantage vis-à-vis larger banks. Moreover, their slender capital base made them highly vulnerable in the event of an economic downturn. To address these problems, a two-pronged strategy was adopted.

- Initiation of privatization process with a clear purpose and renewed vigor;
- Bring about the needed consolidation in the financial system.

In 2000, the country's financial sector embarked upon a guided consolidation process. The aim was to foster financial stability by encouraging mergers and acquisitions within the financial sector for having fewer but stronger banks capable of utilizing the economies of scale and withstanding economic downturns. The voluntary initiatives of mergers amongst themselves by banks & NBFIs were further accelerated when the SBP raised the minimum capital requirement for banks to Rs1 billion in the beginning of year 2002. This was followed by certain tax incentives for mergers and consolidations announced in the Budget for FY2002-03. The response of these measures has so far been quite encouraging.

The consolidation experience of Pakistan is that of a predominantly cross industry one, with a large number of NBFIs taking on and merging into banks. The exercise so far, has had a mixed color with both local and foreign stakeholders taking the ownership of consolidation. Till date 17 cases<sup>5</sup> of mergers and acquisitions have taken place, where a commercial bank was the surviving entity. The consolidation exercise has increased the number of domestic commercial banks, with a consequent fall in the number of foreign banks. In none of the cases large banks are the acquirers so the consolidation process did not lead to enhance the concentration. The process was successful not only in terms of elimination of weak institutions from the system but also in strengthening the capital base of the banks. The average capital base of commercial banks has risen to Rs3.7 billion in CY03 from Rs1.8 billion in CY00, when the consolidation process was initiated.

The two mega acquisitions of management shares of HBL and UBL by foreign funds are in line with the current trend in emerging markets. Besides, it also marked a leap forward in the much stalled privatization process. Privatization helps correct the incentive structure, bring in efficiency and market based discipline and thus has a direct bearing on financial stability.

The idea of having fewer but stronger banks got popular after the ASEAN crisis and a greater number of emerging economies are moving towards the universal banking paradigm. Pakistan too is falling in line with this trend and the SBP has recently allowed banks to form subsidiaries to conduct functions of asset management, venture capital, exchange companies, mutual funds etc. The move though makes the case for economies of scale more compelling and could expedite the process.

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<sup>5</sup> Besides these 17 cases, 13 mergers and acquisitions have taken place among NBFIs as well.

## **11.2 Corporate Governance**

Banks have a fairly dominant position in our financial system and are an important engine of economic growth. The rapid changes brought about by globalization, deregulation and technological advances are increasing the risks in the banking system. Moreover, unlike other companies, most of the funds used by banks to conduct their business belong to their creditors, in particular to their depositors. Linked to this is the fact that the failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All these reasons require that banks are properly managed. Moreover, inadequate corporate governance in banks in turn gives rise to the lack of corporate governance among the corporates, which get funds mainly from the banks. One way of protecting the stakeholders' interest is through regulations and prudential supervision, however, many incidents of banking crises the world over in the recent past have suggested that regulation of the financial system should be supplemented with a strong sense of corporate governance among the system participants. The new developments call for a self-regulation regime where board of directors, the management, auditors and regulators work together towards stability of the system through concerted efforts. Good corporate governance ensures that the business and affairs of the banks are conducted in a manner that is beneficial for all the stakeholders.

The SBP has taken a number of initiatives to propagate a corporate governance culture in the banking system. "Fit and Proper Tests" have been introduced for Board of Directors, the Chief Executive Officer and the senior management of the banks whereby qualification and eligibility criteria for their appointment have been laid down. Furthermore, their roles and responsibilities have been explicitly defined in the Prudential Regulations. The requirements of financial disclosures - both regulatory and public have been made more transparent and meaningful. The role of external auditors has been enhanced whereby they are inter-alia required to submit a special audit report to the SBP in accordance with the guidelines issued to them. The role of the board's audit committees has also been strengthened so as to make them more proactive in detecting any deficiencies. The SBP has also issued a "Handbook of Corporate Governance" for banks to provide guidance. "Code of Corporate Governance" issued by SECP has been implemented for the banking sector as well.

## **11.3 Resolution of Problem Banks**

The banking system in Pakistan now, with only 3 problem banks<sup>6</sup>, is much stronger than it was six years back when most of the public sector<sup>7</sup> banks were in distress. They were critically undercapitalized and burdened with huge level of non-performing loans. The dominating share of such banks in the overall banking system at that time was also posing a systemic risk.

To deal with the situation, a number of measures were taken, under financial sector reforms for their rehabilitation and ultimate privatization. The measures included induction of professional management, branch and staff rationalization and injection of fresh capital. To address the issue of non-performing loans, besides initiating different recovery drives, a public asset management company (Corporate & Industrial Restructuring Corporation) was also set up in 2000. All this helped to achieve a turnaround and now all the public sector commercial banks are profitable and well-capitalized. Two of them namely, UBL and HBL

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<sup>6</sup> Problem banks here mean banks rated as 5 under CAELS Framework

<sup>7</sup> Including Specialized Banks

have been recently privatized<sup>8</sup>. The specialized banks, however, are still undergoing the restructuring process, which is at an advance stage. Nevertheless, the share of specialized banks at less than 5 percent of the total assets of the banking system is not posing any systemic risk.

Besides public sector banks, some of the local private banks have also emerged as problem banks. Financial indiscipline, as a result of poor corporate governance, was the major factor that affected their financial soundness and viability. This required strict enforcement action on part of the regulatory authority. In response to this, SBP cancelled the license of one of the LPBs. The ownership of other three problematic LPBs was changed through sale of majority shares. To make these banks financially sound, the new management of two such banks, among others, has recapitalized the banks. Now only one local private bank is assigned as a problem bank. The restructuring of this bank, along with management change, is in process.

Among development finance institutions, NDFC, which was on the verge of financial collapse, has been merged with one of the public sector banks, while SBFC and RDFC have been merged into a new SME Bank. The bank is undergoing financial restructuring under an ADB loan agreement. Once the restructuring and recapitalization process of this bank is completed, it will be offered for privatization by June 2006.

In addition to specific measures taken for the resolution of problem banks, a number of measures have also been taken to prevent the likelihood of new problem banks. Such measures include the introduction of fit and proper test for the appointment of board of directors, chief executives and senior management of the banks/ DFIs, defining the responsibilities of Board of Directors, enhancing the disclosure requirements and issuance of risk management guidelines etc. Further, to avoid any sudden crisis situation which may cause a systemic risk, the SBP has also devised a strategy to strengthen its interaction with the banks and DFIs. It now holds regular high-level meetings with the Board of Directors and senior management, as well as the External Auditors, of the banks and DFIs. Such meetings are held more frequently with banks and DFIs having unsatisfactory ratings. All these steps will go a long way to minimize the likelihood of new problem banks emerging.

#### **11.4 Payment System-RTGS**

The efficient and well functioning Payment systems are key components of the financial infrastructure and the effectiveness of the financial markets. The poorly designed payment mechanism can contribute to systemic crises and can trigger or transmit disruptions in financial systems both within domestic as well as international markets. Rapid technological changes, combined with increasingly integrated international financial systems and rising financial activity, have led to very high volumes and values of payment transactions being concentrated in individual payment systems.

In its endeavor to further strengthen its core supervisory functions, the SBP has planned to automate the payment settlement system. The objective of moving towards a robust payment system is to promote and maintain financial stability within the economy. In order to institutionalize its focus on payment systems stability, the State Bank of Pakistan has established a separate Payment Systems Department. The objectives of this department are to implement Real Time Gross Settlement System (RTGS) Project, to oversee the existing

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<sup>8</sup> UBL was privatized in 2002, whereas HBL was privatized in early 2004.

payment and settlement systems in place, and to develop a strategy in coordination with banks for improvement in the existing systems. The department will also keep abreast with the current international best practices and deal with the banking sector in Pakistan on all issues relating to payment systems.

It is expected that once RTGS is implemented, market participants will be able to directly initiate high value inter-bank payments through electronic funds transfers to and from their settlement accounts in real time. This will reduce the settlement risk, hence will help promote and maintain the financial stability. The project is planned to be implemented by the end of 2004.



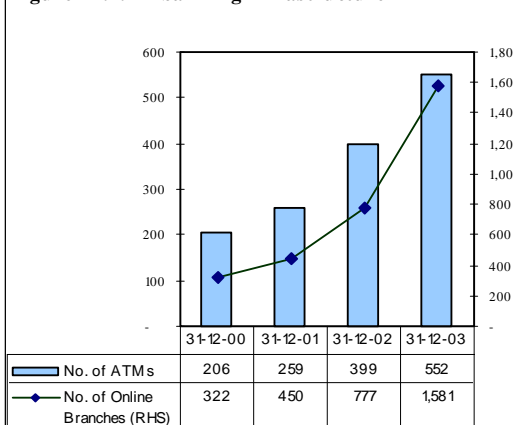
## 12. Issues and Developments in Banking System

### 12.1 Electronic Banking & Technological Developments

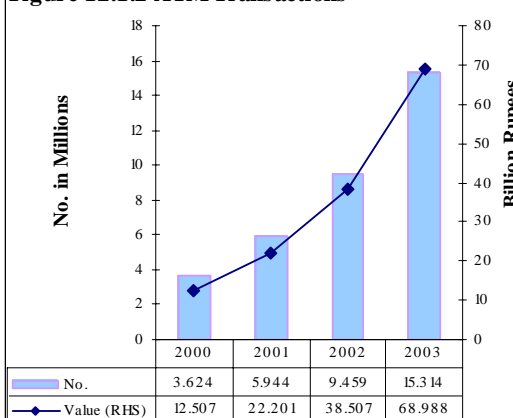
Electronic Banking is the delivery of banking services through the use of electronic communication, like automated teller machines (ATMs), automated loan machines (ALMs), the Internet, the World Wide Web, telephones, stored value cards or other electronic devices. Traditional banking has gone through a major revolution in the last few decades worldwide and banks are adapting themselves to the changing conditions to remain competitive in the financial markets. The effect of e-banking is to augment or facilitate existing banking and payment mechanisms, primarily by making transactions cheaper, faster, secure, and more convenient.

Although still a major chunk of banking transactions in Pakistan is being done through cash and checks, electronic transactions have grown significantly in recent years. Consumers in the country are developing more and more confidence over ease and security of using plastic money. The number of credit card holders which were a little more than 0.200 million at the end of year 2000 are now close to half a million within a span of three years. The average monthly number and volume of transactions has also almost doubled. Keeping pace with the rising consumer demand, banks are also improving their infrastructure by investing in IT (both on hardware/software and human resource fronts), which is evident from the strong growth in the number of online branches and ATMs in the country. The number of ATMs, which was close to 200 at the end of year 2000, has surpassed 500 as of 31-12-2003, while number of online branches has grown almost 5 times to 1581 during the same period (See **Figure 12.1.1**). Similarly, the number and volume of the business transacted through ATMs also witnessed steady progression. The number of transactions through ATMs on average grew by 43 percent per annum while the value of these transactions on average grew by 53 percent per annum (See **Figure 12.1.2**).

**Figure 12.1.1 E-banking Infrastructure**



**Figure 12.1.2 ATM Transactions**



In addition to ATMs and credit cards, other modes of e-banking like phone banking and internet banking are also gaining popularity among the banks for providing round-the-clock, uninterrupted service to their customers. Phone banking has been quite popular and is becoming a more widely used mode of delivering off-branch services. Moreover, some banks have recently ventured into providing a full range of secured internet banking to their

customers. Another recent development has been interconnectivity of two ATM switches (i.e. 1-link and mnet). Now the customers belonging to banks of one ATM switch can also use ATMs of banks of the other switch and vice versa, adding more convenience in the overall services.

Though e-banking has opened up a whole new array of opportunities and prospects both for the financial institutions and consumers, like all other business activities it has its own unique risks and threats to deal with. E-banking warrants an enabling legal infrastructure, strong supervisory oversight and most of all, banks' own set of proper risk management practices. These risks need to be recognized, addressed and managed by banking institutions in a prudent manner according to the fundamental characteristics and challenges of e-banking services.

The government has facilitated adoption of technology in Pakistan by strengthening the communication infrastructure and by making it available at lower prices. The promulgation of Electronic Transaction Ordinance 2002 allows the creation of a legal framework for recognizing an electronic transaction as acceptable evidence in the judicial system of Pakistan. The State Bank, fully aware of its due supervisory responsibilities has also taken steps to ensure robustness of the financial system through implementation of Real Time Gross Settlement (RTGS) system, a necessary condition to a flourishing and sound e-banking environment.

## **12.2 Anti Money Laundering**

Events following September 11 brought the issue of possible use of the financial sector for financing terrorism and money laundering into sharp focus. The need was felt to coordinate globally to combat the financing of terrorism. The Pakistan government is steadfast in its obligation and commitments towards the international community and in this regard is coordinating with other countries and international organizations. To curb illegal activities, Pakistan has reviewed its existing legislation and practices regarding money laundering and formulated a multi track strategy. The salient elements of the strategy are:

1. Adoption of International Standards
2. Strengthening of Regulatory and Supervisory Capacity
3. Revision of Laws & Regulations
4. Assigning clearly identifiable responsibilities to various institutions
5. Training & Technical Cooperation
6. Compliance with UN Resolutions

The rapidly changing global banking scenario and recent technological developments have made the banking system more vulnerable to money laundering. The lack of uniform standards and laws among the supervisory regimes has necessitated establishing a common platform to tackle this issue. The Asia Pacific Group on Money Laundering (APGML) was established to address this problem. The anti money laundering measures common to financial sector are prescribed within the 40 recommendations and subsequent eight special recommendations of the Financial Action Task Force (FATF) of APGML. The SBP being a member of APGML is compliant with most of the recommendations. This has allowed Pakistan to liaise closely with member countries and to adopt best international standards and practices.

The SBP is committed to ensuring that integrity of the financial system is not compromised in any way through any criminal activities. In this regard a comprehensive regulation of *Know Your Customer (KYC)/Customer Due Diligence* has been put in place in line with international best practices. The SBP has issued directives to banks /DFIs to determine the true identity of every prospective customer, together with a minimum set of documents to be obtained from new customers/account holders of various types. Further, for ongoing monitoring of accounts and transaction, the SBP has directed banks to reinforce precaution. The regulation requires that specific procedures be established for ascertaining the customer's status and his source of earnings, monitoring of accounts on a regular basis, checking of identities and bona fides of remitters and beneficiaries for retaining internal record of transaction for future reference. The transactions, which are out of character/inconsistent with the history, pattern or normal operation of account involving heavy deposits/withdrawals/transfers, are to be viewed with suspicion and properly investigated. Additionally, banks have been advised to put in place a compliance program. The Board of Directors of banks has been made responsible to designate a suitably qualified and experienced person as Compliance Officer. Besides ensuring compliance of rules/regulations and laws, the Compliance Officer has to serve as a focal person between President/CEO and senior management on compliance related issues and act as a liaison person with the State Bank concerning compliance issues. A comprehensive Anti Money Laundering Law outlining new roles and responsibilities for the banking sector is also on the anvil.

The effective system of supervision will have clear responsibilities and objectives for each agency involved in the supervision of financial institutions. The State Bank being the central bank is responsible for regulation and supervision of banks and development finance institutions (DFIs). The Non-bank Financial Institutions fall within the supervisory jurisdiction of the Securities & Exchange Commission of Pakistan (SECP). There is close coordination between SBP & SECP for sharing information and supervisory cooperation. In addition, the National Accountability Bureau (NAB) can investigate and prosecute any suspicious financial transaction. The SBP has also deputed its supervisory officials to NAB in order to lend assistance for investigation into white-collar crimes in financial institutions.

The Institute of Bankers, Pakistan has been arranging seminars/ training programs to help bankers develop expertise in the areas of Anti Money Laundering /Combating the Financing of Terrorism. Besides, representatives from the SBP and NAB are attending the meetings/seminars/workshops organized by APGML.

The United Nations has passed various regulations for freezing of funds and other resources of certain individuals and entities. Accordingly, in compliance with UN resolutions, the SBP has issued directives to freeze the bank accounts of the individuals and entities associated with terrorist acts.

### **12.3 Basel Capital Accord II**

Basel II has opened up a host of challenges for Pakistan, which like many other emerging market economies, thrives on a financial system where banks primarily dominate the financial scene and are mostly engaged in less complex activities of deposit taking and lending with a skewed risk-reward relationship. The allied markets of money and capital lack depth and breadth and are caught up in the secondary stage of development. Market discipline is still evolving as are transparency requirements. In this backdrop, implementing

change in business processes propagated by Basel II becomes a challenging task and requires the concerted efforts and sustained will of all the stake-holders.

Pakistan might have to go for standardized and basic indicator approaches in the first phase until both the risk management and data quality reach a reasonable level. Even for this simpler version of Basel II, the following problems have to be overcome:

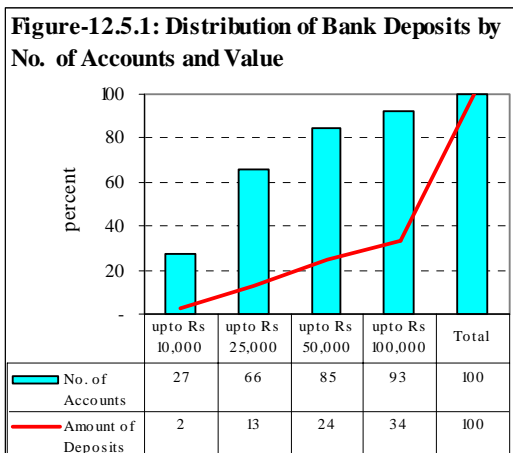
- Standardized approach makes extensive use of external credit rating agencies' ratings to allocate different risk slabs for capital charges. At present, not only is the number of such agencies operating in Pakistan low, they are also catching up on the sophistication of the trade. As Basel II significantly expanded the scope of use of credit ratings, measures are required to encourage new comers into this business but only after thorough and rigorous supervisory screening on a continuous basis.
- Basel II is primarily data driven. The Pakistan banking community needs to make up for the data shortcomings to ensure accuracy, timeliness and reliability of data.
- Presently a considerable part of credit is extended to SMEs, which often do not get themselves rated. Continuing with this situation though will not affect the capital requirements for the banks as even the new approach espouses 100 percent risk weight for the unrated exposure but it will certainly flout the spirit of Basel II - risk focus and having capital that is commensurate with risk. To keep the spirit of the accord alive, exposures over a certain limit will invariably have to be rated and such limit over time can be brought down.
- Securitization is one of the means for reducing risk exposure under the accord. Although some transactions involving securitization did take place in the country but both in terms of amount and scope, this remained insignificant. There is a need to accelerate the process of securitization.
- Capacity building is absolutely vital as present level of expertise in risk management at commercial banks needs major up-gradation to conform to the level demanded by Basel II.
- The skills of existing staff will need to be upgraded both at banks and at the SBP. Further, realignment of regulatory reporting and IT systems at the SBP with the requirements of data capturing under Basel II will be required.

SBP on its part has conducted a couple of seminars on Basel II to create awareness among the local banks. Besides this, the allied measures of risk management guidelines, internal control guidelines and the code of corporate governance are helping set the risk focus called upon by the Basel II. As a measure towards capacity building, in-house expertise is also being built up (in the form of training – both domestic and foreign for its human resource). A working group comprising SBP officials has been constituted to recommend a roadmap for the implementation of Basel II. Overall, capital adds-on are likely to result from the operational risk side of Basel II as risk exposure relating to credit side is fairly covered at present.

#### **12.4 Deposit Insurance Framework**

Severe bouts of financial instability in recent times have led to wide spread adoption of Deposit Insurance System (DIS) in crisis as well as non-crisis countries. A prudent DIS

pacifies the potentiality of system-wide depositor runs that are triggered on the basis of adverse information which cause even sound banks to fail. Besides, it furthers the social objective of protecting the small depositors and builds confidence in the banking system – an objective of immense importance in emerging market economies like Pakistan where the banking culture is not that well developed and bank account holders form an insignificant portion of the total population. In terms of number of depositors, the lion's share of banking sector deposits comprise small depositors; depositors of up to Rs 100,000 form 93 percent of the total banking sector depositors, though their share in terms of value remains miniscule i.e. 34 percent (see **Figure-12.5.1**). These small depositors are generally less sophisticated and have restricted ability to safeguard their interests in the event of any financial distress.

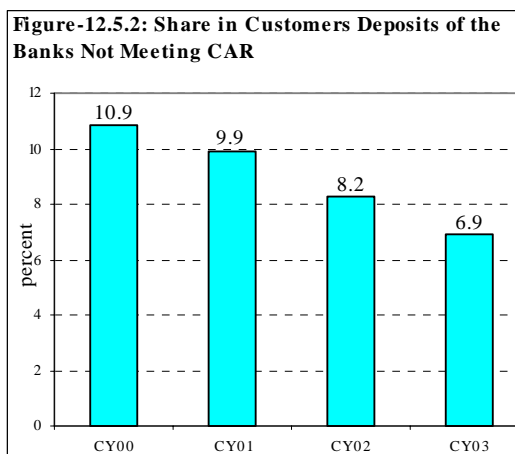


Pakistan embarked on a financial liberalization and reform process in early 1990s; the increased participation of the private sector was an integral part of it. A number of private banks emerged in the process and four of the five large nationalized banks stand denationalized by the end of first quarter of 2004. With all these developments, deposits of the banks in private sector, forming almost 80 percent of the total customer deposits, now in principle stand without implied state guarantee that was previously available to the depositors of public sector banks. The State Bank continues to protect the interests of depositors through its supervisory role and it has shown its commitment by successfully resolving a number of bank failures since the inception of the liberalization process. But this protection does not guarantee direct compensation to the depositors in case of any bank failure.

The State Bank of Pakistan is considering the institution of a deposit insurance scheme (DIS) in the country. The bank has recently completed a study on the subject and a draft proposal is in the making. The bank would engage all the stakeholders in a constructive dialogue for devising and implementing a prudent DIS that provides the right kind of incentives and carries minimum downside effect.

While providing a stabilizing impact to the banking system, a DIS entails certain pitfalls also. If the system is not devised and implemented prudently these impacts can outweigh the potential benefits. Moral hazard is the foremost problem that arises from the banks' excessive risk taking, spurred by the comfort of insurance cover. This also absolves the depositors and borrowers of their responsibility to monitor banks, thus weakening the market discipline. Besides these generally recognized untoward effects of DIS, Pakistan has specific issues emerging from its peculiar economic, legal and political conditions and the state of banking that requires an additional caveat before launching DIS. The major cause for concern could be the weak legal infrastructure, especially with respect to contract enforcement and bankruptcy laws; this can put strain on the efficient working of a DIS.

The banking sector of the country has shown remarkable performance over the last few years and it has largely dispelled apprehensions about its fragility. The recent consolidation drive to develop a vibrant banking system comprising of only sound banks has resulted in merger and acquisition of a number of financially weaker banks which could have posed systemic risk to the sector, and a few remaining such banks are in the process of being merged or acquired. Resultantly, the number of insolvent banks and their share in total banking sector's customer deposits have come down significantly (**Figure-12.5.2**). These statistics become even more appreciable when state owned specialized banks are excluded. The legal and political environment has also witnessed a turn around. The recently promulgated recovery law and the proposed bankruptcy legislation are steps towards this direction. Besides, the implementation of codes of corporate governance by the regulatory authorities that lay due focus on the important issues of accountability and transparency would go a long way to elicit the right kind of response from market players. An ideally transparent mega environment would certainly develop over time.



The most appropriate time for the introduction of a DIS is when the financial sector is sound and free of fragility. The banking sector in Pakistan, presently, is in the most robust position of its last decade history, while future trends are also promising. Additionally, the need for explicit deposit insurance in a private-sector-dominated banking system becomes even more emphatic.

## 12.5 Islamic Banking

The experience of Islamic banking in some of the Muslim countries is quite encouraging. However, there is still a need to offer a wider array of products to capture a lucrative niche of investors and those in need of funds, along with initiating dynamic policies for a progressive and comprehensive Islamic financial system that runs in the competitive global financial environment.

Pakistan has also decided to follow the parallel banking system allowing Islamic banks to operate along with conventional banks. To provide an enabling environment for Islamic banking, the SBP has taken various policy measures (see **Box-II**). It has established a full-fledged Islamic Banking Department and adopted the following three-pronged strategy to promote Islamic banking in the country:

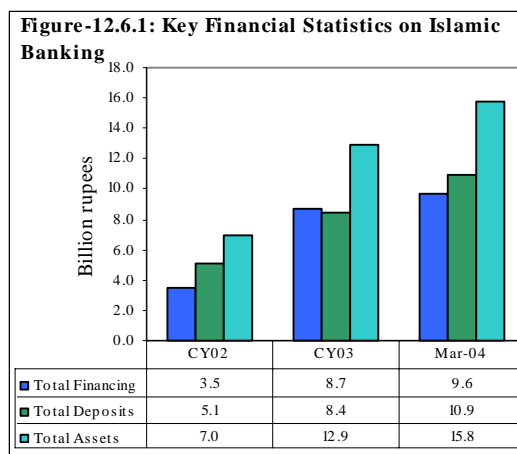
1. Establishment of full fledged Islamic bank(s) in the private sector;
2. Setting up of subsidiaries for Islamic banking by existing commercial banks; and
3. Allowing Stand-alone branches for Islamic banking in existing commercial banks.

In line with the above strategy, the detailed criteria have been issued to establish full fledged Islamic commercial banks, subsidiaries and stand-alone branches. The market response is quite encouraging and the number of Islamic banking players is increasing rapidly (**Table-12.6.1**). Meezan Bank has been licensed as the first Islamic bank in the country. Moreover, the existing commercial banks can also convert themselves into an Islamic bank after getting

approval from the State Bank in order to start their operations afresh. In this regard, Albaraka Bank has had its license put in the process of conversion. Applications for two full-fledged Islamic banks are under review. Four existing commercial banks have started Islamic banking operations through nine stand-alone branches. Two of these banks are in the process of setting up 15 more branches in 2004, whereas three other banks have also been given the approval in principle to set up one stand-alone branch each. Some other banks have also shown their willingness to establish Islamic banking branches.

	Dec-02	Dec-03	Mar-04
No. of Islamic Banks	1	1	1
No. of Branches	6	10	10
No. of conventional banks operating Islamic Banking Branches	-	3	4
No. of Islamic Banking Branches	-	7	9

Though the Islamic banking operations are expanding rapidly (**Figure-12.6.1**), their share in the overall banking system is minuscule. Compared to the last year, the share of the Islamic banking has picked up during the current year both in terms of assets and deposit base owing to increase in the number of branches of the existing Islamic banks, as well as the entry of conventional banks in the system through stand alone branches. While the Islamic banking assets kept the pace of upward growth, the rise in deposits outperformed the growth in financing by them during the year. This is because of the fact that the credit demand has remained lackluster for the overall banking system. It reflects, at the same time, the need for development of new products so that the funds can be deployed efficiently. On the backdrop of the positive trends, the size of the market has a growing pace although the sector is facing teething problems in the preliminary stage of its establishment. The trend and policy reforms on part of the supervisory authority and the banks are also promising.



The sizeable growth of Islamic banking in other countries, like Malaysia, Bahrain etc., is mainly because of their focus on strengthening the Shariah, the legal and institutional infrastructure, as well as enhancing consumer education and intellectual capital development. This indicates the need for the Pakistani Islamic financial market to initiate the process of reforms that could be enhanced over time in order to fortify the emerging sector. The need of the hour for the industry to grow is to diversify and develop new sources of revenue by evolving new products rather than competing in a narrow range of products. The target market of the Islamic financial products in the country is huge, provided practical and acceptable solutions to all the financial problems of the end users are worked out.

From the marketing perspective, Shariah compliance will draw all those prospective customers into the ambit of banking, who have so far opted to remain out of the system, provided the performance of the Islamic banking sector meets the expectations. The industry is required to offer a broad range of Islamic financial products both for the end consumer as well as for the financial institutions. Therefore, in order to deepen the Islamic financial market, an Islamic inter bank money market, the Takaful industry and the Islamic capital

market should emerge in the country over time. A task force on Takaful has been formed recently by the SECP to draft rules and regulations for this industry.

The regulatory and supervisory framework of the Islamic financial institutions will play a significant role in shaping the overall character of the industry and its development, provided the emphasis is laid on the vigilant monitoring of the financial condition and soundness of the Islamic banks. Moreover, the adoption of pre-emptive strategies to address any adverse trends and enhancing corporate governance structures as well as risk management systems will have to be beefed up in comparison to what they were in the past.

The risks of the Islamic banking are relatively of different nature than those of conventional banks. The emphasis is more on Shariah compliance. Given that it is the Islamic bank that determines the profit share, their management is facilitated in case of liability exposure. This means that Islamic banks usually enjoy greater autonomy than their conventional counterparts. As their niche market is less crowded and deposit base is more stable, the Islamic banks could be more open in their financing activities. Moreover, tying debt to the value of tangible assets such as land or property in case of Sukuk offers some protection against the debt market downturn. Any operational losses can also be translated into reduced nominal value of the investments deposits; however this also exposes the banks to market risk that if market-related returns exceed the return offered by the Islamic banks, the chances for deposit withdrawals increase. As far as money laundering is concerned, the Islamic banks are less likely to involve in such activities, as the banks possess intimate knowledge about customers' business compared to conventional banks. Basel II will be an additional area to be considered by the Islamic banks, where they might be able to run lesser CARs, based on their risk profile. This might call for enhanced disclosure requirements. Thus, a strong framework with timely implementation and proper legal support promises a thriving Islamic banking sector.



## Box- II. Measures taken for the Promotion of Islamic Banking

Pakistan has been operating an interest free banking system since 1984, using various modes of financing under the traditional legal and regulatory framework. However, the Supreme Court decision on Riba, announced in December 1999, proved to be a milestone requiring all the banks to transform according to the Islamic modes. As per the directives of the Supreme Court regarding transformation, a Commission and two task forces were established in the State Bank and Ministries of Finance and Law, respectively. Later, the decision regarding transformation of the whole system was set aside in a review petition by the Supreme Court and has been sent to the Federal Shariat Court to start fresh hearings. However, the deferment in the final decision has not dampened the efforts to lay the groundwork for the emerging sector. Steps have been taken to set up a parallel banking system, so that an enabling environment is ensured for the sector, avoiding any serious repercussions of entire transformation of financial sector.

As part of this process, the State Bank has introduced various policies. In December 2001, criterion for the establishment of Islamic banks was announced and in September 2002, an amendment in the Sec 23 of BCO 1962 was promulgated in order to promote Islamic banking through establishment of Islamic banking subsidiaries. Cognizant of the fact that detailed guidelines on the issue were needed, the State Bank issued **Policies for the Promotion of the Islamic Banking** on January 1, 2003 defining criteria for establishment of Islamic banks in the private sector, Islamic banking subsidiaries and stand alone branches by conventional banks. The policies encompass the eligibility conditions, licensing requirements, and guidelines on the physical set up along with Shariah compliance and other operational matters of the banks.

In recognition of the need for a separate department to look after the regulation and promotion of the Islamic banking sector, a full fledged **Islamic Banking Department (IBD)** was established in the State Bank in September, 2003. The department has been staffed with personnel having rich experience in regulating the banking industry and with in depth knowledge of all aspects of Islamic banking, including conceptual as well as business.

With the purpose of advising the authorities on the modes, procedures, laws and regulations for Islamic banking and ensuring Shariah Compliance, a **Shariah Board** has been established in the State Bank comprising experts in the field of Shariah, banking, accounting and law. The constitution of the Board ensures viable solutions to emerging problems.

The State Bank has participated actively on the international front and is one of the founding member of the **Islamic Financial Services Board (IFSB)**, which is committed to the promotion and development of international standards consistent with principles of Shariah in order to ensure transparency in the Islamic financial services industry. The Board is dedicated to developing international prudential regulatory standards in accordance with the distinct features and risks of Islamic financial institutions to ensure soundness and stability. State Bank has its representation in the Technical Committee and the Working Groups of Risk Management and Corporate Governance. The Working Group will devise guidelines for risk management in Islamic financial institutions. Besides, the State Bank has made arrangements for mutual cooperation in the areas of Islamic banking regulations and Sukuk Program with the **Bahrain Monetary Agency**. Recently BMA and the State Bank signed a **Memorandum of Understanding (MoU)** to strengthen cooperation between the two central banks on a host of issues including supervision, technical expertise and training assistance. To enhance investment opportunities and strengthen linkages with the global Islamic financial market, the State Bank is also a member of the **International Islamic Financial Market (IIFM)**. This is in continuation of the overall efforts to strengthen the efficacy of the Islamic financial system of the country. In consideration of accounting standards for the Islamic Banks, a committee has been constituted in ICAP for developing and reviewing the **accounting standards for Islamic modes of financing**. State Bank is also represented in the committee. At present, the standards for Murabaha have been finalized and sent to the SECP for notification, and those of Ijara and Musharika are in the process of completion. Furthermore, **Essentials of Islamic Modes of financing** approved by the Shariah Board of the State Bank have been issued as guidelines which will eventually become a part of Prudential Regulations on Islamic banking. The Shariah Board has also vetted **Model Agreements for Islamic Modes** which have been circulated to the banks, whereby they can amend the model agreements as per their product needs with the approval of the Shariah Board. This will ensure adherence of the banks to Shariah principles and the harmonization of the product development standards countrywide. In September 2002, a Musharika based **Islamic Export Refinance Scheme** has been introduced in order to provide finance to the eligible exporters as per Islamic modes. Meezan bank was allowed export Refinance under the scheme, and other Islamic banks and Islamic bank branches (IBBs) can also avail refinance on the same lines. Moreover, in order to enhance product diversity, spur financial innovation and support the overall development of the Islamic financial system, efforts are in progress to develop Islamic products for **SLR** and for other investment purposes, which will be on leasing of fixed assets presently owned by the Federal Government. Currently, the Islamic banks and IBBs are allowed to maintain Statutory Liquidity under Sec 29 of BCO 1962 in the form of current account with the SBP to the extent of 40 percent of SLR applicable to the commercial banks. Similarly 40 percent of SCR is also to be maintained on FE-25 deposits in current account with State Bank. Moreover, the presence of the SBP in global Islamic scene will also open up avenues for the Islamic banks to mobilize foreign capital according to Shariah principles, stimulate the creation and trading of Islamic financial instruments and facilitate liquidity management.

Since Islamic banking is still in its infancy stage in Pakistan, an **Islamic Banking Awareness Program** has been initiated by the State Bank, whereby the human resources of the State Bank, Chamber of Commerce, and the interested banks, are being trained countrywide, regarding the issues involved in Islamic banking. The State Bank has simultaneously put in place **Learning Program** aimed at learning from the experiences of other Muslim countries in the field of Islamic banking. An orientation program on Islamic banking and Takaful was arranged in collaboration with the Bank Negara, Malaysia. More so, a State Bank delegation visited Bahrain to learn about Islamic government securities, regulations for Islamic banks and activities of Liquidity Management centre (LMC) and IIFM. This process of information acquisition and dissemination will go a long way in establishing the distinct status of Islamic banking from the conventional banking system, enhancing intellectual capital development and resolving the perplexity of the issues at the grass root level.

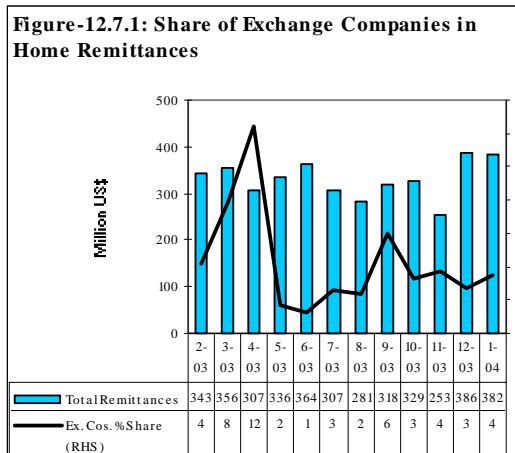
## 12.6 Establishment and Regulation of Exchange Companies

The establishment of Exchange Companies is the basic step taken by the State Bank to document foreign exchange transactions taking place through informal and undocumented sources commonly known as Hundi or Hawala. In the recent past, these have been extensively used modes of money transfer for both, legitimate and illegal purposes. Among the various reasons for the existence of this parallel money transfer system has been its cost effectiveness, the exchange rate arbitrage that existed between the inter bank and the kerb market, quick delivery and total confidentiality, to avoid the attention of the authorities. However, its impact on the economy was severe, resulting in the creation of un-documented wealth, inability on the part of the authorities to use the foreign exchange inflows generated through this system for external payments, facilitation to illegal activities and the circumvention of the country's foreign exchange regulations. Complete transformation was required to curb these activities; and as an intermediary step, money changers were licensed by the State Bank to conduct the business on a limited scope. This gave birth to a secondary foreign exchange market in addition to normal inter bank market. Despite the large number of money changers in operation, it was observed that the Hundi operators were still in business. Therefore, rules and regulations for the formation of exchange companies were devised. Accordingly, the authorized money changers have been allowed to operate till June 30<sup>th</sup> 2004, after which their licenses will be discontinued. To carry on their business, they can either convert into independent exchange companies or enter into franchise arrangements with the existing exchange companies as per rules and regulations.

At the very outset, the objective for the formation of exchange companies was to introduce corporate culture in the business of money changing and remittances in the country and at the same time liberalizing the foreign exchange regime. The basic purpose was to block money laundering and ensure larger inflow of home remittances through official channels thus ensuring transparency in foreign exchange transactions. In addition to restrain any clandestine

dealing in the foreign exchange market, these exchange companies would also ensure that the various risks associated with such business have been properly addressed. Presently, the share of exchange companies in terms of total home remittances is trivial; however, the gap between the two is shrinking (See **Figure-12.7.1**). Although the remittances in the current fiscal year are lower than the last fiscal year, the inflows are well within the targets. The share of exchange companies in home remittances, however, showed mixed trend throughout the CY03 and has shown slight improvement in the beginning of CY04. This

share is expected to rise owing to the delivery network allowed to the exchange companies and the likely increase in the number of exchange companies when the money changers meet the dead line to get registered as exchange companies. In the past, the preference for official channels owed its existence to a variety of reasons, including the September 11 event, the curb on Hawala and Hundi and the elimination of the differential between the open and inter bank market rates, leaving lesser attraction for those abroad to remit through the unofficial channels. Still, the popularity of the unofficial channels cannot be solely attributed to rate



differential. Official channels will have to improve their efficiency and significantly reduce the time required in transfer of remittance.

By coming under the regulatory purview of the State Bank, operations of the exchange companies will be streamlined on sound governance principles. The exchange companies are required to document all of their transactions and get their books audited by the auditors approved by the SBP. By virtue of being lesser in number and properly documented, the companies will comply with all the rules and regulations as laid down by the State Bank and subject their records to on site inspection and supervision. Moreover, it will serve as a vehicle for the exchange rate unification, resulting into the exchange companies finally taking over the demand and supply of kerb market as their scope of business is much wider. Unlike money changers, exchange companies are allowed to deal in foreign currency notes, coins, drafts, travelers' cheques catering to the requirements of both the individuals and the incorporated companies effecting remittances on account of royalty, franchise, technical fee etc. However, they cannot undertake the deposit-taking and lending business. Exchange companies can take part in the buying and selling of foreign exchange in 'Ready', 'Tom' and 'Spot' value dates with the banks as their counter party, and are allowed to sell their surplus foreign exchange in the inter bank market.

Currently 12 exchange companies have been licensed, 5 NOCs have been issued and 9 applications are under review. In order to promote their business, exchange companies can open branches and currency exchange booths all over the country. Commercial banks have also been allowed to establish exchange companies as subsidiary. Irrespective of the fact that this system would offer a legal recognition and standing, money changers have some reservations in becoming part of the forex companies system. Moreover, the initial capital requirement of Rs100 million, which is to be enhanced to Rs200 million in the next two years, is another concern for the money changers.

So far, the establishment of the exchange companies reflects the SBP's endeavor to transform the foreign exchange scenario from what had existed in the country for several years. This would not only lead to better regulation and supervision of the activities of this market but also allow for better service provision to the end user. Thus, remittances harnessed through a well documented and properly regulated system will have a positive effect on the economy and will also facilitate the efforts to curtail activities of the black economy. The objectives to establish exchange companies would take some time to translate into reality; however the culture of documentation will prevail eventually.

## **12.7 KIBOR as a Reference Lending Rate**

Karachi Inter-Bank Offered Rate (KIBOR) was launched earlier in the year 2004 as the reference rate for loans (Rupee denominated floating and fixed rate term loans) to corporate sector. Banks are now required to quote rates on their corporate loans on KIBOR plus terms. Initially, it was available for one, three and six-month tenors but from 31<sup>st</sup> March 2004, its tenors have also been expanded up to a one-year time horizon. The concept of KIBOR is not new to our financial market as it came into force in September 2001 when some big banks, including both local and foreign banks, accepted the challenge of creating a benchmark rate. However, at that time its scope was confined to the inter bank market only, though yields on PIBs served as benchmark for the corporate sector to price their long-term debt raising instruments. But as the banks were reluctant to pass on the benefits of changes in monetary

policy to the corporate sector, the need to introduce the reference rate beyond the inter bank market was felt strongly.

The KIBOR is put into effect as benchmark with multiple objectives: to encourage transparency, promote consistency in market based pricing, pass on the benefit of change in the monetary policy to customers and improve management of market risk. The results may not be visible in the very short run. Firstly, because the completion of these objectives needs that reference rate be extended to SMEs and consumer finance too. Secondly, the banks may quote any level equal to the present rate structure, hence to think about its immediate impact on customers is unrealistic. However, the rate may be rationalized in the long run when the banks will be competing in spreads, especially in the loans to sectors other than the corporate sector where the level is quite high. Moreover, the banks will become cautious while quoting their spreads owing to market competition and the customers, on the other hand, would try to improve their risk profile to get better rates. This would help in achieving the very objectives of this reference rate.

## **12.8 Derivatives Market**

Financial derivatives have become imperative to the overall risk profile and profitability of any business throughout the world. These instruments allow for the free trading of individual risk components thereby improving market efficiency. Popular types include futures, forwards, options and swaps.

In Pakistan, the history of derivatives is not too long. Earlier, there had been currency swaps called “Dirty Swaps” in the market during the early 90s in the time of low reserves of the central bank. Inter bank players have also been carrying out swaps to square their daily currency exposures. But the market appetite for formal derivatives, pulled out from the need for risk management strategies, prevailing low interest rates and a comparatively stable exchange rate, has started to come forward in the past few quarters. Some big players with overseas operations took the initiative and responded to the private sector’s demands to lock in their liabilities and future currency inflows at better prices. However, in the absence of imaginative products and a less developed debt market, the customers are left with very few options. At present, the nascent derivative market has started to emerge with few contracts of forward rate agreements (FRAs), plain-vanilla swaps and currency options but its volume lies around Rs5 billion, which is quite small.

Nevertheless, using financial derivatives brings up a number of concerns. In addition to risk sharing properties, derivative instruments facilitate information gathering. In the presence of frictions and market incompleteness, their benefits should be compared with the risks stemming from the derivatives' trading activities. The basic risks associated with these transactions are not new to the banks. In general these are explicit market risks along with credit risk, liquidity risk, operational risk, legal risk and the ones stemming from the informational and functional characteristics of a given financial market structure. Since they facilitate the specific identification and management of these risks, derivatives have the potential to enhance the safety and soundness of financial institutions and to produce more efficient allocation of financial risks. However, as derivatives also repackage these basic risks in combinations that can be quite intricate, they can also threaten the safety and soundness of institutions if not clearly understood or properly managed.

Our financial system is in a developing stage in defining and monitoring these risks in terms of risk management, information disclosure and market transparency. Though the absence of active secondary market of fixed income long-term securities poses a lodge to the emerging derivative market, OTC trading of the limited number of securities provides the slender base. The potential for excessive speculation is another threat. This leads to design policies and actions that the financial community should observe in order to guarantee that the benefits of derivative products be actively pursued without threatening the stability of the financial system.

As our market is not fully developed to take large exposures, the State Bank of Pakistan has been actively intervening in these riskier initiatives of the banks. It requires formal approval of derivative agreements. Presently, approvals have been given on a case-to-case basis considering the bank's potential of risk management. Down the road, the approvals may become institution specific and only sound banks may be allowed to play within the defined parameters. Moreover, the SBP is also preparing the risk management guidelines for derivatives. These derivatives, if used cautiously, are expected to be a positive step towards gaining economic efficiency.

## 13 Developments in Banking Supervision

### 13.1 Institutional Risk Assessment Framework (IRAF)

The rapidly changing financial scenario has forced regulators to recognize the importance of changing the risk profile of financial institutions. The expanding business avenues, deregulation and globalization of financial activities, developments such as use of highly automated technology, growth of electronic banking and greater risk appetite have considerably broadened risk horizons.

To ensure financial stability through proactive monitoring of risks faced by the banks, the SBP has developed an Institutional Risk Assessment Framework (IRAF)<sup>9</sup>. The IRAF signifies a major up-gradation over the existing supervisory approach. It has expanded the ownership by taking the banks management on board whereby the management will be required to rate itself on compliance with standards, codes and guidelines (that in turn will be verified by the SBP). The move will foster a greater degree of transparency and discipline in banks working with an automatic check on management. In the existing approach, market information was not given due weight-age. Market information is an important input in the supervisory process as it precedes any actual downgrade in the working of banks and could serve as a trigger point for supervisory response.

The new framework ties in the supervisory resources of various departments within the SBP in a more integrated and collaborative manner. Being technology driven, the framework would ensure swift flow of information leading to more efficient and effective banking supervision. In addition, it will also help with continuous monitoring, integrating on-site inspection, off-site surveillance and current market information. The IRAF shall be based on the following four inputs that would go into evaluation of banks: -

1. Compliance with Standards, Codes and Guidelines
2. Supervisory and Regulatory Information
3. Financial Performance and Condition
4. Market Information and Intelligence

The Banks and DFIs would carry out a self assessment exercise regarding compliance with the standards, codes and guidelines - like regulatory and statutory requirements, regulations, code of corporate governance and risk management guidelines and instructions for sound business and financial practices. The assessment would be carried out on a half yearly basis, duly endorsed by the respective Board of Directors. This self-assessment would be validated during the on-site inspection by the Banking Inspection teams and exceptions to be reported to the Banking Supervision Department.

Over and above the self-assessment by the institution, the SBP will make use of supervisory and regulatory information gathered from various sources. On-site inspection, off-site surveillance reports as well as enforcement/compliance status from Banking Supervision Department and policy related issues from Banking Policy Department will form the basis for the second input of this framework.

The actual financial performance and condition of banks/DFIs gleaned from audited annual statements, inspection reports, off-site surveillance reports/data and information submitted by

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<sup>9</sup> The Framework is in implementation process.

banks/DFIs through statutory returns form the major core of this input. Being the most important aspect of the assessment, it also needs closer coordination between supervisory departments.

The basic input for market information and intelligence would be drawn from credit rating agencies, research reports, volume and gravity of complaints, media and press reports and, where applicable, international supervisory reports. Further, the market news and overall profile of institutions in the peer group would also form the basis for this input.

Besides taking aggregate weights assigned to above-mentioned four inputs, major economic and financial industry developments will also be taken into account and each bank/DFI would be assigned on a quarterly basis a rating on a scale of 1 to 5, having similar connotations as in the CAMELS-S approach being presently used by the SBP.

The Information System Department of the SBP, in close coordination with the Banking Inspection Department, is developing a software for effective implementation of IRAF.

### **13.2 Risk Management Guidelines**

Like any other developing country, Pakistan's banking industry was highly regulated till a few years back. The rule based regulation is simple to enforce and easy to conform to. But at the same time it promotes a culture where efficiency and regard to risk may not be at optimum. During the past decade, Pakistan banking scene underwent a considerable change: liberalizing the economy, privatization drives, consolidation, doing away with much of the directed lending, and fixation of minimum and maximum rates on loans are some of the steps taken in this regard. While the broader environment was changing rapidly, the adaptation to these changes at banks was progressing at a slow pace, with little heed being paid towards the increasing risk their business was being subjected to by these changes.

Risk Management Guidelines issued by the SBP in CY03 are aimed at institutionalizing a culture of due appreciation of risks and endeavoring for their proper implementation in the banking industry. These can also be viewed as a precursor to the upcoming regime of new capital accord, which will change fundamentally the business practices of the financial community. Risk management guidelines held the board of directors, responsible for overall risk structure of the bank, accountable for designing and maintaining a proper set of risk framework. The management's role was defined as the executing arm for carrying out these activities on behalf of board. These risk management guidelines can also be viewed as a move towards market based supervisory ambience from the rule based supervisory regime. Right now the SBP is in the processes of evaluating the progress being made by the banks/DFIs towards adoption of these guidelines.

### **13.3 Consolidated Supervision**

Banking is becoming more and more complex day by day. The industry has evolved over time from comprising simple depository institutions to more sophisticated financial supermarkets. This has necessitated banks to carry on part of their business - in some cases the major part - through subsidiaries and affiliates. For bank supervisors it has become imperative to be able to supervise the activities of the banking group rather than the bank itself only on a solo basis. Moreover, a bank may often belong to a group headed by a holding

company, and in such cases supervisors need to take account of the activities of the holding company and fellow subsidiaries of the bank. Consolidated supervision, therefore, signifies a comprehensive approach to banking supervision which seeks to evaluate the strength of an entire group, taking into account all the risks which may affect a bank, regardless of whether these risks are carried in the books of the bank or related entities. Though the financial sector in Pakistan still lacks an enabling legal framework for consolidated supervision of financial groups, the SBP has taken a number of measures to enhance its capabilities and achieve this objective. An MoU has been signed with the Securities & Exchange Commission of Pakistan whereby both regulators will share information and expertise with a view to conduct supervision of banks/DFIs and NBFCs with a holistic approach. The banks and NBFCs owned by the same group are also required now to be audited by the same external auditors. Furthermore, arrangements have been made with a number of supervisors all over the world to better supervise internationally active banks operating in each other's jurisdictions. In addition, the banks are also required to fulfill Capital Adequacy Ratio requirements on consolidated as well as solo basis.

### **13.4 Stress Testing**

Frequent events of financial distress in the recent times have impressed upon regulators the importance of continuous, proactive supervision. Stress testing is one of the techniques that help regulators as well as the financial institutions to forecast any distress that may arise due to adverse developments in the environment, thus enable them to take preemptive measures to stall the situation from developing into a fully blown up crisis.

The technique involves identifying the factors, particularly the risk factors, which have a bearing on the financial health and performance of institutions, and determining the degree by which these factors affect the vital financials. The stress tests are then applied to gauge the impact of the exceptional but plausible movements in these identified risk factors on institutions. The approaches used range from "simple sensitivity test" that gauge the impacts of one risk factor to the more advanced "scenario analysis" that calibrates the impacts of simultaneous change in more than one risk factor. The scenario used can be either historical – drawing on the historical behaviors of the risk factors to forecast their future trends – or a hypothetical one focusing on the novel, but plausible, shifts in risk factors that may emerge due to dynamic conditions in the economy.

Realizing the importance of the technique, the State Bank has taken the initiative and started an in-house exercise to assess the potential vulnerability of the financial system. The bank is actively building up its expertise in the field. Presently, a cross-functional team that pools the expertise of different areas is working on a stress test project. The project focuses on simple sensitivity and scenario analysis on historical as well as hypothetical movements in the risk factors, and at its inception stage covers only the systemically important five large banks which hold around 60 percent share in the banking sector. The exercise is being carried out in relation to interest rate risk, exchange rate risk, credit risk, vulnerabilities to changes in equity prices and real estate price risk, primarily using the single factor sensitivity analysis that measure the impact of shock associated with one financial variable at a time. The results are calibrated in terms of capital of the bank. Though there is a list of limiting factors that hinders the development of advanced regression and simulation models, a road map is scheduled to



gradually upgrade and implement the stress test as a part of recurring activity to be carried out both by the individual banks and the SBP.

### **13.5 Coordination with ICAP**

In order to discuss the issues of mutual interest and to have close coordination on issues relating to accounting and auditing of banks, a Coordination Committee comprising the representatives of Institute of Chartered Accountants of Pakistan (ICAP) and the SBP was formed in June 2003. The Committee meets every quarter and till now three meetings have been held. The basic aim of this coordination is to strengthen the regulatory aspect of the Central Bank by addressing issues such as finalization of the accounting standards for Islamic modes of financing, cooperation of external auditors with the SBP inspection teams and improvement in the criteria for the SBP Panel of Auditors.

The Committee has also taken up the task of implementation of International Accounting Standard 39 and 40 and Internal Control Guidelines for Banks/DFIs. Due to importance of these issues, the Coordination Committee decided to form two sub-committees, the Implementation Committee on IAS 39 & 40 and the Internal Control Guidelines Committee. Beside the representatives of SBP & ICAP, these sub-committees also have members from Pakistan Banks Association. The initial report along with the recommendations on implementation of IAS 39 & 40 has been finalized.

Further, with the help of Financial Sector Reform and Strengthening Initiative (FIRST), the SBP has started a project “Uniform Chart of Accounts” for banks/DFIs. The objective of the project is to enhance the consistency, transparency and reliability of accounting data of banks/DFIs.

### **13.6 Awarding Single Rating to Banks and DFIs**

The prime task of banking supervision is to ensure safety and soundness of the banking system. To monitor the health of banks, off-site surveillance and onsite monitoring are widely practiced measures. At the SBP, banks and DFIs are rated in the light of CAMELS-S & CAELS frameworks by on-site and off-site monitoring respectively. These ratings at times could be different and may cause confusion with regard to exact set of actions to be taken for a bank or DFI. To ensure harmony in ratings, a Rating Review Committee comprising Directors of BID, BSD and BPD has been constituted which will award the final composite ratings to banks and DFIs. The on-site rating will serve as the base and off-site surveillance reports will be used to either downgrade or upgrade the on-site ratings to arrive at the final rating.

### **13.7 Recovery Efforts to Reduce Non-Performing Loans**

The presence of a high level of non-performing loans (NPLs) had been a major drag on the profitability of the banking system and was also a constant threat to its capital. Their presence was also an obstacle to credit expansion as financial institutions were shy of fresh lending because of their unpleasant past experience. Realizing the enormity of the threat, the SBP undertook various proactive measures not only to arrest but also to reduce the quantum of NPLs of banks/DFIs. These schemes yielded very positive results and, as has already been

discussed in the credit risk section, the current level of NPLs of the banking system is much lower as compared to that in 1997. In the following sections we give a snapshot of various schemes and entities as well as their performance in terms of recovery;

**SBP Incentive Scheme-1997:** Under this scheme 15,360 cases involving outstanding amount of Rs 9.406 billion were settled by 8 Nationalized Commercial Banks/DFIs up till February 16, 1998 and recovered cash amount of Rs4.165 billion from defaulters/borrowers.

**Committee for Revival of Sick Industrial Units (CRSIU):** It has restructured loans worth Rs 45.3 billion and helped revive 170 sick units by allowing waivers and write-offs up till January 31, 2004.

**Corporate & Industrial Restructuring Corporation (CIRC):** As on March 31, 2004, the CIRC has purchased loans worth Rs46.886 billion from banks at a discounted price of Rs5.807 billion and auctioned off 87 units, recovering Rs2.822 billion.

**SBP Guidelines on Write-off-2002:** As on February 29, 2004, a total of 51,152 borrowers approached banks/DFIs to settle their defaulted loans involving an aggregate amount of Rs89.622 billion under the scheme. Banks/DFIs have also settled 49,816 cases involving outstanding amount of Rs41.966 billion. The scheme has so far resulted in cash recovery of Rs3.304 billion.

### **13.8 Streamlining of Data Collection**

The data reporting system for banks/DFIs was too onerous in the past and contained a large number of returns which apart from being cumbersome would also be used to undermine the quality of reporting by banks and DFIs. Moreover, large amount of data would generally end up losing its value when it came to its manageability.

The SBP undertook an elaborate exercise to rationalize the reporting system and to determine the ultimate usage of various returns submitted mainly to Banking Supervision Department (BSD) and Banking Policy Department (BPD). Previously, banks and DFIs used to submit around eighty-two statements to BSD and BPD. However, after determining the data needs, the SBP managed to discontinue fifty four returns while four were merged to reduce the tally to twenty four.

The process of returns rationalization does not end here. This is an on-going exercise which depends upon regulators' need and changing realities. What is more important is the quality of data contained in these returns and the substantial reduction in returns should relieve the banks' burden, enabling them to improve the quality of data. Data warehouse project in the SBP is another significant development, which, once operational, will further facilitate better data transmission and usage. Preparation of a chart of accounts for the banking system will also help ensure harmony and uniformity in data reporting. All these positive developments in turn would further facilitate the SBP in carrying out a more meaningful and effective analysis of the banking system's health.

### **13.9 CIB On-Line**

Accurate and timely information about the credit worthiness of borrowers holds vital significance in lending decisions of financial institutions; any asymmetry or paucity of this information could cause untoward distortions in the intermediation process. Fully aware of

this, the State Bank has been catering to this information need of the financial sector since 1992. The bank's Credit Information Bureau (CIB) collects credit information from banks/NBFIs including leasing companies and Modaraba Companies in respect of their borrowers having credit exposure of Rs0.5 million and above. This information comprises financial and non-financial data on the borrowers as well as their repayment behavior. The data base so compiled is available to the institutions for their credit decision analysis.

The system of the bureau till April 2003 was manual and counter based; any request from a bank/NBFI used to take a couple of days to entertain. This system was prone to inexpediency and operational errors, so in order to overcome these shortcomings, in collaboration with the Pakistan Banks Association, the State Bank of Pakistan undertook a project to fully automate its CIB. This project was in place by the end of April 2003, and since then the bureau has been receiving and disseminating information online, via dial up. This development has significantly transformed the credit information process into that of a more user friendly and efficient one; it also reflects the SBP's continued commitment to adopt internationally accepted best practices.

Besides this technological facilitation, the State Bank, in the face of dynamic market conditions, appreciates the importance of continuous improvement and strengthening of its credit information function. The recent move of banks into consumer finance operations has substantially increased the number of borrowers, and credit information in respect to these newly emerged borrowers is lacking in the system. The State Bank has already initiated a project to expand the coverage of credit information to virtually all borrowers, irrespective of their borrowing limits. This expansion would enable the banks to benefit from this newly emerging lending avenue while keeping the default rates at a bare minimum.

The SBP is also carrying out a detailed study both for further strengthening the National Credit Information system as well as determining the scope of private sector credit bureaus in the country. In view of the recommendations, a legal and regulatory framework will be developed under which private sector credit bureaus will start functioning and deliver services according to best international practices.

### **13.10 Amendments in Banking Laws**

From January 2002 to June 2003, the following amendments were made in the Banking Laws (BCO, 1962 and SBP Act, 1956):

#### **1) Banking Companies Ordinance, 1962**

##### **A. Gazette Notification dated 13<sup>th</sup> May, 2002**

The Federal Government in exercise of its powers conferred by Section 3A of the Banking Companies Ordinance, 1962 has through Gazette Notification dated 13<sup>th</sup> May, 2002 specified M/s Pak-Oman Investment Company (Pvt.) Limited for the purpose of Section 3 ibid. The effect of the Notification is to bring the Company under the regulatory purview of the State Bank of Pakistan.

##### **B. Ordinance No. CXI of 2002 dated 4<sup>th</sup> November, 2002**

- **Section 3A:** The NBFIs (except DFIs) were excluded from the said section to shift the responsibility of regulation of these institutions to SECP.

- **Section 5:** Shares of Bankers Equity Limited were excluded from list of eligible securities.
- **Section 23:** With the insertion of new (aa) the formation of subsidiary for the purpose of carrying on of banking business in conformity with injunctions of Islam was allowed.
- **Section 31:** With the amendment in the said section deposits denominated in other currencies were brought under the purview of unclaimed deposits.
- **Section 41A:** Governor SBP has been empowered to determine the period of time until which chairman or director or chief executive or other officer of a banking company cannot take part in the management of the banking company against which action has been taken under the said section.
- **Section 41B:** Governor SBP has been empowered to determine the period of supersession of board of a banking company.
- **Section 47:** Sub-section (16) has been substituted to provide for merger/ amalgamation of banking institutions and banking companies as specified therein viz. IDBP, HBFC, Investment finance companies, venture capital companies, housing finance companies, leasing companies and other financial institutions specified in Section 3A.
- **Section 48: :** Sub-section (7) has been substituted to provide for merger/ amalgamation of banking companies as specified therein viz. IDBP, HBFC, Investment finance companies, venture capital companies, housing finance companies, leasing companies and other financial institutions specified in Section 3A.

## **2) State Bank Of Pakistan Act, 1956**

State Bank of Pakistan (Amendment) Ordinance, 2002, Ordinance No. CX of 2002 dated November 4, 2002.

### **Section 9B**

In the said section after sub-section (5), the following new sub section shall be added namely:-

“(6) In carrying out its assigned functions of coordinating fiscal, monetary and exchange rate policies and for ensuring constituency among macro economics, targets of growth, inflation and fiscal, monetary and external accounts as laid down in sub section (1), (2), (3), (4) and (5), the Coordination Board shall not take any measure that would adversely affect the autonomy of the State Bank of Pakistan as provided in this Act.”

### **Section 10:**

In section 10 for sub-section (3), the following shall be substituted, namely:-

“(3) Subject to sub-section (11), the Governor shall be appointed by the President for a term of three years, and on such salary and terms and conditions of service as the President may determine, except that neither the salary of the Governor nor his other terms and conditions of service shall be varied to his disadvantage after his appointment:

Provided that the Governor shall be eligible for re-appointment for another term of three years:

Provided further that no person shall hold the office of the Governor after attaining the age of sixty five years.”

**Section 15:**

In sub-section (1) of section 15, for the word “Federal Government” the word “President” shall be substituted.

**Section 22:**

For section 22 the following shall be substituted, namely:-

“22 *Service Charges*,-(1) The Bank shall make public from time to time the standard service charges at which it is prepared to provide financial accommodation to the borrowing entities.

(2) In respect of finance provided by the Bank it may determine, from time to time, the terms and conditions either generally or specially.”

**13.11 Prudential Regulations**

In the year 2003 the SBP undertook an exhaustive review of the existing Prudential Regulations to further strengthen the prevailing regulatory framework. As a result of the review process, three different sets of prudential regulations were devised for three different areas viz. corporate and commercial banking, SME financing and consumer financing, so that each set serves the relevant area in the best possible way.

The Prudential Regulations for corporate and commercial banking put in place broader guidelines in the area of credit risk management, corporate governance and anti-money laundering operations while the Prudential Regulations for SMEs have been issued to avoid certain constraints faced by the SMEs during meeting their financing requirements. The regulations will now facilitate and encourage the flow of bank credit to the SME sector. The last set of regulations for consumer financing has been devised to encourage the banks to diversify their loan portfolio through creation of new products on the one hand and to ensure that banks undertake consumer financing in a prudent manner on the other. Specialized tailored Prudential Regulations for Microfinance have already been issued with the main objective to boost micro credit activities.

## **14. Update on Compliance with International Codes and Standards**

### **14.1 Basel Core Principles**

The Basel Core Principles (CPs) for Effective Banking Supervision have gained great importance for prudent regulation and supervision of financial sector. These principles are considered as benchmark for the banking supervision and their compliance reflect the robustness of the supervisory framework of a country. Cognizant of the importance of these principles, the SBP has been preparing an internal assessment of compliance with these principles since 2001. The assessment methodology is based on criteria prescribed by the Basel Committee on Banking Supervision (BCBS). The extent of compliance with each principle is expressed in terms of a ranking continuum i.e. compliant, largely compliant, materially non-compliant, and non compliant.

In February 2004 a joint mission of the IMF and the World Bank carried out an independent assessment of the SBP's compliance with CPs under Financial Sector Assessment Program (FSAP) of the country. This was the first such assessment and it provided an independent evaluation of the level of robustness of supervisory framework of the country. The final report of the mission is awaited.

An update on the principles where the SBP has made some further progress is outlined in Table-14.1. With these developments, Pakistan, as per our internal assessment, is now compliant with 22 principles, largely compliant with 5 and materially non-compliant with 3.

### **14.2 International Accounting Standards**

All banks operating in Pakistan are required to follow the International Accounting Standards as notified by the Securities and Exchange Commission of Pakistan with the exception of IAS 39 and 40. However, a Coordination Committee consisting of the representatives of Institute of Chartered Accountants of Pakistan (ICAP) and the SBP has taken up the task of implementation of International Accounting Standard 39 and 40 and Internal Control Guidelines for Banks/DFIs. Due to importance of these issues, the Committee has formed two sub-committees; the Implementation Committee on IAS 39 & 40 and the Internal Control Guidelines Committee. Beside the representatives of SBP & ICAP, these sub-committees also have members from Pakistan Banks Association. The initial report along with the recommendations on implementation of IAS 39 & 40 has recently been finalized.

### **14.3 Principles of Corporate Governance**

The SBP in its efforts to introduce the international best corporate practices has taken a number of steps. To further strengthen the need of good corporate governance in banks and to help stakeholders develop understanding of the subject, a "Handbook of Corporate Governance" has been published and also posted on the SBP website. In the handbook a set of wide ranging guiding principles and instructions have been compiled regarding; appointments, duties and responsibilities of board of directors, senior management, auditors and guidelines regarding financial disclosure of banks and DFIs. The "Code of Corporate Governance" issued by the Securities and Exchange Commission of Pakistan has been made

applicable to banks as well. Besides, to enlighten the importance of corporate governance, a high level conference was held by the SBP which was attended by the board members and chief executives of banks and DFIs.

#### **14.4 Code of Good Practices on Transparency in Monetary and Financial Policies**

The SBP has also been conducting its internal assessment of observances of Code of Good Practices on Transparency in Monetary and Financial Policies issued by IMF. Based on internal assessment, the SBP is fully observing 25 of the total 36 codes. Of the remaining 11 codes, 5 are broadly observed, 2 partly observed whereas the remaining 4 are not applicable.

A joint mission of the IMF and the World Bank also carried out an independent assessment of the SBP's observance of these codes under Financial Sector Assessment Program (FSAP) of the country. However, they have not yet provided their final report.

**Table 14.1 - Update on Core Principles**

Legal Protection (CP-1.5)	Legal protection to the actions taken by the employees of SBP in the conduct of their official duties, provided such actions have been taken in good faith, has already been provided in the Banking Companies Ordinance, 1962. The scope of legal protection has been further broadened through amendment in SBP Staff Regulations whereby it would be the responsibility of the SBP to provide for the cost of legal expenditure to the staff if he/she encounters litigation because of performing his/her official duty.
Licensing Criteria (CP 3)	Explicit criteria for establishment of Islamic Banks/ Islamic branches of existing banks, Exchange Companies and Microfinance Institutions have been put in place. Although there has been a moratorium on issuance of new commercial banking licenses for quite some time, the requirements of CPs regarding licensing criteria are fully complied with while issuing licenses to newly merged or acquired banks.
Capital Adequacy (CP 6)	The minimum capital requirement for banks has been enhanced to Rs 1 billion since January 1, 2003, while recently the requirement for DFIs has also been brought inline with that of the commercial banks. Capital charge for market risk has not yet been made a part of the Capital Adequacy Requirement, however a draft circular in this regard is under active consultation with stake holders. The banks will be required to hold capital for their market risk once the proposed circular is notified.
Loan Evaluation (CP 8)	Separate Prudential Regulations for Corporates, SMEs and Consumer financing have been issued to strengthen the regulatory framework especially with regard to measurement of credit risk and adequacy of provisions as mitigants. The regulatory reporting of NPLs by banks has been made more meaningful and transparent.
Country Risk (CP 11)	Guidelines on Country risk covering "Sovereign", "Transfer" and "Contagion" risks have been issued recently emphasizing upon the banks to put in place policies and procedures to control and mitigate this risk.
Market Risk (CP-12)	Detailed guidelines on risk management, encompassing credit risk, market risk, liquidity risk and operational risk have been issued to banks/DFIs during the year 2003. Different components of market risk e.g. interest rate risk, foreign exchange risk and equity price risk have been elaborated in the said guidelines. Banks adherence to these guidelines is being monitored through off-site progress reports and on-site examinations verifications.
Other Risks (CP-13)	Different sets of regulations and guidelines on risk management, internal controls and corporate governance largely encompass all the risks faced by the banks. Further, through on-site and off-site monitoring the SBP ensures that the banking risks are timely identified and taken care of.
Internal Controls and Audit (CP-14)	The SBP has been promoting a good corporate governance culture and internal control environment within the banking industry through frequent interaction with the industry. Recently Internal Control Guidelines have also been issued to provide the banks with model approach towards achieving robust internal controls.
Money Laundering (CP-15)	Prudential Regulations M1 & M2 in the new prudential regulations issued in 2003 deal with specific issue of money laundering and possible use of banking system for criminal activities/terrorist financing.



## 15 Performance of the Banking Sector in Post Financial Liberalization Era

After nationalization in 1974, Pakistan's banking sector underwent major structural changes and become dominated by public sector banks, especially the five large banks. The banking sector was burdened with all implications that were characteristic of a state owned banking system. It was not efficient in terms of operating cost, interest rate spreads and had huge infected loan portfolios. The last decade or so witnessed the initiation of the financial liberalization process. The process was aimed at eliminating these inefficiencies by infusing competition through increased participation of the private sector. The ensuing paragraphs discuss the extent to which these identified objectives of reducing concentration, enhancing private sector participation, and increasing market efficiency, through increased competition and rationalization of cost structures, have been achieved.

### Changes in Industry Concentration and Composition:

While the five large banks continue to dominate the banking sector, (See **Figure-15.1**), medium sized private sector banks have started to weigh more significantly on its landscape. **Figure-15.2** which represents Herfindahl Index<sup>10</sup> endorses this view. Here the level of concentration has been measured in terms of total assets (Herf-assets), advances (Herf-advances) and deposits (Herf-deposits). Evidently, the trends since 1999 and onward have been more significant and consistent. By the end of 2003, the value of Herf-advances and Herf-assets indices have come down to well below 1,000, while the value of Herf-deposits is almost touching this level. The highest value for the latter shows the ability of five dominating banks to mobilize deposits with ease owing to their wider outreach and their decades old presence.

The number of equivalent sized banks, a hypothetical measure derived from Herfindahl index, has inched up from 9 to 11 over the period from 1996 to 2003. On the other hand a number of weaker banks have undergone mergers and acquisitions over the same period, and total number of banks has come down from 46 to 40. This augurs well for the

Figure-15.1:Share of Five Large Banks

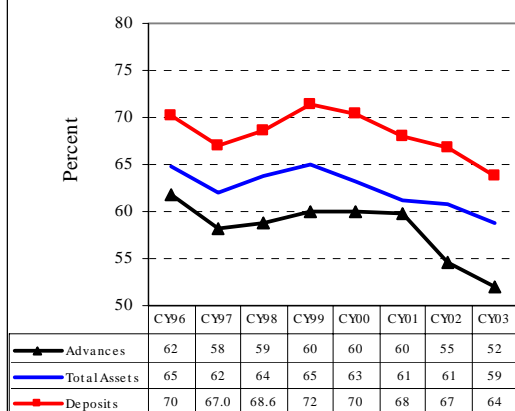
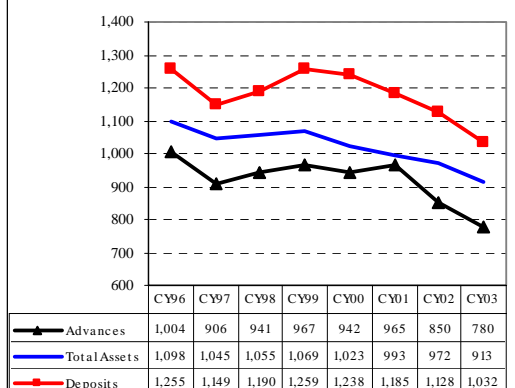


Figure-15.2:Herfindahl Index for Industry



<sup>10</sup> Herfindahl Index is defined as sum of squares of the market share of all banks. The maximum value that the index can assume is 10,000 i.e. only one bank holding 100 percent market share – an example of absolute concentration. Authorities over the world use the index to measure and control market concentration. Sometimes H below 1,000 is considered relatively limited concentration, and H above 1,800 indicates significant concentration.

development of an efficient, competitive market.

Due to the reforms process, the share of private sector banks in the banking sector has increased significantly. This increase has come from privatization of nationalized banks as well as strong market build up by private banks which started to enter the market in the early 1990s. The most recent success of privatization of HBL has further affected the scene; now more than 80 percent of the banking sector assets are with private/privatized banks.

### **Interest Rate Spread and Intermediation Costs<sup>11</sup>**

The Pakistani banking sector has been marked with wide interest rate spreads and the worst part of this anomaly was that the spread across the banks have been quite variant. Such a phenomenon generally emerges from banks' high operating costs and regulatory credit controls. And wide dispersion in the individual bank spreads indicate an inefficient market structure which allows banks to price their assets and liabilities without paying due regard to market dictates.

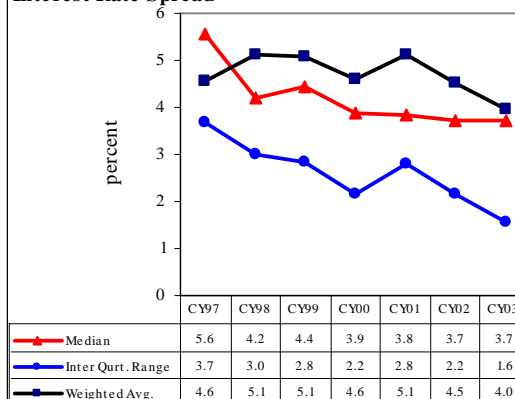
Under the financial liberalization and reform process, almost all the mandatory lending requirements and limits on interest rates were withdrawn. Banks' profiling of assets and liabilities and pricing thereof are market based – driven by demand and supply conditions.

**Figure-15.3** which shows decline in interest rate margins of the industry, reduction in median and weighted average, convergence of individual bank spreads towards a market average and contraction of inter quartile ranges. The latter development suggests increasing efficiency of the market where pricing by an increasing number of banks is now conforming to a benchmark market rate.

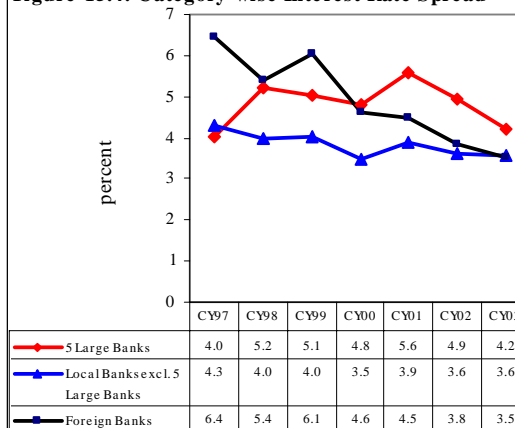
This phenomenon also underlies the recent benchmarking of corporate lending rates to KIBOR, whereby the SBP has asked the banks to link the pricing of their lending to KIBOR so as to enhance transparency, consistency in lending rates, and management of market risk.

The industry's average which was on the wane for the last couple of years has remained quite high; a number of factors were on the back of this phenomenon. Higher intermediation costs, particularly, of the five big banks (See **Figure-15.5**) pushed up their lending rates, thus distorting the industry average. On the funding side again these five banks enjoy access to cheaper funds. Therefore, on the one hand availability of cheaper funds, and on the other, higher lending rates made the gap wider. This was a classical example of dis-economies of

**Figure-15.3: Trends and X-sectional Dynamics of Interest Rate Spread**



**Figure-15.4: Category-wise Interest Rate Spread**



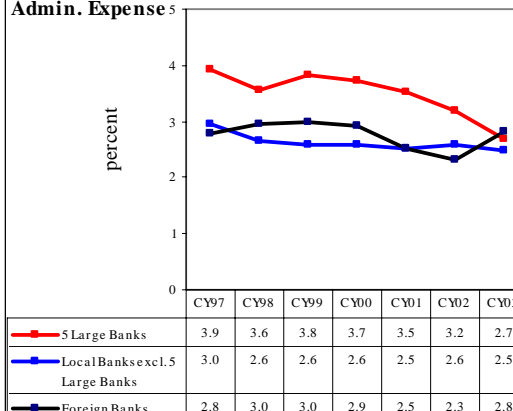
<sup>11</sup> To ensure comparability, forthcoming discussion focuses on commercial banks only and excludes the specialized banks whose nature of business differs significantly and they have limited scope of operations.

scale, where big banks were too big to control their costs. Nevertheless, these very banks in recent years have shown a significant improvement in this regard by rationalizing their cost structure.

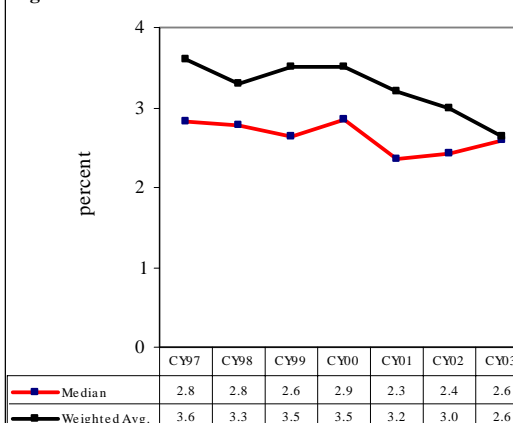
The **intermediation cost** of the industry, though still on the higher side, has shown gradual improvement. Administrative expenses have grown at a compound growth rate of 5.2 percent since 1997. This growth has been even more passive in recent years: a compound growth of 2.3 percent since 2001. The growth seems to be quite controlled, especially when seen in the backdrop that medium-sized banks have geared up efforts to build up market share. This period also marked some extraordinary expenses. The large banks introduced voluntary separation schemes which involved heavy outlays, a part of which was charged to the banks operating expenses; besides, fuller compliance of IAS-19<sup>12</sup> by the industry further burdened the administrative expense bill. However, capitalizing on the expansion in scale arising from a compound growth of around 10.2 percent in fund base since 1997, intermediation costs registered

gradual decline (See **Figure-15.6**). And improvements in the banks earnings over the years have significantly increased the operating expenses coverage in terms of Gross Income. Another expense that adds to intermediation cost is provision charges for non-performing loans. These charges have remained high in the initial years of the period under study (See **Figure-15.7**). This was a result of strict enforcement of the Prudential Regulations after the autonomy of the SBP, whereupon a number of banks, especially nationalized banks, provided heavier amounts of provisions against NPLs. The banking industry's efforts at bringing down the level of NPLs during recent years have been quite successful.

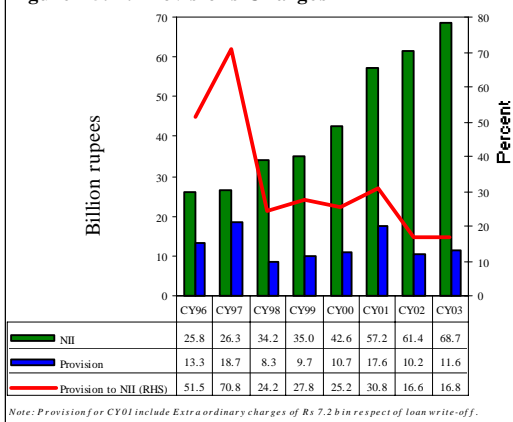
**Figure-15.5: Category-wise Intermediation Cost, Admin. Expense**



**Figure-15.6: Trends in Intermediation Cost**

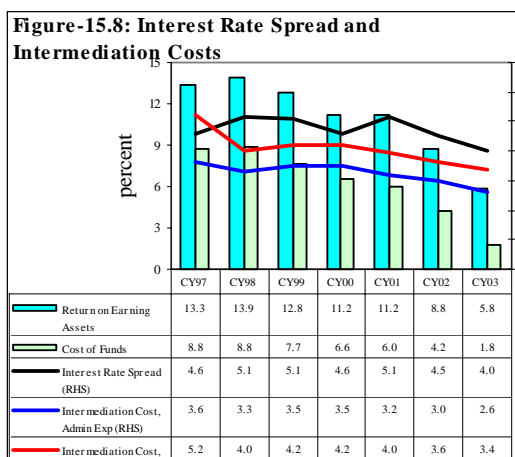


**Figure-15.7 : Provisions Charges**

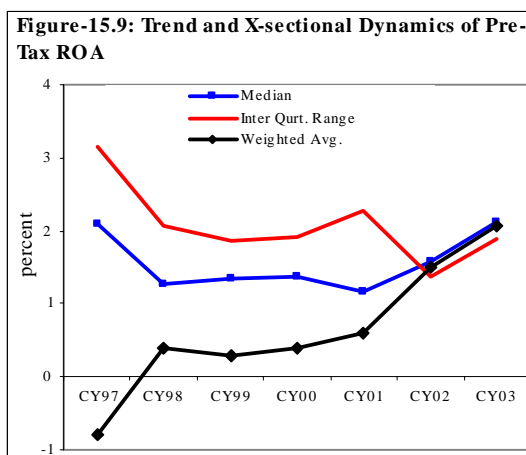


<sup>12</sup> International Accounting Statndard-19 inter alia requires that an organization which offers post retirement benefits to its employees should appropriately provide for these benefits over the years in which employees' service entitle them for such benefits. The standard was adopted in Pakistan in 2000.

**Figure-15.8** summarizes the above discussion. It shows that the banks over the last seven years have curtailed their intermediation cost largely through expansion in volume of business: spreading their operating costs over larger fund base. These gains have been translating into the reduction in pricing of banks' assets and interest rate spreads as well. However the decline in returns on earning assets has also to do with easy monetary settings. The banks' fund base has expanded significantly and a major portion of these funds rested in government papers. In the wake of a significant improvement in the government's financials, the return on these papers substantially came down. On the other hand, increased competition among banks to market these funds led to sharp decline in returns on loans as well. On the funding side, availability of cheaper, rate-insensitive funds and shift in banks' fund base from remunerative to non-remunerative or low cost deposits have enabled the banks to withstand the effects of this sharp decline in returns. However, this flexibility in passing on the effects of declining returns to depositors, to the extent that real returns on deposits ranges in negative, shows the restricted reach of the capital market and the relative monopoly of the banking sector in the financial market. Since the capital market is performing well for quite some time and has started to introduce more competitive products to attract the savings of the masses, the banks' low cost fund base may face stress in the coming years.



Besides expansion in scale, the sector has experienced considerable scope expansion as well. This includes the liberalization of the exchange regime, the introduction of new products and the development of a secondary market for government papers. All of these developments have improved banks' incomes and profitability (See **Figure-15.9**). The impact of the latter development in particular is significant for the last couple of years. The figure also reflects upon the increased competitiveness and efficiency in the sector; contracting Inter Quartile ranges suggest that more and more banks are having profits in line with market norms.



The liberalization and reform process has considerably changed the structure and the face of the Pakistani banking sector. It has reduced the concentration and role of the public sector and enhanced symmetry, not only in the size of banks but also in their pricing behavior. These are now more influenced by market dictates. While the recent fall in lending rates has substantially helped economic recovery of the country, the increasing pressure of competition has pushed banks into sectors which have so far remained largely under-served. All this would lead to realization of allocative efficiency and balanced growth in the industry.

## **16. Future Outlook**

The banking system of Pakistan has made long-strides in recent years towards its goal of becoming a financially viable and firm arm of the economy which in turn would help promote growth and prosperity. Its remarkable performance in terms of assets growth, particularly unprecedented loans expansion, and significant rise in profits during the year 2003, would further strengthen the process. Acceleration in lending to SMEs was the distinct feature of loans growth and it speaks not only of the success of monetary and credit policies pursued under the reform program but also signifies potential influence on aggregate demand which would further stimulate economic activity in the country.

Consumer finance so far has been the domain of a few banks. However, as competition gets intense and more banks enter the market, this area is expected to grow further in the near future. Banks have not tapped the housing finance market to its full potential. With the removal of legal impediments, the generation of matching funds and an increasing expertise in this area, banks may allocate more funds to this vital part of the economy. Results for the first quarter of CY04 show that lending to these three areas have increased substantially.

The rapid growth in loans during the year 2003 has broken the protracted spell of stagnation and is a good omen for the economy. Data for the first quarter of CY04 reveals a continuation of this trend. However, the fast expansion in loans, at the same time, has raised credit risk concerns. The level of non-performing loans is well contained, as this has been diminishing. In the first quarter of CY04, total NPLs of the banking system declined even further. However, persistent fall in NPLs should not allow banks to become complacent because reckless and imprudent lending may easily translate into bad loans. It calls for simultaneous development of internal administrative and management controls to keep up with the expanding loan portfolio for effective and profitable operations. Over-lending against highly inflated asset prices was one of the main reasons for the South East-Asian Crisis of late 90s. Therefore, banks will have to be vigilant while lending against assets that have experienced steep rise in their values recently. It is hoped that with overall capacity building within the banking system as well as strengthened supervision, chances of such occurrences would be minimal.

Mounting upward pressures on interest rates and swift expansion in loans might also alter the profitability structure with a declining reliance on non-interest income and surging core earnings. Comparatively, low capital gains during the first quarter of CY04 confirm this belief to some extent. Banks would have to properly align their resources to changing market conditions to keep market and liquidity risks at bay.

The ongoing process of consolidation is an important step forward in meeting the challenges of a more liberalized market. The process would enable banks not only to withstand unexpected shocks arising out of greater volatility in market behavior but also force them to innovate and diversify in order to carve their share in an intensely competitive environment. In the ultimate analysis, the economy at large will reap the benefits of a much stronger and resilient banking sector.

The persistent improvement in the key macroeconomic indicators plus growing opportunities, given that there is no unexpected exogenous shocks, indicate that the banking system would continue its march on the growth path. Another factor, which supports this view is the inner strength of banks, gained through systematic overhauling in recent years. The effective watchdog function of the SBP would also provide the needed support to achieve this.

## Annex-I

### Financial Soundness Indicators of Banking System

	1997	1998	1999	2000	2001	2002	2003
<b>CAPITAL ADEQUACY</b>							
<b>Risk Weighted CAR</b>							
Public Sector Commercial Banks	(1.3)	11.6	10.6	10.4	9.6	12.3	11.0
Local Private Banks	11.9	11.4	10.7	9.2	9.5	9.7	9.0
Foreign Banks	14.6	15.6	18.6	18.0	18.6	23.2	23.0
<b>Commercial Banks</b>	<b>6.0</b>	<b>12.5</b>	<b>12.2</b>	<b>11.4</b>	<b>11.3</b>	<b>12.6</b>	<b>11.1</b>
Specialized Banks	(6.2)	(1.4)	0.3	(3.3)	(13.9)	(31.7)	(28.2)
<b>All Banks</b>	<b>4.5</b>	<b>10.9</b>	<b>10.9</b>	<b>9.7</b>	<b>8.8</b>	<b>8.8</b>	<b>8.5</b>
<b>Tier 1 Capital to RWA</b>							
Public Sector Commercial Banks	(2.0)	8.3	7.7	7.7	7.1	8.6	8.2
Local Private Banks	11.4	10.2	9.3	8.1	8.4	6.6	7.1
Foreign Banks	14.4	15.4	18.4	17.9	18.6	23.0	23.0
<b>Commercial Banks</b>	<b>5.5</b>	<b>10.5</b>	<b>10.3</b>	<b>9.8</b>	<b>9.7</b>	<b>9.7</b>	<b>9.1</b>
Specialized Banks	(6.3)	(1.6)	0.3	(3.4)	(13.9)	(31.7)	(28.7)
<b>All Banks</b>	<b>4.1</b>	<b>9.1</b>	<b>9.2</b>	<b>8.3</b>	<b>7.3</b>	<b>6.2</b>	<b>6.5</b>
<b>Capital to Total Assets</b>							
Public Sector Commercial Banks	0.3	4.9	3.8	4.6	3.7	5.6	6.1
Local Private Banks	4.9	4.9	4.9	3.5	3.8	5.2	5.1
Foreign Banks	7.9	8.8	9.7	8.8	8.5	10.6	10.0
<b>Commercial Banks</b>	<b>3.1</b>	<b>5.6</b>	<b>5.0</b>	<b>4.9</b>	<b>4.6</b>	<b>6.1</b>	<b>6.0</b>
Specialized Banks	8.8	0.2	1.7	(1.1)	(10.3)	(23.0)	(9.5)
<b>All Banks</b>	<b>3.5</b>	<b>5.3</b>	<b>4.8</b>	<b>4.5</b>	<b>3.8</b>	<b>4.8</b>	<b>5.4</b>
<b>ASSET QUALITY</b>							
<b>NPLs to Total Loans</b>							
Public Sector Commercial Banks	30.8	29.0	30.7	26.3	25.9	25.5	20.4
Local Private Banks	10.2	11.1	15.5	15.4	16.3	15.4	11.3
Foreign Banks	5.0	5.3	5.1	4.7	4.3	3.8	3.1
<b>Commercial Banks</b>	<b>20.1</b>	<b>19.5</b>	<b>22.0</b>	<b>19.5</b>	<b>19.6</b>	<b>17.7</b>	<b>13.7</b>
Specialized Banks	50.6	47.2	51.6	52.4	53.0	54.7	55.6
<b>All Banks</b>	<b>23.5</b>	<b>23.1</b>	<b>25.9</b>	<b>23.5</b>	<b>23.4</b>	<b>21.8</b>	<b>17.0</b>
<b>Provision to NPLs</b>							
Public Sector Commercial Banks	52.9	55.6	48.8	59.2	56.6	57.1	65.8
Local Private Banks	57.8	53.3	35.0	36.9	40.5	58.6	62.7
Foreign Banks	65.9	75.0	63.4	65.9	74.1	73.3	77.4
<b>Commercial Banks</b>	<b>54.2</b>	<b>56.2</b>	<b>46.6</b>	<b>53.9</b>	<b>53.2</b>	<b>58.2</b>	<b>64.7</b>
Specialized Banks	22.8	65.3	54.2	58.1	59.2	66.9	60.8
<b>All Banks</b>	<b>46.6</b>	<b>58.6</b>	<b>48.6</b>	<b>55.0</b>	<b>54.7</b>	<b>60.6</b>	<b>63.7</b>

# Annex-I

## Financial Soundness Indicators of Banking System

	1997	1998	1999	2000	2001	2002	2003
<b>Net NPLs to Net Loans</b>							
Public Sector Commercial Banks	17.0	15.0	18.5	12.7	13.1	12.8	8.1
Local Private Banks	4.6	5.5	10.7	10.3	10.4	7.0	4.5
Foreign Banks	1.8	1.4	1.9	1.7	1.1	1.1	0.7
<b>Commercial Banks</b>	<b>10.3</b>	<b>9.6</b>	<b>13.1</b>	<b>10.1</b>	<b>10.3</b>	<b>8.3</b>	<b>5.3</b>
Specialized Banks	44.1	23.6	32.8	31.6	31.5	28.5	33.0
<b>All Banks</b>	<b>14.1</b>	<b>11.1</b>	<b>15.3</b>	<b>12.2</b>	<b>12.1</b>	<b>9.9</b>	<b>6.9</b>
<b>Net NPLs to Capital</b>							
Public Sector Commercial Banks	2,081.0	119.9	212.0	124.5	160.2	83.4	50.0
Local Private Banks	43.3	51.4	103.5	153.5	125.2	54.8	40.5
Foreign Banks	10.0	7.1	9.9	9.0	5.8	4.7	3.3
<b>Commercial Banks</b>	<b>143.6</b>	<b>72.1</b>	<b>117.4</b>	<b>96.7</b>	<b>100.7</b>	<b>54.2</b>	<b>37.5</b>
Specialized Banks	380.0	11,139.0	1,502.3	-	-	-	-
<b>All Banks</b>	<b>183.8</b>	<b>92.6</b>	<b>149.8</b>	<b>131.3</b>	<b>150.5</b>	<b>85.5</b>	<b>55.4</b>
<b>EARNINGS</b>							
<b>Return on Assets (Before Tax)</b>							
Public Sector Commercial Banks	(3.4)	(0.4)	(0.4)	0.5	0.0	1.3	1.8
Local Private Banks	1.4	0.9	0.9	(0.1)	0.9	1.4	2.2
Foreign Banks	3.0	1.7	1.8	1.4	1.7	2.3	2.6
<b>Commercial Banks</b>	<b>(0.8)</b>	<b>0.4</b>	<b>0.3</b>	<b>0.4</b>	<b>0.6</b>	<b>1.5</b>	<b>2.1</b>
Specialized Banks	(0.2)	(9.4)	1.8	(2.3)	(8.4)	(10.2)	(2.5)
<b>All Banks</b>	<b>(0.8)</b>	<b>(0.3)</b>	<b>0.4</b>	<b>0.3</b>	<b>0.1</b>	<b>0.9</b>	<b>1.9</b>
<b>Return on Assets (After Tax)</b>							
Public Sector Commercial Banks	(3.1)	0.7	(1.0)	0.2	(0.5)	0.6	1.0
Local Private Banks	0.5	0.4	0.4	(0.7)	0.4	0.7	1.4
Foreign Banks	1.4	0.4	0.7	0.6	0.8	1.5	1.5
<b>Commercial Banks</b>	<b>(1.3)</b>	<b>0.5</b>	<b>(0.3)</b>	<b>(0.01)</b>	<b>(0.01)</b>	<b>0.8</b>	<b>1.2</b>
Specialized Banks	(0.2)	(9.4)	1.7	(2.3)	(8.8)	(12.1)	(3.2)
<b>All Banks</b>	<b>(1.2)</b>	<b>(0.1)</b>	<b>(0.2)</b>	<b>(0.2)</b>	<b>(0.5)</b>	<b>0.1</b>	<b>1.1</b>
<b>ROE (Avg. Equity &amp; Surplus) (Before Tax)</b>							
Public Sector Commercial Banks	(272.7)	(14.6)	(9.6)	10.9	0.5	26.3	29.9
Local Private Banks	29.0	17.5	18.5	(3.2)	25.4	32.3	42.2
Foreign Banks	37.7	20.5	19.3	15.6	19.3	24.2	25.2
<b>Commercial Banks</b>	<b>(23.8)</b>	<b>8.0</b>	<b>6.5</b>	<b>8.8</b>	<b>12.2</b>	<b>27.5</b>	<b>34.0</b>
Specialized Banks	(1.8)	(211.0)	182.8	-	-	-	-
<b>All Banks</b>	<b>(20.2)</b>	<b>(6.4)</b>	<b>8.7</b>	<b>5.7</b>	<b>1.4</b>	<b>21.1</b>	<b>36.4</b>

## Annex-I

## Financial Soundness Indicators of Banking System

	1997	1998	1999	2000	2001	2002	2003
<b>ROE (Avg. Equity &amp; Surplus) (After Tax)</b>							
Public Sector Commercial Banks	(255.0)	24.0	(24.0)	4.9	(12.2)	11.5	17.3
Local Private Banks	10.9	7.3	8.1	(17.4)	10.3	17.3	26.2
Foreign Banks	17.2	5.1	7.1	6.1	9.1	15.2	14.9
<b>Commercial Banks</b>	<b>(36.2)</b>	<b>12.0</b>	<b>(6.2)</b>	<b>(0.3)</b>	<b>(0.3)</b>	<b>14.3</b>	<b>20.5</b>
Specialized Banks	(2.0)	(211.6)	179.1	-	-	-	-
<b>All Banks</b>	<b>(30.7)</b>	<b>(2.7)</b>	<b>(3.9)</b>	<b>(3.5)</b>	<b>(12.6)</b>	<b>3.2</b>	<b>20.5</b>
<b>NII/Gross Income</b>							
Public Sector Commercial Banks	36.1	58.6	56.5	61.8	69.9	69.5	64.1
Local Private Banks	50.2	54.9	53.4	63.2	72.1	65.5	56.8
Foreign Banks	56.1	50.1	50.0	54.0	59.4	57.5	55.3
<b>Commercial Banks</b>	<b>46.5</b>	<b>55.6</b>	<b>54.3</b>	<b>61.2</b>	<b>68.9</b>	<b>66.1</b>	<b>59.4</b>
Specialized Banks	88.5	85.1	71.7	78.6	86.7	78.0	75.8
<b>All Banks</b>	<b>48.7</b>	<b>59.3</b>	<b>55.6</b>	<b>62.3</b>	<b>70.4</b>	<b>67.1</b>	<b>60.5</b>
<b>Cost / Income Ratio</b>							
Public Sector Commercial Banks	140.0	92.1	84.7	70.1	62.3	56.9	42.8
Local Private Banks	60.9	73.8	76.6	80.9	67.3	60.0	53.2
Foreign Banks	43.6	55.5	57.0	59.4	54.5	45.4	48.3
<b>Commercial Banks</b>	<b>85.8</b>	<b>78.5</b>	<b>76.9</b>	<b>71.6</b>	<b>62.7</b>	<b>56.7</b>	<b>48.6</b>
Specialized Banks	74.6	32.2	62.2	70.5	59.0	84.7	55.6
<b>All Banks</b>	<b>85.2</b>	<b>72.7</b>	<b>75.8</b>	<b>71.6</b>	<b>62.4</b>	<b>59.1</b>	<b>49.1</b>
<b>LIQUIDITY</b>							
<b>Liquid Assets/Total Assets</b>							
Public Sector Commercial Banks	39.4	40.4	38.6	37.1	36.5	49.0	49.0
Local Private Banks	40.6	40.1	38.0	34.0	39.8	47.1	42.9
Foreign Banks	47.6	46.0	40.3	45.2	50.3	48.5	49.8
<b>Commercial Banks</b>	<b>41.4</b>	<b>41.3</b>	<b>38.7</b>	<b>37.5</b>	<b>39.9</b>	<b>48.1</b>	<b>46.0</b>
Specialized Banks	14.1	14.6	10.5	12.7	13.6	16.4	22.2
<b>All Banks</b>	<b>39.5</b>	<b>39.7</b>	<b>36.8</b>	<b>36.0</b>	<b>38.5</b>	<b>46.7</b>	<b>45.1</b>
<b>Liquid Assets/Total Deposits</b>							
Public Sector Commercial Banks	46.0	48.4	46.4	45.0	43.4	59.6	59.0
Local Private Banks	49.9	49.7	48.0	44.3	49.6	60.2	54.5
Foreign Banks	57.9	56.9	55.6	67.7	78.3	74.2	69.7
<b>Commercial Banks</b>	<b>49.4</b>	<b>50.3</b>	<b>48.2</b>	<b>48.0</b>	<b>50.3</b>	<b>61.5</b>	<b>57.9</b>
Specialized Banks	102.8	134.8	78.8	90.8	79.8	98.5	131.5
<b>All Banks</b>	<b>50.0</b>	<b>51.0</b>	<b>48.6</b>	<b>48.5</b>	<b>50.7</b>	<b>61.8</b>	<b>58.5</b>
<b>Advances/Deposits</b>							
Public Sector Commercial Banks	48.4	46.5	50.8	54.0	53.8	44.3	45.6
Local Private Banks	56.6	57.0	59.6	67.5	57.9	52.3	58.3
Foreign Banks	54.3	56.7	68.2	71.5	66.8	72.0	63.9
<b>Commercial Banks</b>	<b>51.8</b>	<b>51.2</b>	<b>55.9</b>	<b>60.5</b>	<b>56.9</b>	<b>51.0</b>	<b>53.6</b>
Specialized Banks	551.7	671.3	586.8	553.0	450.5	453.8	381.5
<b>All Banks</b>	<b>57.6</b>	<b>56.6</b>	<b>62.0</b>	<b>66.2</b>	<b>61.7</b>	<b>54.9</b>	<b>56.5</b>



## Chronology of Policy Announcements

<b>Date of Announcement</b>	<b>Circular No.</b>	<b>Policy Decision</b>
2003 1-January	(BPD-1)	<p><b><u>POLICIES FOR PROMOTION OF ISLAMIC BANKING</u></b></p> <p>In order to promote Islamic Banking in Pakistan, the State Bank decided to follow a three-pronged strategy as under:</p> <ul style="list-style-type: none"> <li>➤ Establishment of full-fledged Islamic bank(s) in the private sector;</li> <li>➤ Setting up of subsidiaries for Islamic Banking by existing commercial banks; and</li> <li>➤ Allowing stand-alone branches for Islamic banking in the existing commercial banks.</li> </ul> <p>These instructions are a further build-up on the guidelines issued on 1st December 2001, for setting up of scheduled Islamic Commercial Banks based on Shariah Principles in the Private Sector. The scheduled commercial banks were also allowed to open subsidiaries for Islamic Banking operations and a detailed criterion for setting up of Islamic Banking Subsidiaries by existing commercial banks was issued. The guidelines for opening of stand-alone branches for Islamic Banking by existing commercial banks, enlisting eligibility criteria, licensing requirements and other operational guidelines on the subject were given.</p>
2003 11-January	(BSD-1)	<p><b><u>MASTER CIRCULAR – AUDIT OF ANNUAL ACCOUNTS</u></b></p> <p>A Master Circular consolidating all instructions regarding duties of external auditors of the banks/DFIs was issued. The circular contains instances, which are required to be verified by the auditors. The Auditors are expected to also report any matter of substantial nature, which in the auditors' opinion may have the potential to prejudice materially the interest of depositors of the bank. If nothing of this nature has come to the attention of the auditors, a confirmation to that effect should be given in the report.</p>
2003 14-February	(BSD-2)	<p><b><u>GUIDELINES FOR MOBILE BANKING OPERATIONS OF MICROFINANCE BANKS/ INSTITUTIONS</u></b></p> <p>Guidelines For Mobile Banking Operations of Micro Finance Banks / Institutions were issued that included:</p> <ul style="list-style-type: none"> <li>• License to operate branch be construed to allow mobile banking operations within 50 KMs of the licensed branch. Further the mobile banking operations should be cost effective and financially viable with minimum infrastructure of 2-3 persons but not to offer savings/deposit mobilization services and not to maintain overnight record or cash. This record would only to be maintained at the licensed branch under which the service center would operate.</li> <li>• The Bank to ensure standardization while providing mobile banking services and shall prepare a Bank-wide Mobile Banking Strategy in consultation with its field staff highlighting its objectives, services to be offered, frequency of visits, insurance, security, control mechanisms, the operating cost and record keeping etc. A copy of the complete strategy shall be submitted to the SBP for information. The strategy shall be reviewed semi-annually in the light of field experiences and other developments in the</li> </ul>

		<p>sector.</p> <ul style="list-style-type: none"> <li>• While opening of deposit and loan accounts etc., due care shall be observed in identification of clients as prescribed under Prudential Regulations for MFBs/MFIs. The Branch Manager or his/her designated officer other than the officer who opened the account shall randomly make physical/field verification of at least 25 percent of the deposit/loan accounts within one month of opening of accounts.</li> <li>• All cash deposits received shall be recorded on the passbook available with the depositors and similarly the collection against loans shall be acknowledged by proper receipts. The clients shall be provided with Statement of Accounts at regular intervals (quarterly/half yearly or some other period)</li> <li>• All officers on mobile duty to return to the branch the same day by evening, and deposit the collected cash at the branch duly acknowledged by a responsible officer. All mobile banking transactions shall be reviewed by a duly authorized officer/Branch Manager and recorded in the branch ledgers etc. on the same day. The bank shall develop control mechanism, which inter-alia should ensure safekeeping of the vouchers books, voucher books issue and utilization record and safe keeping of counter folios. The scope of Internal Audit and their periodic audit plans shall comprehensively cover the mobile banking activities records. The bank shall have an appropriate policy for rotation of mobile staff. The mobile team shall maintain logbook etc. having complete record of the vehicle running along with proper authorization.</li> </ul>
2003 24-February	(BSD-3)	<p><b><u>PANEL OF AUDITORS UNDER SECTION 35 OF BANKING COMPANIES ORDINANCE, 1962</u></b></p> <p>Under Section 35 of the Banking Companies Ordinance, 1962 the following consolidated/revised instructions on the subject were issued which supersede all earlier directives issued from time to time:</p> <ol style="list-style-type: none"> <li>1. The existing panel shall remain operative as under: - <ol style="list-style-type: none"> <li>a) Auditing Firms in Category 'A' are eligible to conduct audit of all Banks/DFIs.</li> <li>b) Auditing Firms in Category 'B' are eligible to conduct audit of the Banks/DFIs having total assets (net of contra items) up to Rs.50 billion or number of branches up to 99.</li> <li>c) Auditing Firms in Category 'C' are eligible to conduct audit of the Banks/DFIs having total assets (net of contra items) below Rs.5 billion or number of branches below 10.</li> </ol> </li> <li>2. Banks/DFIs shall appoint auditors from the Panel of Auditors of the State Bank of Pakistan.</li> <li>3. The panel will be reviewed continuously to accommodate new applicant firms and to upgrade/downgrade the firms on the basis of emerging evidences.</li> <li>4. The State Bank may remove any firm from the panel in case of specified violation by the Auditors</li> </ol>
2003 25-February	(BSD-04)	<p><b><u>CIB ON-LINE.</u></b></p> <p>The State Bank of Pakistan made its Credit Information Bureau (CIB) facilities online in collaboration with the Pakistan Banks Association (PBA). Through this facility, banks/financial institutions could now seek credit worthiness reports and submit their monthly credit data to the Bureau electronically via dial up. Resultantly, the time lag in submission of data to CIB and retrieval of credit reports is minimized with efficiency in the credit appraisal processes of banks/DFIs/NBFCs.</p>

2003 12-March	(BPD-8)	<p><b><u>MINIMUM GUIDELINES FOR CONDUCTING DUE DILIGENCE OF BANKS/DFIS FOR THE PURPOSE OF MERGER/AMALGAMATION</u></b></p> <p>In the wake of consolidation and strengthening of financial sector in Pakistan, detailed guidelines were issued which should be followed uniformly to structure and discipline the process of conducting due diligence of banks/DFIs for the purpose of merger/amalgamation or local incorporation of banks. The minimum guidelines are as follows:</p> <ul style="list-style-type: none"> <li>➤ The parties/financial institution(s), one of which is a bank, interested in amalgamation/merger or local incorporation, shall request the SBP's prior clearance approval to commence the due diligence by submitting its credentials and its proposed team for conducting due diligence.</li> <li>➤ After getting the SBP's clearance, the intending group of sponsors/financial institution, shall submit an "Undertaking" to the SBP confirming that all information, particularly all non public information, and documents etc., shall be kept strictly confidential and shall not be divulged to any person/organization not included in the due diligence team as advised to the SBP. The due diligence can then commence. In case of any breach of the "Undertaking", the SBP can withdraw clearance/approval given to parties/financial institution(s).</li> <li>➤ The due diligence team shall also be bound under the aforesaid "Undertaking" to keep the information, documents etc., confidential and shall not divulge any information that they come across during the course of the due diligence. The party conducting the due diligence shall not demand, from the other party, any information given by the SBP or the SBP inspection report, either in part or full.</li> <li>➤ On completion of the due diligence, the party conducting the due diligence shall inform in writing to the State Bank that the process of due diligence has been completed.</li> </ul>
2003 18-March	(BPD-10) Circular Letter	<p><b><u>FIT AND PROPER TEST FOR APPOINTMENT OF <u>PRESIDENT/CHIEF EXECUTIVE AND BOARD MEMBERS</u></u></b></p> <p>It has been decided that the criteria of "Fit &amp; Proper Test" laid down for the appointment of Chief Executive shall henceforth be equally applicable to the Country Heads of foreign banks operating in Pakistan.</p>
2003 25-March	(BSD-05)	<p><b><u>MASTER CIRCULAR – MINIMUM CAPITAL REQUIREMENTS</u></b></p> <p>For ease of reference of banks, a master circular was issued regarding Minimum Capital Requirement (MCR) consolidating various amendments made from time to time in earlier instructions issued on 4th November 1997.</p>
2003 29-March	(BPD-10)	<p><b><u>KNOW YOUR CUSTOMER (KYC)</u></b></p> <p>In view of heightened global efforts to prevent the possible use of the banking sector for money laundering, terrorist financing, transfer of illegal/ill-gotten monies and as a conduit for white collar crime etc., the SBP issued minimum guidelines to be followed by banks while opening /dealing with the accounts of the customers. Banks are, however, free to obtain any further information/documents as they deem fit, provided the same are reasonable and applied across the board to all of their customers. These broad guidelines are as follows:</p>

		<ul style="list-style-type: none"> <li>➤ All reasonable efforts shall be made to determine true identity of every prospective customer</li> <li>➤ The Banks shall obtain “Introduction” on the new account to assess the prospective customer’s/account holder’s integrity, respectability and the nature of business etc., Any laxity in this regard may result in serious consequences for the banker.</li> <li>➤ For the purpose of prudent banking practices, the process of due diligence will remain on-going process.</li> <li>➤ The banks shall develop guidelines for customer due diligence, including a description of the types of customers that are likely to pose a higher than average risk to a bank. In preparing such policies, factors such as customers’ background, country of origin, public or high profile position, nature of business etc should be considered. Enhanced due diligence shall be applied:</li> </ul> <p>Each Bank shall formulate and keep in place, in writing, a comprehensive Know-Your-Customer policy duly approved by their Board of Directors and in case of branches of foreign banks, approved by their head office, and cascade the same down the line to each and every branch/office/ concerned officers for strict compliance.</p>
2003 5-April	(BPD-11)	<p><b><u>ASSESSING THE FITNESS AND PROPRIETY OF KEY EXECUTIVES</u></b></p> <p>To further enlarge the scope of good governance it was decided that the ambit of “Fit and Proper Test” for Presidents/Board of Directors be expanded to include appointment of key executives particularly those having the following functional responsibilities:</p> <ol style="list-style-type: none"> <li>1. Chief Financial Officer/Head of Finance/Head of Accounts,</li> <li>2. Head of Internal Audit,</li> <li>3. Country Treasurer,</li> <li>4. Head of Credit/ Risk Management,</li> <li>5. Head of Operations,</li> <li>6. Head of Compliance,</li> <li>7. Head of Human Resource</li> </ol> <p>It was also notified that no prior approval is required from the State Bank for aforementioned appointments and each bank/DFI shall itself be responsible to ensure that FPT guidelines have been followed in letter and spirit. The banks/DFIs shall report only brief information of such appointments, as and when made. Further strict punitive action will be taken in case it is found at subsequent stage that guidelines of FPT have not been followed.</p>
2003 10-April	(BSD-06) Circular Letter	<p><b><u>MINUTES OF THE BOARD OF DIRECTORS’ MEETINGS</u></b></p> <p>The banks/DFIs were required to record detailed minutes of the meetings of their Board of Directors so that the deliberations and contributions of the Board can be properly evaluated by the external auditors and the regulators.</p>
2003 3-May	(BPD-16)	<p><b><u>GUIDELINES FOR APPOINTMENT/DESIGNATION OF COMPLIANCE OFFICER</u></b></p> <p>In order to keep the activities of banks in compliance with the relevant laws and regulations, especially with regard to Know Your Customer (KYC), and other</p>

		<p>Anti Money Laundering Law rules/regulations, it was deemed necessary that banks may appoint/designate a “Compliance Officer” (CO) to ensure compliance relating to (a) the State Bank Prudential Regulations, (b) relevant provisions of existing laws and regulations, (c) guidelines for KYC, (d) anti money laundering laws and regulations, (e) timely submission of accurate data/returns to regulator and other agencies and (f) monitor and report suspicious transactions to President/CEO of the Bank/DFI and other related agencies. The CO will (i) serve as a contact point between President/CEO and senior management, with regard to functioning of the compliance program, (ii) provide assistance in this area to branches and other departments of the bank, and (iii) act as liaison with the SBP concerning the issues related to compliance.</p>
2003 11-June	(BPD-17) Circular Letter	<p><b><u>VERIFICATION OF ANTECEDENTS OF PERSONS SEEKING EMPLOYMENT IN BANKS/DFIs</u></b></p> <p>The SBP observed that some of the banks/DFIs have failed to exercise due care while hiring such personnel and further that instead of terminating the services of persons involved in fraud, forgeries, disciplinary action etc prefer to accept their resignation and so such type of unwanted persons were able to join other financial institutions. In order to avoid such instances the banks/DFIs were advised to re-enforce their existing procedure of verification of antecedents of persons seeking employment within a period of 30 days. The banks/DFIs will provide the SBP with information of such instances separately for the last ten years (i.e. from 01-01-1993 to 31-05-2003). The banks/DFIs shall, thereafter, continue reporting of said information within 7 days from the date of accepting of forced resignation or termination of services of such employee.</p>
2003 13-June	(BPD-18) Circular Letter	<p><b><u>CREDIT POLICY- HOUSING FINANCE</u></b></p> <p>To further facilitate banks in developing and marketing their housing finance products, revised instructions were issued as under:</p> <ul style="list-style-type: none"> <li>➤ Commercial banks to ensure that their total exposure to housing finance would at no time exceed 10 percent of their net advances.</li> <li>➤ The housing finance facility to attract minimum debt equity of 80:20</li> <li>➤ Banks were made free to extend mortgage loans for housing up to a maximum period of 20 years. The commercial banks to ensure matching of asset-liability and encouraged to float long-term housing bonds of not less than 10 years maturity.</li> <li>➤ The maximum per party limit to be Rs7.5 million.</li> <li>➤ While extending financing facilities to their customers, banks would evaluate the cash flow and payment capacity of the borrower in addition to banks’ usual evaluations of each proposal concerning credit worthiness of the borrowers as also the fact that the banks’ portfolio under housing finance fulfils the prudential norms and instructions issued by the SBP.</li> </ul> <p>Banks were encouraged to develop floating rate products for extending housing loans, thereby managing interest rate risk to avoid its adverse effects. SBP encourage banks to develop in-house system to stress test their housing portfolio against adverse movements in interest rates as also maturity mismatches.</p>
2003 25-June	(BPD-19)	<p><b><u>PRINTING OF CHEQUES - TECHNICAL SPECIFICATION</u></b></p> <p>In order to protect the interest of the depositors and public at large and to avoid printing of spurious cheques by unauthorized printers on sub-standard paper, it was decided that the banks should follow the specified minimum criteria for printing of cheques. During its normal course of inspection of the banks, the SBP shall check the compliance of specifications &amp; report of the laboratory tests, where applicable. The SBP shall also, on sample basis, carry out</p>

		occasional laboratory tests for the cheques books & security stationery to ensure that the same are in conformity with international standards.
2003 25-June	(BPD-20)	<p><b><u>PAYMENT OF RETURNS TO INVESTORS AND DEPOSITORS- ENFORCEMENT OF ISLAMIC PRINCIPLES</u></b></p> <p>It has been decided that, the Banks/DFIs shall determine on their own the returns payable to investors and other depositors of funds with them. The banks/DFIs are reminded to ensure that returns are paid strictly in accordance with the principles of Shariah and after they have fully met and provided for all the actual and accrued expenses of the related period. The banks/DFIs shall ensure that returns on investment /deposits are declared and paid within 20 days of closing of the half year to which they relate.</p>
2003 30-June	(BPD-22)	<p><b><u>PROVISION OF INFORMATION REGARDING PROFIT/ RETURN TO CBR.</u></b></p> <p>It has been decided that all banks/DFIs are required to report the profit/return paid to their clients to CBR. The SBP directed all banks/DFIs to provide information to CBR on biannual basis, in respect of those accounts where bank/DFI pays any profit/return in excess of Rs 10,000 per annum in an account or on deposit maintained with the bank/DFI. Officials of CBR will however not ask for any further information from banks/DFIs, directly or indirectly.</p>
2003 4-July	(BPD-23)	<p><b><u>REVIEW OF THE INSTRUCTIONS ON SERVICE CHARGES ON PLS DEPOSIT ACCOUNT</u></b></p> <p>In view of the representation received from banks, the instructions contained in PR-XIII have been reviewed. Accordingly, all terms and conditions of operation of an account shall be made known to the person opening the account at the time of opening. Further, the accounts maintained by (i) Students (ii) Mustahiqeen of Zakat (iii) employees of Government/Semi-Government institutions for salary and pension purposes shall be exempted from levy of service charges in any manner whatsoever. Non-compliance of instructions will attract penal provisions of Banking Companies Ordinance.</p>
2003 4-July	(BPD-24)	<p><b><u>CONSTITUTION OF The SBP COMMITTEE FOR RESOLUTION OF DISPUTES BETWEEN BORROWERS AND BANKS</u></b></p> <p>Complaints have been received from borrowers of different banks wherein it has been pointed out that banks are compounding mark up, in violation of guidelines issued by the SBP for elimination of 'riba' from the Banking System. In order to resolve such issues promptly, the SBP, has decided to constitute a "Resolution Committee" (RC) under the chairmanship of Director, Banking Policy Department, and comprising members from Banking Inspection Department of SBP. This will include a person who will be a Chartered Accountant – (Permanent Member), a representative of the concerned bank–(Revolving Member), a Chartered Accountant from the Chartered Accountancy firm listed on the panel of the SBP to represent the borrower–(Revolving Member) and Joint Director Complaints Cell, SBP Member/Secretary. The Committee will examine the complaints falling in its purview and shall decide the issues in terms of guidelines issued by the SBP from time to time.</p>
2003 4-July	(BPD-25)	<p><b><u>RELAXATION IN PRUDENTIAL REGULATIONS FOR INFRASTRUCTURE PROJECT FINANCING (IPF)</u></b></p>

		<p>To encourage private sector investment in infrastructure sector, which are capital intensive and require heavy capital outlay, the prescribed maximum debt equity is being relaxed to 80:20 for the following infrastructure projects:</p> <ol style="list-style-type: none"> <li>A road, including toll road, a bridge, mass transit or a rail system;</li> <li>Telecommunication services, whether basic or cellular;</li> <li>Generation and distribution of power;</li> <li>Transmission or distribution of power by laying a network of new transmission or distribution lines;</li> <li>A natural gas exploration and distribution project, LPG extraction project;</li> <li>A water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system;</li> <li>Dams and canals;</li> <li>Port, shipping, container terminals, airport, aviation project, inland waterway or inland port;</li> <li>A refinery project;</li> <li>A pipeline project;</li> <li>Any other infrastructure facility of similar nature.</li> </ol> <p>Further “Concession Agreement/License/Right of Way” issued by Government may be accepted as a collateral for infrastructure project financing, in the overall collateral arrangements worked out with the creditors, subject to the following stipulations:</p> <ol style="list-style-type: none"> <li>The Right of Way is free of encumbrances;</li> <li>Utilities are shifted appropriately from the area;</li> <li>The Concession Agreement/License/Right of Way is assignable to lenders in the event of default;</li> <li>Commercial banks/DFIs, are satisfied regarding the secure nature of Concession Agreement/License/Right of Way, the expected source of repayment and the overall collateral arrangements.</li> </ol>
2003 5-July	(EDMD-8)	<p><b><u>RULES GOVERNING PRIMARY DEALER SYSTEM</u></b></p> <p>In order to make the Primary Dealer system more broad based and meaningful new Rules has been issued in suppression of earlier Rules The new rules envisages in detail the selection criteria, rules binding the status of a Primary Dealer, obligations and privileges of the Primary Dealers and other related details.</p>
2003 15-August	(BSD-07)	<p><b><u>GUIDELINES ON RISK MANAGEMENT</u></b></p> <p>The SBP has issued guidelines containing a brief introduction to risk management and a detailed elaboration of major risks that financial institutions may be exposed to. Risk Management encompasses risk identification, assessment, measurement, monitoring and mitigating/controlling all risks inherent in the business of banking. The basic principles relating to risk management that are applicable to every financial institution, irrespective of its size and complexity include:</p> <ul style="list-style-type: none"> <li>➤ The overall responsibility of risk management vests in the Board of Directors, which shall formulate policies in various areas of operations of the bank. The senior management is, inter-alia, responsible for devising risk management strategy and well-defined policies and procedures for mitigating/controlling risks, which should be duly approved by the Board. The senior management is also responsible for the dissemination, implementation, and compliance of approved policies and procedures.</li> <li>➤ At operational level, risk assessment may be made on portfolio or business line basis, however, at the top level the management need to adopt a holistic approach in assessing and managing risk profile of the</li> </ul>

		<p>bank.</p> <ul style="list-style-type: none"> <li>➤ Irrespective of a separate risk review or management function, individuals heading various business lines or units are also accountable for the risk they are taking.</li> <li>➤ Wherever possible risks should be quantitatively measured, reported, and mitigated.</li> <li>➤ The risk review function should be independent of those who approve and take risk.</li> <li>➤ Banks should have contingency plans for any unexpected or worst case scenarios.</li> <li>➤ The major risks to which the financial institutions can be exposed to include credit, market, liquidity, and operational risks.</li> </ul> <p>Banks were encouraged to put in place an effective risk management strategy based on these guidelines that will also facilitate the banks in their preparation for the implementation of New Basel Capital Accord. Once the New Basel Accord is introduced in Pakistan, these guidelines will converge with the requirement of the Accord and will become enforceable regulation.</p>
2003 23-August	(BPD-28)	<p><b><u>GUIDELINES ON COMMERCIAL PAPER</u></b></p> <p>In order to facilitate the development and growth of Commercial Paper (CP) in Pakistan and to encourage active participation of banks/DFIs in this area, the SBP formulated certain guidelines, which were framed in consultation with all stakeholders to facilitate the development of CPs' primary and secondary markets in Pakistan. They were:</p> <p><b><u>GENERAL GUIDELINES:</u></b></p> <p>Banks/DFIs shall not deal in any manner and in any capacity in commercial papers (CPs) of denomination below Rs 1 million while it was encouraged that the CP should be in a script less form but there was no bar placed on dealing with CP in script form as well. All the endorsements made by the banks/DFIs to the subsequent purchasers of their holding of CPs shall be strictly on “without recourse basis”. While underwriting the issue, banks/DFIs shall ensure that their total exposure including underwriting does not exceed their per party exposure limits prescribed in these guidelines and under Prudential Regulations. It was also decided that underwriting commitment was assigned a weight of 50 percent for the purpose of calculating per party exposure limit. Banks/DFIs were asked not to provide any fund based or non-fund based facility against the security of Commercial Paper.</p> <p><b><u>ISSUING AND PAYING AGENT (IPA):</u></b></p> <p>Banks &amp; DFIs were eligible to perform the role of IPA, provided that:</p> <ul style="list-style-type: none"> <li>(i). They meet the minimum capital requirement of the SBP and have a minimum credit rating of A- (medium to long term) and A2 (short term) from the credit rating agencies approved by the SBP or from Standard &amp; Poor, Moody's or Fitch.</li> <li>(ii). They ensure that all the regulatory requirements as prescribed by SECP and the SBP are duly met by the issuer before the issue can be taken up by the prospective investors/dealers.</li> <li>(iii). They have in place written internal guidelines (operational procedures) duly approved by their Board of Directors for dealing with commercial papers in the capacity of IPA.</li> <li>(iv). They open a separate escrow account for receiving and disbursing funds on account of CP.</li> <li>(v). They make it clear to the investors in the offering document that their investment is subject to credit and other risks inherent in such</li> </ul>



		<p>instruments and payment will be made to them only if the issuer has made the funds available to IPA.</p> <p>(vi). They inform the prospective investors that in case of default, the IPA will not be in a position to seek recovery from the issuer or initiate any action against the issuer either on its own or on behalf of the investors.</p> <p>(vii). In case of default by the issuer, it will be the responsibility of the bank/DFI acting as IPA to notify promptly such default to the investors. For the purpose of these guidelines, payment of only partial amount shall also be considered default.</p> <p>(viii). In case of partial payment by the issuer, bank/DFI acting as IPA shall distribute the received funds as per terms of the underlying agreements.</p> <p><b><u>CUSTODIAN:</u></b></p> <p>At the discretion of the issuer and IPA, investors may be required to invariably inform the custodian about the sale/purchase to make the transfer effective. If a bank / DFI desires to perform the role of custodian, it should comply with the following guidelines:</p> <p>(i) The bank / DFI desirous of performing the role of custodian would develop operational procedures (manual) for this purpose.</p> <p>(ii) The bank / DFI shall take necessary steps and all reasonable measures to protect them from the risk of frauds and forgeries and consequent obligations arising thereto.</p> <p><b><u>INVESTORS:</u></b></p> <p>The banks/DFIs shall invest in only those CPs:</p> <p>a) Which have been issued in pursuance of SECP's guidelines for the issue of Commercial Paper and meet all the requirements laid down by the State Bank of Pakistan.</p> <p>b) Where the equity of the issuer is not less than Rs. 100 million.</p> <p>c) Where the current and debt-equity ratios of the issuer do not fall below 1:1 and 60:40. For this purpose, the numbers of the last audited accounts of the issuer will be applicable.</p> <p>d) Where the issuer does not have any overdue or default as evidenced by a report received from Credit Information Bureau of the State Bank of Pakistan. The CIB report obtained by the bank/DFI for this purpose should not be more than two months old.</p> <p>e) Where the current credit rating of the issuer, rated by a credit rating agency approved by the State Bank of Pakistan, should not be below "A-" (long term) and "A2" (short term).</p> <p>f) Where the IPA is either a scheduled commercial bank, DFI or an investment bank with a minimum credit rating of A- (long term) and A2 (short term) from a credit rating agency approved by the State Bank of Pakistan.</p> <p>g) Where the total borrowings of the issuer by way of CPs do not exceed its equity (paid up capital and reserves).</p> <p>The banks/DFIs investing in CP shall ensure that their total exposure, including investment in commercial papers, at all time remains within the per party exposure limit prescribed under Prudential Regulations and the investment in CPs of an issuer shall not exceed 10 percent of the equity (paid-up capital and reserves) of the bank/DFI and 25 percent of the size of the issue. In case a bank/DFI intends to take up the whole issue or invest more than the limit of 25 percent, at the time of issue of CP, for subsequent sell down in the market, it shall be required to dispose off the CPs in excess of above limit in the following manner:</p> <p>a) Within 20 days where tenure of CP is 90 days or more</p> <p>b) Within 15 days where tenure of CP is 60 days or more but less than 90</p>
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2003 15-August	(FE-15)	<p><b><u>AMENDMENTS IN FOREIGN EXCHANGE MANUAL -IMPORT/ EXPORTS</u></b></p> <p>With a view to further liberalize the foreign exchange regime, certain amendments /additions have been made in the Foreign Exchange Manual (Eighth Edition-2002) after incorporation of the facilities extended to importers and exporters under Trade Policy 2003-04. The same are appended below:</p> <ol style="list-style-type: none"> <li>1. The Incoterms 2000 introduced by ICC have been adopted.</li> <li>2. The limit for retention of export proceeds in Special Foreign Currency Accounts has been enhanced by 10 percent.</li> <li>3. The limit on imports, without opening letters of credit, by actual/end users (USD 5,000) has been abolished.</li> <li>4. The limit on imports, without opening letters of credit, by industrial users (USD 30,000) has been abolished.</li> </ol>

2003 22-October	(BPD-34)	<p><b>ASSET MANAGEMENT AND FINANCIAL &amp; INVESTMENT ADVISORY SERVICES</b></p> <p>It has been decided to withdraw the Prudential Regulation concerning Asset Management and Financial &amp; Investment Advisory Services and to allow commercial banks to establish subsidiaries for the purpose of Asset Management and Financial &amp; Investment Advisory. However, commercial banks desirous of establishing a subsidiary for any activity mentioned in the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003 shall strictly observe the following guidelines:</p> <ol style="list-style-type: none"> <li>Banks desiring to set-up any NBFC under the NBFC Rules will do so through a separate subsidiary after obtaining prior approval from the State Bank of Pakistan.</li> <li>The subsidiary to be set-up for the purpose shall be a public limited company.</li> <li>The transactions undertaken / services provided by the subsidiary set-up under the NBFC Rules should not create any financial obligation, whether contingent or otherwise, on the balance sheet of the holding company or otherwise.</li> </ol>
2003 24-October	(BSD-13) Circular Letter	<p><b><u>MINIMUM CAPITAL REQUIREMENT (MCR)</u></b></p> <p>It has been decided that the banks, instead of submitting half yearly MCR statements shall submit these statements on a quarterly basis. These four quarterly MCR statements may be un-audited and will have to be submitted on the prescribed format within one month of the close of respective quarter throughout the year. In addition to this, the banks will also submit their Annual MCR statement, duly certified by their external auditors, not later than three months to the close of the year.</p>
2003 12-November	(BSD-09)	<p><b><u>REPORTING OF LOANS / ADVANCES, ACCRUED MARK-UP AND NON-PERFORMING LOANS (NPLs)</u></b></p> <p>It was observed that Banks/DFIs were currently using different approaches for recording their loans/advances, accrued mark-up and non-performing loans (NPLs) in their books of accounts. In order to bring uniformity and consistency in the accounting/reporting pattern of banks/DFIs and also to adopt best international practices in this area, it has been decided that banks/DFIs shall observe the following guidelines for recording/ reporting of loans / advances, accrued mark-up and NPLs in their books of accounts and various returns.</p> <ol style="list-style-type: none"> <li>Accrued mark-up should only be shown under the head of "Other Assets" and not made part of loans / advances. Moreover, no mark-up should be capitalized except in cases covered under BID Circular Letter No. BID(Gen)2470/601-04-90 dated 17th June 1990. Further, as non-performing loans (NPLs) are sub-set of loans / advances, so no unrealized mark-up should be included in NPLs.</li> <li>Once a loan / advance is classified as NPL under the Prudential Regulations, it should be placed on non-accrual status and the unrealized mark-up already taken to income account should be reversed and kept in a memorandum account. The subsequent mark-up should also be kept in the memorandum account. The total amount of mark-up kept in memorandum account should be reported to the SBP.</li> </ol>

		<p>iii) A non-performing loan / advance should only be up-graded to regular status when bank receives payment of the loan's overdue principal and mark-up and remaining payments are expected as scheduled in the loan agreement. However, the funds for repayment of overdue amounts should not be obtained through creation of a new loan/advance from the same bank.</p>
2003 17-November	(BSD-10)	<p><b><u>CREDIT RATING OF MICRO FINANCE BANKS</u></b></p> <p>The SBP has decided to make it mandatory for Micro finance Banks to get themselves rated. A new Prudential Regulation, the PR 29, for Micro Finance Banks regarding credit rating of MFBs has been issued.</p>
2003 30-December	(BSD-12)	<p><b><u>QUARTERLY REPORT OF CONDITIONS</u></b></p> <p>In its efforts to streamline the data reporting to the SBP through consolidation of returns and also to adopt the international best practices in this regard, the SBP has decided to revise the format of the Quarterly Report of Condition. The Quarterly Statement on Minimum Capital Requirement (MCR) has been merged with the Quarterly Report of Condition as Part-C. The Annual MCR Statement, duly certified by the external auditors will, however, continue to be submitted by the banks within three months of the close of their accounting year. The DFIs, however, are not required to submit information on MCR (Part-C and Annual MCR Statement). The banks and DFIs shall report the information on their exposure to connected parties like subsidiaries, controlled firms, managed modarabas and other related parties to the SBP in the revised Quarterly Report of Condition.</p>
2004 7-January	(BSD-01)	<p><b><u>MASTER CIRCULAR ON FINANCIAL DISCLOSURE – FREQUENCY &amp; TIMELINES</u></b></p> <p>In order to facilitate banks/DFIs to ensure compliance of statutory/regulatory requirements regarding financial disclosure, it has been decided to issue this Master Circular containing consolidated instructions on financial disclosure. All banks/DFIs, listed or non-listed – including branches of foreign banks and those which have peculiar shareholding structure, are advised to follow the instructions as given below:</p> <p>At the end of each accounting year, all banks are required to prepare their annual financial statements in the prescribed manner, as on the last working day of that year. These financial statements together with the auditor's report, as passed in the Annual General Meeting, shall be published and circulated as well as furnished, as returns, to the SBP as prescribed in the BCO,1962.</p> <p>Further, all DFIs are also required to prepare their annual financial statements at the end of each accounting year as on the last working day of that year. These financial statements together with the auditor's report, as passed in the Annual General Meeting, shall be circulated to the shareholders and furnished as returns to the SBP within three months of the close of the period to which they relate. Furthermore, an abridged version of the financial statements shall also be published in the newspaper(s) within the stipulated time.</p> <p>For 1st and 3rd quarter, quarterly un-audited financial statements, along with directors' review, shall be prepared by all banks / DFIs, including the branches of foreign banks, within 45 days of the close of the quarter to which they relate. Half yearly (2nd quarter) financial statements, with limited scope review by the statutory auditors, shall be prepared by all banks / DFIs, including the branches of foreign banks, within two months of the close of the half-year (2nd quarter). These financial statements shall be circulated by domestic banks / DFIs to their shareholders. Furthermore, an abridged version of the financial statements shall</p>

		<p>be published in the newspaper(s) by all banks / DFIs, including branches of foreign banks, within the aforesaid time.</p> <p>Besides above, other requirements of Code of Corporate Governance regarding financial disclosure shall remain applicable, provided they are not inconsistent with the SBP's instructions.</p>
2004 14-January	(BSD-2)	<p><b><u>STRENGTHENING OF INTERACTION BETWEEN THE SBP AND BANKS / DFIS</u></b></p> <p>The banking sector is witnessing a change from a fully controlled and compliance-based supervisory regime to a market based one. As a result, the concept of risk-based banking supervision is gaining importance and needs to be strengthened.</p> <p>It will now be mandatory for all banks/DFIs to inform the State Bank promptly about any substantive changes in their activities or any material adverse development, including breach of legal and prudential requirements. Such information should be submitted to the relevant department in a concise manner, as and when any such developments take place. During the course of regular inspections, Banking Inspection Department shall check, on a test basis, whether the banks / DFIs have followed these instructions. Additionally, the State Bank of Pakistan will also enhance direct interaction with the Board of Directors and Senior Management, as well as the External Auditors, of the banks / DFIs. Accordingly, it will hold regular high-level meetings with them; at least once during each calendar year, with banks / DFIs having satisfactory rating but more frequently with banks / DFIs having unsatisfactory ratings. Such meetings will help the banks/ DFIs share with the regulators the different challenges facing their respective organizations and discuss matters like group structure, strategy, market positioning, corporate governance, risk management, performance, capital adequacy, liquidity, asset quality, etc. The schedule, agenda and level of participation of such meetings will be communicated in advance to each bank / DFI. The meeting would be held in a structured manner focusing on the agenda items. Banks / DFIs are expected to ensure participation of all those invited by the State Bank for these meetings.</p>
2004 21-January	(BPD-01)	<p><b><u>BENCHMARKING CORPORATE LENDING PRODUCTS TO KIBOR</u></b></p> <p>In order to bring consistency in the lending rates of corporate and commercial operations of banks, a benchmark of KIBOR has been provided, which is the average task rate in the inter bank market. From 1<sup>st</sup> January all the commercial banks are required to link their lending rates with one, three, six month &amp; any other longer period tenors, if available. The rate over &amp; above KIBOR will be decided with mutual consent between borrower &amp; bank. All the floating &amp; fixed rate time loans/TFCs/Commercial Papers with reset dates, overdrafts &amp; running finances obtained after 31-01-2004 are required to be benchmarked against KIBOR. Financing under export refinance scheme of the SBP, consumer &amp; SME financing, overdrafts, running finances, term loans, TFCs, CPs approved by SECP &amp;/ or submitted to any stock exchange before 31-01-2004 are exempted from application of KIBOR.</p>
2004 29- January	(BPD-2)	<p><b><u>SECTION 33-A OF BCO-1965 FIDELITY &amp; SECRECY</u></b></p> <p>In order to create uniformity in obtaining declaration under Section 33-A of BCO, 1965, it has been decided that President and Chairman &amp; members of the Board of all banks/DFIs will sign a declaration before assuming office. In case of foreign banks, which are represented in Pakistan by their branch offices only, the declaration will be signed by the Country Managers. The declaration is</p>

		required to be kept in safe custody with the banks/DFIs.
2004 10-February	(BPD-5)	<p><b><u>UNDERTAKING OF BROKERAGE BUSINESS BY BANKS/DFIs</u></b></p> <p>The SBP issued regulations to banks/DFIs to conduct brokerage business through their separately setup subsidiaries for this activity. It, however, needs to be ensured that the relationship between the bank/DFI and its brokerage subsidiary is at an arms length basis and foolproof firewalls have been built to avoid conflict of interest and to restrict the banks/ DFIs' responsibilities and liabilities vis-à-vis their brokerage subsidiaries</p>
2004 12-February	(FE-01)	<p><b><u>FRANCHISE ARRANGEMENTS OF THE EXCHANGE COMPANIES</u></b></p> <p>In order to facilitate the Exchange Companies, the following Franchise Arrangement has been decided to be allowed.</p> <ol style="list-style-type: none"> <li>i) Franchiser and Franchisee would enter into a formal agreement, which should be duly registered as per existing laws of the land.</li> <li>ii) Franchisee may be an existing company or partnership/firm or sole proprietorship carrying out only Money Changing business or a new company or partnership/firm or sole proprietorship specifically formed to carryout Money Changing business.</li> <li>iii) Franchisee by virtue of the Agreement, in consideration of the same, would pay the Franchiser an agreed amount as Franchise Deposit. This Franchise Deposit would be maintained by the Franchiser in his books during the currency of the Agreement.</li> <li>iv) Franchise Deposit would be treated as "Second Tier Capital" in the books of the Franchiser. For the purpose of calculation of 25 percent SLR requirement and 50 percent of the Exposure Limit, this "Second Tier Capital" would be added to the paid up capital of the Franchiser. It may, however, be noted that at any point of time, combined Exposure of Franchiser and Franchisee should not exceed 50 percent of the sum of paid up capital and Second Tier Capital (Franchise Deposit) of the Exchange Company.</li> <li>v) Franchiser and Franchisee will have to make arrangement for a completely integrated/compatible computerized system so that Exchange Company may provide a consolidated reporting of exchange business transactions carried out by Franchiser &amp; Franchisee as per requirement of the SBP.</li> <li>vi) All the Rules &amp; Regulations specified by the State Bank for the Franchiser shall be equally applicable to the franchisee in addition to the clauses of the Franchise Agreement.</li> <li>vii) Franchiser would be fully responsible for the activities of the Franchisee and shall also have the right to inspect/visit franchisee's operations as per their agreement.</li> <li>viii) The State Bank reserves the right to inspect Franchisee's books of accounts and premises as and when it may deem fit and necessary.</li> <li>ix) In case of any violations of related rules, the SBP shall hold the Franchiser directly responsible for the same, reserving, however, the right to take such direct action against Franchisee as it may deem fit.</li> </ol>

2004 24-February	(FE-02)	<p><b>LOCAL US DOLLAR INSTRUMENTS COLLECTION AND SETTLEMENT SYSTEM</b></p> <p>With the liberalization of the foreign currency regime in the country, and to facilitate operations for maintaining Foreign Currency Accounts under FE-25, the State Bank of Pakistan has introduced “Local US Dollar Instruments Collection and Settlement System” in Pakistan with effect from March 11, 2004. Presently, the clearing process has to be routed through New York, which takes a long time in settlement, and the cost of the above process is also quite high for the account holders. The key objectives of this new system are quick settlement locally, cost effectiveness and facilitation of the market.</p>
2004 8-March	(BPD-08)	<p><b>ESTABLISHMENT OF SUBSIDIARIES BY BANKS/DFIs</b></p> <p>In order to maintain appropriate regulatory oversight and to facilitate the Banks/DFIs in establishing subsidiaries for the purpose of diversification of their activities, the following instructions have been issued:</p> <ul style="list-style-type: none"> <li>➤ The Banks/DFIs desiring to establish any subsidiary shall obtain prior approval of the State Bank of Pakistan.</li> <li>➤ The subsidiary shall be a public limited company.</li> <li>➤ The Board of Directors of the subsidiary should be completely independent and different from the Board of Directors of the Bank/DFI. The Bank/DFI may nominate its employees on the Board of Directors of the subsidiary up to 25 percent of the total directors, and the remaining directors nominated by the Bank/DFI should be independent individuals.</li> <li>➤ The Bank/DFI will fulfill all the other legal and regulatory requirements needed for the establishment of proposed subsidiary. In case of banks, it should be ensured that the subsidiaries are established only for activities as are admissible under Section 23 of the Banking Companies Ordinance, 1962.</li> <li>➤ Before increasing its investment in the equity of the subsidiary, the Bank/DFI will seek prior approval of the State Bank of Pakistan.</li> <li>➤ Per party exposure limit proposed by regulation R-1 of Prudential Regulations for Corporate/Commercial Banking will be applicable on exposure to the subsidiary and any type of placement in the form of deposit, purchase of COI, certificates, units, etc. shall be considered part of the exposure of the Bank/DFI. Further, the exposure of the Bank/DFI on mutual funds launched/administered by the subsidiary shall also be considered exposure on the subsidiary.</li> </ul> <p>The Banks/DFIs shall take sufficient measures to ensure that the Bank/ DFI is not exposed to risks, especially reputation and legal risks, on account of its subsidiary. The Non-Bank Finance Companies set-up as subsidiaries will be regulated by the SECP.</p>
2004 24-April	(BPD-10)	<p><b><u>COLLATED INSTRUCTION ON MARGIN RESTRICTIONS</u></b></p> <p>The SBP has withdrawn instructions on the margin requirements Banks have now been free to fix/determine the margin requirements on facilities provided by them to their clients for Corporate, SME and Consumer Financing products, taking into account the risk profile of the borrower(s). However banks are advised to follow: -</p> <ul style="list-style-type: none"> <li>(i) Margin restrictions on shares/TFCs as per existing instructions</li> <li>(ii) Existing cash margin requirement of 100 percent on Caustic Soda (PCT heading 2815.1200) for opening Import Letter of Credit as advised by Federal Government and notified earlier shall continue</li> </ul>

		<p>to remain applicable until further instructions.</p> <p>It is also added that the relaxation shall not be applicable in case of items, import of which are banned by the Government. Banks are advised not to open import letter of credit for these items in any case till such time the lifting of ban on any such item is notified by the State Bank. The SBP shall continue to exercise its powers for fixation/reinstatement of margin requirements on financing facilities being provided by banks for various purposes including Import Letter of Credit on a particular item(s), as and when required.</p>
2004 26-April	(BPD-12) Circular Letter	<p><b><u>SETTLEMENT OF WILFUL DEFAULTER CASES REFERRED TO NAB UNDER SECTION 31-D OF NAB ORDINANCE</u></b></p> <p>It was observed that some of the financial institutions after forwarding the cases of their willful defaulters to NAB under Section 31-D through the SBP, enter into agreements with the borrowers for settlement of outstanding liabilities without obtaining prior consent of the NAB. This practice on the part of financial institutions renders the whole exercise futile. It has advised that financial institutions should not enter into any agreement with the borrowers in the cases which have already been referred to NAB by the Governor SBP under Section 31-D of NAB Ordinance without obtaining prior written permission/clearance from the NAB. With regard to cases, which have been forwarded to the SBP and are still in the process of referring the same to NAB, the financial institutions should first withdraw their request/cases from the SBP before entering into settlement agreements with borrowers.</p>
2004 17-May	(BSD-03)	<p><b><u>GUIDELINES ON COUNTRY RISK</u></b></p> <p>The SBP has issued guidelines for Country Risk Management for Banks/DFIs, having cross border exposures both on and off balance sheets. All banks/DFIs are required to put in place their respective Country Risk Management policies and procedures duly approved by their BOD within three months. The SBP inspectors, during the course of their regular inspection of the banks/DFIs, will check the policies and procedures on Country Risk Management of the concerned bank/DFI.</p>



## Glossary

**Capital adequacy ratio:** The amount of risk-based capital (Tier I and II) as a percent of risk-weighted assets.

**Capital gearing:** The ratio between long-term borrowing and shareholders' funds.

**CIRC:** A Corporation working under the Corporate and Industrial Restructuring Ordinance 2000 for acquisition, restructuring, rehabilitation, management, disposition and realization of non-performing loans and other assets of various banks and financial institutions.

**Consumer Financing** means any financing allowed to individuals for meeting their personal, family or household needs. The facilities categorized as Consumer Financing are given as under:

- (i) **Credit Cards** mean cards which allow a customer to make payments on credit. Supplementary credit cards shall be considered part of the principal borrower for the purposes of these regulations. Corporate Cards will not fall under this category and shall be regulated by Prudential Regulations for Corporate / Commercial Banking or Prudential Regulations for SMEs Financing as the case may be. The regulations for credit cards shall also be applicable on charge cards, debit cards, stored value cards and BTF (Balance Transfer Facility).
- (ii) **Auto Loans** mean the loans to purchase the vehicle for personal use.
- (iii) **Housing Finance** means loan provided to individuals for the purchase of residential house / apartment / land. The loans availed for the purpose of making improvements in house / apartment / land shall also fall under this category.
- (iv) **Personal Loans** mean the loans to individuals for the payment of goods, services and expenses and include Running Finance / Revolving Credit to individuals.

**Corporate:** Corporate means and includes public limited companies and such entities, which do not come under the definition of SME.

**Corporate Governance:** A system of checks and balances designed to protect the interest of an entity's owners and other stakeholders. The three essential ingredients of Corporate

Governance are (1) Checks and balances, (2) Clear division of responsibilities, and (3) Disclosure and transparency.

**Credit risk:** The credit risk arises from the potential that a borrower or counter-party will fail to perform an obligation or repay a loan.

**Debt-Equity ratio:** The long-term debt divided by shareholders equity plus long-term debt; the amount of long-term debt per rupee of equity.

**Derivatives:** The instruments that are based on or derived from the value of an underlying asset, reference rate or index. For example, interest rate futures are based on various types of securities trading in the cash market.

**Discount rate:** It is the rate at which the SBP provides three-day repo facility to the banks, acting as the lender of last resort.

**Duration (Macauley Duration):** A time weighted present value measure of the cash flow of a loan or security that takes into account the amount and timing of all promised interest and principal payments associated with that loan or security. It shows how the price of a bond is likely to react to different interest rates environments. A bond's price is a function of its coupon, maturity and yield.

**Foreign exchange risk:** The risk associated with exposure to fluctuation in spot exchange rates.

**Forward points:** A phrase used to describe a value in points, to be added or subtracted from the spot price of a currency for those transactions where settlement date is beyond two business days from today.

**GAP:** Term commonly used to describe the rupee volume of the interest-rate sensitive assets versus interest-rate sensitive liabilities mismatch for a specific time frame; often expressed as a percentage of total assets.

**Gross income:** Net interest income (before provisions) plus non-interest income; the income available to cover the operating expenses.

**Incidence of NPLs:** Impact of non-performing loans on the earnings of a bank; spread between effective return (interest income on loans minus provision & direct write off expenses divided by gross loans) and actual return (interest income divided by performing loans) on loans.

**Inter-bank rates:** The two way quotes, namely bid and offer rates, quoted in the inter bank market are called as inter bank rates.

**Interest rate risk:** It is the exposure of an institution's financial condition to adverse movement in interest rates, whether domestic or worldwide. The primary source of interest rate risk is difference in timing of the re-pricing of bank's assets, liabilities and off-balance sheet instruments.

**Interest rate spread:** The ratio obtained by subtracting the cost of factor for interest bearing liabilities from the percentage yields on earning assets. Because interest-bearing liabilities are not normally equal to total earning assets, the spread is usually different from the net interest margin.

**Intermediation cost:** Administrative expenses divided by the average deposits and borrowings.

**Liquid assets:** The assets that are easily and cheaply turned into cash – notably cash and short term securities. It includes cash and balances with banks, call money lending, lending under repo and investment in government securities.

**Liquidity risk:** It is the risk that the bank will be unable to accommodate decreases in liabilities or to fund increases in assets. The liquidity represents the bank's ability to efficiently and economically accommodate decreases in deposits and to fund increases in loan demand without negatively affecting its earnings.

**Liquidity spread:** Liquidity spreads are apparent in the secondary market and are based on the tradability of any security. Off-the-run securities are routinely traded at spreads over and above the comparable on the run treasuries. The spread between the on-the-run and off-the-run securities is called liquidity spread.

**M2:** It is a measure of money supply next to M1 and is slightly broader than M1. It includes M1 plus (1) savings and small denomination time deposits at all depository institutions, (2) overnight repo agreements at commercial banks, and (3) balances of the money market mutual funds.

**Market risk:** The risk that changes in the market rates and prices will impair an obligor's ability to perform under the contract negotiated between the parties. Market risk reflects the degree to which changes in interest rates, foreign exchange rates, and equity prices can adversely affect the earnings of a bank.

**Modified duration:** Describes the sensitivity of a price of a bond to a small change in its yield – and is often referred to its bond volatility. It provides a measure of percentage price volatility. The longest is the duration of a security; the highest is the price variation.

**Net interest income:** Total interest income less total interest expense. This residual amount represents most of the income available to cover expenses other than interest expense.

**Net interest margin (NIM):** Net interest income as a percent of average earning assets.

**Net loans:** Loans net of provision held for non-performing loans.

**Net margin (for corporate sector):** It is a measure of corporate sector's performance and is described as profit expressed as a percent of total sales volume.

**Net non-performing loans (NPLs):** The value of non-performing loans minus provision for loan losses.

**Net NPLs to net loans:** Net NPLs as a percent of net loans. It shows the degree of loans infection after making adjustment for provision held.

**Non-Performing loans (NPLs):** Loans and advances whose mark-up/interest or principal is overdue by 90 days or more from the due date are classified as non-performing.

**NPLs to loans ratio:** Non-performing loans as a percent of gross loans.

**Off-the-run securities:** Less liquid securities signifying low trading activity in the secondary market.

**On-the-run securities:** The relatively high liquid securities with active trading in the secondary market. These are the seasoned securities.

**Paid-up capital:** This is equity amount actually paid by the shareholders to a company for acquiring its shares.

**Rate sensitive assets (RSA):** Assets susceptible to interest rate movements; that will be re-priced or will have a new interest rate associated with them over the forthcoming planning period.

**Return on assets:** It measures the operating performance of an institution. It is the widely used indicator of earning and is calculated as net profit as percentage of average assets.

**Return on equity:** A measure that indicates the earning power of equity and is calculated

as net income available for common stockholders to average equity.

**Risk weighted Assets:** Each asset and off-balance sheet item is assigned to one of the four broad risk categories based on the perceived credit risk of the obligor. These risk categories are assigned weights of 0 percent, 20 percent, 50 percent and 100 percent. The standard risk category is 100 percent. The rupee value of the amount in each category is multiplied by the risk weights associated with that category. The off-balance sheet items are first converted to credit equivalent values by using the conversion factors. The resulting values for each of the risk categories are added together. The resulting sum is the total risk weighted assets.

**Secondary market:** A market in which securities are traded following the time of their original issue.

**SME:** means an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing concern) and 50 persons (if it is trading / service concern) and also fulfills the following criteria of either 'a' and 'c' or 'b' and 'c' as relevant:

(a) A trading / service concern with total assets at cost excluding land and building upto Rs50 million.

(b) A manufacturing concern with total assets at cost excluding land and building upto Rs100 million.

(c) Any concern (trading, service or manufacturing) with net sales not exceeding Rs300 million as per latest financial statements.

**Tier I capital:** The risk based capital system divides capital into two tiers- core capital (Tier I) and supplementary capital (Tier II). Tier I capital is defined as common stockholders' equity (including common stock, surplus and undivided profits), non-cumulative perpetual preferred stock and minority interest in consolidated subsidiaries.

**Tier II capital:** Supplementary Capital (Tier II) is limited to 100 percent of core capital (Tier I). It includes cumulative perpetual preferred stock, mandatory convertible debt, the general provision or reserves for loan losses, term subordinated debt, limited life preferred stock and other hybrid capital instruments.

**Yield risk:** The risk arising out of the changes in interest rates on a bond or security when calculated as that rate of interest which, if applied uniformly to future time periods sets the discounted value of future bond coupon and principal payments equal to the current market price of the bond.

**Yield spread:** It is the difference in the rate of 10-year bond and overnight rate. Yield spread is positive when rate on longer tenor bond is higher.

## List of Abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
BMR	Balancing, Modernization and Replacement
CAMELS-S	Capital, Assets, Management, Earning, Liquidity, Sensitivity and Systems & Controls.
CAR	Capital Adequacy Ratio
CBs	Commercial Banks
CIB	Credit Information Bureau
CIRC	Corporate and Industrial Restructuring Corporation
CPs	Core Principles
CY	Calendar year
DFI	Development Finance Institution
EBIT	Earnings Before Interest and Taxes
FBs	Foreign Banks
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
IMF	International Monetary Fund
KSE	Karachi Stock Exchange
KYC	Know Your Customer
LPBs	Local Private Banks
MCR	Minimum Capital Requirement
MFI	Micro Finance Institutions
MTBs	Market Treasury Bills
NBFCs	Non Bank Finance Companies
NBFIs	Non Bank Financial Institutions
NDFC	National Development Finance Corporation
NII	Net Interest Income
NIM	Net Interest Margin
NPLs	Non Performing Loans
NSS	National Saving Schemes
OMOs	Open Market Operations
PIBs	Pakistan Investment Bonds
PSCBs	Public Sector Commercial Banks
PTCs	Participation Term Certificates
RDFC	Regional Development Finance Corporation
ROA	Return on Assets
ROE	Return on Equity
RSAs	Rate Sensitive Assets
RSLs	Rate Sensitive Liabilities
RTGS	Real Time Gross Settlement
RWA	Risk Weighted Assets
SBFC	Small Business Finance Corporation
SBP	State Bank of Pakistan
SBs	Specialized Banks
SECP	Securities and Exchange Commission of Pakistan
SME	Small and Medium Enterprises
SMEs	Small and Medium Enterprises
TFCs	Term Finance Certificates
UBL	United Bank Limited
ZTBL	Zarai Taraqiati Bank Limited

## Annex- V

### Group-wise Composition of Banks 1997-2003

1997-1998	1999-2000	2001	2002	2003
<b>A. Public Sector Comm. Banks</b> Habib Bank Ltd. National Bank of Pakistan United Bank Ltd. First Women Bank Ltd. The Bank of Khyber The Bank of Punjab <b>B. Local Private Banks</b> Askari Commercial Bank Ltd. Bank Al-Falah Ltd. Bank Al Habib Ltd. Bolan Bank Ltd. Faysal Bank Ltd. Metropolitan Bank Ltd. Platinum Commercial Bank Ltd. Prime Commercial Bank Ltd. Prudential Commercial Bank Ltd. Gulf Commercial Bank Ltd. Soneri Bank Ltd. Union Bank Ltd. Muslim Commercial Bank Ltd. Allied Bank of Pakistan Trust Bank Ltd. Indus Bank Ltd. <b>C. Foreign Banks</b> ABN Amro Bank Al Baraka Islamic Bank American Express Bank Ltd. ANZ Grindlays Bank Bank of America Bank of Ceylon The Bank of Tokyo – Mitsubishi Citibank, N.A. Credit Agricole Indosuez Deutsche Bank A.G. Doha Bank Emirates Bank International Habib Bank A. G. Zurich The Hongkong & Shanghai Banking Corporation Ltd. IFIC Bank Ltd. Masreq Bank PJSC Oman International Bank S.A.O.G. Rupali Bank Ltd. Societe Generale Standard Chartered Bank <b>D. Specialized Banks</b> Agriculture Development Bank of Pakistan Industrial Development Bank of Pakistan Federal Bank for Co-Operatives Punjab Provincial Co-operative Bank Ltd. <b>All Commercial Banks</b> Includes A + B + C <b>All Banks</b> Includes A + B + C + D	<b>A. Public Sector Comm. Banks</b> Habib Bank Ltd. National Bank of Pakistan United Bank Ltd. First Women Bank Ltd. The Bank of Khyber The Bank of Punjab <b>B. Local Private Banks</b> Askari Commercial Bank Ltd. Bank Al-Falah Ltd. Bank Al Habib Ltd. Bolan Bank Ltd. Faysal Bank Ltd. Metropolitan Bank Ltd. Platinum Commercial Bank Ltd. Prime Commercial Bank Ltd. Prudential Commercial Bank Ltd. <sup>2</sup> PICIC Commercial Bank Ltd. Soneri Bank Ltd. Union Bank Ltd. Muslim Commercial Bank Ltd. Allied Bank of Pakistan <b>C. Foreign Banks</b> ABN Amro Bank Al Baraka Islamic Bank American Express Bank Ltd. ANZ Grindlays Bank Bank of America <sup>1</sup> Bank of Ceylon The Bank of Tokyo – Mitsubishi Citibank, N.A. Credit Agricole Indosuez Deutsche Bank A.G. Doha Bank Emirates Bank International Habib Bank A. G. Zurich The Hongkong & Shanghai Banking Corporation Ltd. IFIC Bank Ltd. Masreq Bank PJSC Oman International Bank S.A.O.G. Rupali Bank Ltd. Societe Generale Standard Chartered Bank <b>D. Specialized Banks</b> Agriculture Development Bank of Pakistan Industrial Development Bank of Pakistan Federal Bank for Co-Operatives Punjab Provincial Co-operative Bank Ltd. <b>All Commercial Banks</b> Includes A + B + C <b>All Banks</b> Includes A + B + C + D	<b>A. Public Sector Comm. Banks</b> Habib Bank Ltd. National Bank of Pakistan United Bank Ltd. <sup>3</sup> First Women Bank Ltd. The Bank of Khyber The Bank of Punjab <b>B. Local Private Banks</b> Askari Commercial Bank Ltd. Bank Al-Falah Ltd. Bank Al Habib Ltd. Bolan Bank Ltd. Faysal Bank Ltd. Metropolitan Bank Ltd. Platinum Commercial Bank Ltd. <sup>4</sup> Prime Commercial Bank Ltd. Saudi Pak Commercial Bank Ltd. PICIC Commercial Bank Ltd. Soneri Bank Ltd. Union Bank Ltd. Muslim Commercial Bank Ltd. Allied Bank of Pakistan United Bank Ltd. Meezan Bank <b>C. Foreign Banks</b> ABN Amro Bank Al Baraka Islamic Bank American Express Bank Ltd. Standard Chartered Grindlays Bank <sup>7</sup> Bank of Ceylon The Bank of Tokyo – Mitsubishi Citibank, N.A. Credit Agricole Indosuez Deutsche Bank A.G. Doha Bank Habib Bank A. G. Zurich The Hongkong & Shanghai Banking Corporation Ltd. IFIC Bank Ltd. Masreq Bank PJSC Oman International Bank S.A.O.G. Rupali Bank Ltd. Societe Generale <sup>6</sup> Standard Chartered Bank <b>D. Specialized Banks</b> Agriculture Development Bank of Pakistan Industrial Development Bank of Pakistan Federal Bank for Co-Operatives <sup>8</sup> Punjab Provincial Co-operative Bank Ltd. <b>All Commercial Banks</b> Includes A + B + C <b>All Banks</b> Includes A + B + C + D	<b>A. Public Sector Comm. Banks</b> Habib Bank Ltd. National Bank of Pakistan First Women Bank Ltd. The Bank of Khyber The Bank of Punjab <b>B. Local Private Banks</b> Askari Commercial Bank Ltd. Bank Al-Falah Ltd. Bank Al Habib Ltd. Bolan Bank Ltd. Faysal Bank Ltd. Metropolitan Bank Ltd. KASB Bank Ltd. Prime Commercial Bank Ltd. Saudi Pak Commercial Bank Ltd. PICIC Commercial Bank Ltd. Soneri Bank Ltd. Union Bank Ltd. Muslim Commercial Bank Ltd. Allied Bank of Pakistan United Bank Ltd. Meezan Bank <b>C. Foreign Banks</b> ABN Amro Bank Al Baraka Islamic Bank American Express Bank Ltd. Bank of Ceylon The Bank of Tokyo – Mitsubishi Citibank, N.A. Credit Agricole Indosuez Deutsche Bank A.G. Doha Bank Habib Bank A. G. Zurich The Hongkong & Shanghai Banking Corporation Ltd. IFIC Bank Ltd. <sup>10</sup> Masreq Bank PJSC <sup>9</sup> Oman International Bank S.A.O.G. Rupali Bank Ltd. Standard Chartered Bank <b>D. Specialized Banks</b> Zari Taraqati Bank Ltd. Industrial Development Bank of Pakistan Punjab Provincial Co-operative Bank Ltd. <b>All Commercial Banks</b> Includes A + B + C <b>All Banks</b> Includes A + B + C + D	<b>A. Public Sector Comm. Banks</b> Habib Bank Ltd. <sup>9</sup> National Bank of Pakistan First Women Bank Ltd. The Bank of Khyber The Bank of Punjab <b>B. Local Private Banks</b> Askari Commercial Bank Ltd. Bank Al-Falah Ltd. Bank Al Habib Ltd. Bolan Bank Ltd. Faysal Bank Ltd. Metropolitan Bank Ltd. KASB Bank Ltd. Prime Commercial Bank Ltd. Saudi Pak Commercial Bank Ltd. PICIC Commercial Bank Ltd. Soneri Bank Ltd. Union Bank Ltd. Muslim Commercial Bank Ltd. Allied Bank of Pakistan United Bank Ltd. Meezan Bank NDLC-IFIC Bank Ltd Crescent Bank Ltd. <b>C. Foreign Banks</b> <sup>4</sup> ABN Amro Bank Al Baraka Islamic Bank American Express Bank Ltd. The Bank of Tokyo – Mitsubishi Citibank, N.A. Dawood Bank# Deutsche Bank A.G. Habib Bank A. G. Zurich The Hongkong & Shanghai Banking Corporation Ltd. Oman International Bank S.A.O.G. Rupali Bank Ltd. Standard Chartered Bank Trust Bank <sup>7</sup> <b>D. Specialized Banks</b> Zari Taraqati Bank Ltd. Industrial Development Bank of Pakistan Punjab Provincial Co-operative Bank Ltd. <b>All Commercial Banks</b> Includes A + B + C <b>All Banks</b> Includes A + B + C + D

1. Bank of America – Pakistan Operations were purchased by and merged with Union Bank Ltd. - 03-07-2000.
2. Prudential Commercial Bank was acquired by Saudi-Pak Industrial & Agricultural Investment Company and renamed as Saudi-Pak Commercial Bank Ltd. - 05-11-2001.
3. On its privatization, UBL shifted from PSCB to LPB in 2002.
4. Platinum Commercial Bank Ltd. was purchased by KASB and renamed as KASB Bank Ltd. – 17-10-2002.
5. Emirates Bank International – Pakistan Operations were purchased by Union Bank Ltd. – 02-09-2002.
6. Societe Generale – Pakistan Operations – were acquired by Meezan Bank Ltd. – 30-04-2002.
7. ANZ Grindlays Bank was merged into / acquired by Standard Chartered – 30-11-2002.
8. FBC is under liquidation, hence excluded from 2002.
9. Masreq Bank, after merger with Crescent Investment Bank, converted to a local private bank in 2003.
10. IFIC, after merger with NDLC, converted to NDLC-IFIC Bank Ltd in local banks on 03-10-2003.

#### Post Review Developments

- @ HBL now stands as local private bank after being privatized on 26-02-2004.
- # Bank of Ceylon now stands as local private bank after being merged into Dawood Bank on 25-03-2004.
- \$ Credit Agricole now stands as local private bank after being merged into NDLC-IFIC Bank on 19-04-2004.
- \* Doha Bank now stands as local private bank after being merged into Trust Bank on 05-05-2004.