BSR

Banking System Review

For the year ended December 31, 2004

State Bank of Pakistan
Banking Supervision Department

The Team

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List of Abbreviations

ADD	Authorized Derivatives Dealer
AML	Anti Money Laundering
APGML	Asia-Pacific Group on Money Laundering
BCBS	Basel Committee on Banking Supervision
BMR	Balancing, Modernization and Replacement
CAELS	Capital, Assets Quality, Earnings, Liquidity and Sensitivity
CAMELS-S	Capital, Assets Quality, Management, Earning, Liquidity, Sensitivity and Systems & Controls
CAR	Capital Adequacy Ratio
CB	Commercial Bank
CFT	Combating the Financing of Terrorism
CIRC	Corporate and Industrial Restructuring Corporation
COT	Carry Over Transactions
CRSIU	Committee for Revival of Sick Industrial Units
CY	Calendar Year
DFI	Development Finance Institution
DIS	Deposit Insurance System
EBIT	Earning Before Interest and Taxes
FATF	Financial Action Task Force
FB	Foreign Bank
FDBR	Financial Derivatives Business Regulations
FRA	Forward Rate Agreement
FSAP	Financial Sector Assessment Program
FX	Foreign Currency
FY	Fiscal Year
GDP	Gross Domestic Product
GST	General Sales Tax
HBL	Habib Bank Limited
IMF	International Monetary Fund
IRAF	Institutional Risk Assessment Framework
IRB	Internal Ratings Based
IRS	Interest Rate Swap
KSE	Karachi Stock Exchange
KYC	Know Your Customer
LPB	Local Private Bank
LSM	Large Scale Manufacturing
MCR	Minimum Capital Requirement
MFB	Micro Finance Bank
MTB	Market Treasury Bill
NMI	Non Market Maker Financial Institution
NPF	Non Performing Finance
NPL	Non Performing Loan
OMO	Open Market Operations
OTC	Over the Counter
PIB	Pakistan Investment Bond
PSCB	Public Sector Commercial Bank
PTC	Participation Term Certificate
ROA	Return on Assets
ROE	Return on Equity
RSA	Rate Sensitive Asset
RSL	Rate Sensitive Liability
RTGS	Real Time Gross Settlement
RWA	Risk Weighted Assets
SB	Specialized Bank
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SME	Small and Medium Enterprise
TFC	Term Finance Certificate
UBL	United Bank Limited
UNO	United Nations Organization
YoY	Year on Year

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Foreword

Since its first edition in 2002, the Banking System Review (BSR) has developed into a core publication of SBP, which captures the performance as well as major trends in the banking system of Pakistan. The exercise not only helps promote transparency, the core value adopted by SBP, but also attempts to assess the major risks confronting the banking system of Pakistan. The wide acceptance of the BSR for 2003 and the encouraging feedback received from various quarters not only highlights the importance of the document but also acknowledges the efforts put into its compilation. All this could not have been possible without the inspiration and continued guidance from the senior management of SBP, particularly Dr. Ishrat Husain, Governor SBP.

While preparing the BSR for 2004, the prime objective remained the assessment of financial soundness and health of the banking system. For this purpose, the overall assessment is based primarily on the financial soundness indicators used in the previous reviews. However, to make the analysis more comprehensive and inquisitive, a number of additional measures have also been used. In this respect, a separate chapter employing stress testing techniques makes the analysis relatively more systematic and forward-looking. Further, a critical review of the prudential stability of the return on equity of the banking system has been included to add value to the profitability section.

The financial stability of the banking system has strong correlation with the macroeconomic environment and the performance of corporates and households. After giving an overview of the overall performance of the banking system in the first chapter, the next three chapters deal with the growth and trends on the macroeconomic front and the condition of corporate and household sectors with a special focus on their solvency. To determine the ultimate solvency of the banking system and its resilience to various shocks, chapters five and six dwell at length on the financial soundness of the banking system and its exposure to various risks. The overall performance as well as exposure to various risks of the banking system is linked strongly with their assets and funding structure. For this purpose, chapter seven examines the composition and growth patterns of the assets and funds of the banking system. Separate chapters covering overseas and Islamic banking operations, performance of Development Finance Institutions (DFIs), Microfinance Banks (MFBs) and exchange companies have also been included to make the discussion all-inclusive.

The goal of financially sound and viable banking system would remain elusive without the existence of necessary infrastructure, built in line with international best practices. To achieve this objective, a number of reforms were initiated and the process continues unhindered. Chapters thirteen to fifteen recount the initiatives towards; financial system stability, issues & developments in the banking system and finally the developments in banking supervision. To give an independent opinion on the status of compliance with international standards and codes by the financial sector of Pakistan, chapter sixteen sketches the evaluation of the financial sector of Pakistan under the Financial Sector Assessment Program (FSAP) of the IMF and the World Bank. Finally, a new chapter has been added at the end to assess the resilience of the banking system to stress tests of various magnitudes.

The data source remained primarily the annual audited accounts of banks and DFIs for the year ended December 31, 2004. However, wherever necessary, data from other sources have also been used to cover the remaining areas. In this respect we would like to acknowledge the cooperation of various SBP departments including Banking Inspection Department, Banking Policy Department, Exchange & Debt Management Department, Exchange Policy Department, Islamic Banking Department, Payment System Department and Research Department in compiling information pertaining to their respective areas. We would also like to highly appreciate the support of M/s Vital Information Services (VIS), a private concern, for providing data on corporates.

As always, SBP would welcome suggestions for further improvement of the future reviews.

June 04, 2005

JAMEEL AHMAD
DIRECTOR
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1 Overview

With surging profits, improving asset quality and solvency, the year 2004 proved to be a milestone for the banking system. The favourable macroeconomic environment coupled with the institutionalization of reforms, introduced over the last five years, continued to provide the vital support. The banking system, by capitalizing on the opportunities created by the sharp upswing in the business cycle, expanded its balance sheet at an exceptional pace. This not only produced substantial profits for banks with the increasing high-earning assets but also conferred benefits to the growing number of customers in the form of improved and diversified financial services. The significant achievements and trends during the year are highlighted as follows:

- The financial soundness indicators of the banking system showed further strengthening in 2004 with major improvements for the commercial banks. A further disaggregation reveals that the five largest banks holding more than fifty percent of the assets of the banking system have indicators well above the internationally acceptable benchmarks. Credit, market and liquidity risk parameters do not show any adverse movement.

- The loan portfolio of the banking system, on the back of strong business confidence, grew strongly. This gave a significant boost to the economic activities as the businesses expanded their capacities to meet strong demand pressures. The loans growth was also broad-based as substantial funds flowed to consumer, Small and Medium Enterprises (SMEs) and agriculture sectors. The share of SME and agriculture sectors in total loans of the banking system in 2004 has risen to 25 percent which is quite impressive, while that of consumer financing was less than 10 percent. Banks' growing interest in these sectors not only helped in increasing their clientele, but also helped in credit risk diversification. The persistent inflow of deposits kept the banking system sufficiently liquid to meet the strong credit demand.
- Profits touched new heights. Return on Assets (ROA) this year was the highest ever-1.2 percent. A decomposition of the sources of changes in Return on Equity (ROE) indicates that the operating efficiency was a major contributory factor in CY03 but the quality of equity and risk profile of the assets were the main factors this year. The composition of earnings, however, changed significantly with the growing reliance on core income as well as non-fund based income. Capital gains, which were instrumental in last year's profits, lost much of their share with the rising interest rates, which started to reduce the value of the investment portfolio of banks. Consequently, banks had to cut their exposure to government securities quite significantly.
- Asset quality improved further despite the fast increase in loans. Non-performing loans (NPLs) kept their downward trend leading to substantial improvement in the key relevant ratios. Net NPLs to net loans declined from 6.9 percent to 3.6 percent. The banks continued to make provisions in the existing stock of NPLs.
- Solvency of the banking system improved markedly. The improvement in solvency indicators came on the back of enhanced minimum capital requirement (MCR), aimed at consolidation and strengthening of the banking system. The increasing profits and improving asset quality supplemented the regulatory measures in this respect. Capital Adequacy Ratio (CAR) rose from 8.5 percent to 10.5 percent.
- Liquidity conditions also remained comfortable despite SBP's efforts at mopping up excess funds to restrain inflationary pressures. The rapid expansion in the deposit base assisted by remittances from the expatriates helped the system to remain fairly liquid.

- The dominant share of private sector in the banking system has already started to become visible in the form of appreciable improvement in operating efficiency. The competitive spirit seems to have taken firm hold as banks are striving hard either to retain or to increase their market share.
- The Islamic Banking operations continued to expand as a growing number of banks have started Shariah based modes of financial activities. The total assets of the Islamic banking have expanded three and a half times of 2003 level. Similarly, the depth of microfinance activities increased with the expanding branch network and customer-base of this type of financing.
- SBP also remained focused on improving and consolidating the supervisory and regulatory standards. The focus remained on creating awareness through seminars and conferences as well as issuing guidelines in certain key areas e.g. anti-money laundering measures, implementation of Basel II, strengthening of internal controls and improvement of corporate governance etc.

The banking system not only gained strength from the positive interplay of economic and political factors, but also became an engine of growth for the economy. Corporate profits this year were quite impressive which bolstered their solvency and helped in expanding their businesses. The higher retained earnings provided most of the financing for business expansion and investment as the capital gearing ratio declined to 39 percent from 51 percent in 2003. Double digit growth in large scale manufacturing (LSM) is thus a product of higher borrowing from the banking system but more so large infusion of own funds by the corporate sector.

A critical examination of the top twenty borrowing groups in Pakistan for the year 2004 reveals that these groups have also performed exceptionally well. Accounting for 12.5 percent of total lending of banks and DFIs, this sample of 90 companies posted an ROA of 7.1 percent-much higher than the average ROA of the corporate sector as a whole.

Despite a very strong expansion, the household sector still accounts for 9.4 percent of total bank loans and household debt to GDP ratio in 2004 was only 2.8 percent. The ratio of NPLs to total loans for consumer financing was insignificant at only 0.9 percent.

The achievements during the year were also accompanied by some mounting concerns. Following the vertical rise in loans, the credit risk also increased significantly. The simultaneous increase in interest rates started to generate worries about the debt repayment capacity of the borrowers. In this perspective, consumer financing, being a growing sector, came under focus. Keeping in view the fact that the consumer financing is a more recent phenomenon and the banks are still going through the stage of developing an adequate credit culture for this type of financing, the likelihood of default in this sector remains the highest. Moreover, the high demand pressures might also have rendered the household balance sheets highly-leveraged, thereby increasing the cost with the rising interest rates. The concerns also hold true for the SMEs and agriculture sector, considering the relatively lower level of banks' expertise and monitoring abilities in these sectors.

The inflationary pressures, driven by high prices for oil & food items as well as increase in monetary aggregates, started to assume serious proportions. SBP, faced with the delicate policy choice between controlling inflation and maintaining the tempo of economic activities, started to gradually tighten its monetary stance. The impact became visible with the rising interest rates. This scenario may become discomforting for the banks that extended their loans against inflated collateral values. The rising interest rates might not only pressurize the debt repayment capacity of the borrowers but also raises the risk of erosion in the value of collaterals.

Notwithstanding these concerns, there are also certain mitigating factors, which may help to manage these risks. The banking system's venture into these under-explored sectors has also helped in diversifying their overall portfolio. Moreover, the regulatory authorities, in consultation with banks, have also remained engaged in developing necessary safeguards and proper systems to minimize risks associated with financing to these areas. As the banking system matures, with the strengthened credit appraisal systems, strong risk management, sound corporate governance, and improving infrastructure, the benefits of expanding & diversifying their activities are expected to far exceed the likely losses. Above all, it will allow the lower segment of the society to avail the hitherto inaccessible financial services and will continue to provide fuel for the economy to sustain its growth patterns.

The downside effects of inflation and the rising interest rates may be contained by the higher output growth. The corporate sector, taking advantage of the negative real lending rates, has already expanded their capacity through significant fixed investments. The likely improvement in the supply conditions, thus, would help quell the increasing demand pressures on prices. Consequently, the monetary tightening would not have any significant detrimental impact on the economy, which means banks' balance sheets will keep growing with the growing economy.

Future Outlook

The outlook, at least in the short term, appears positive. The banking system, helped by the resolute and concerted efforts of the policy-makers over the last couple of years, seems to have developed inherent strength to endure the unexpected shocks. This perception is vindicated by the stress test results, which show the banking system having resilience to withstand single factor or multifactor shocks of varying degrees with only a tolerable squeeze in the solvency position.

With the growth momentum of the economy and continuation of the business friendly policies, the demand for credit by the private sector is likely to remain intact, leading to further increase in the loan portfolio of banks. However, the pace of growth might slow-down with the increasing interest rates. Particularly, the squeeze on consumer financing might be pronounced considering the high risk factor and loss of purchasing power in the face of high inflation. The manufacturing sector, especially the automobile industry, which benefited immensely from the strong growth in consumer finance, might also feel some pressure. Another major determinant of the future loans growth will be the trends in banks' financing to the SMEs and agriculture sectors. Considering the fact that these sectors have been traditionally under-served compared to their potential and contribution in the economy, there is still considerable scope for banks to make further inroads. Results for the first quarter of CY05 indicate the continued upsurge in loans, though at a relatively lower pace compared with the same in the last quarter of CY04.

Given the persistent rise in loans, the earnings prospects for the banking system look even brighter for 2005. It, however, hinges a great deal on banks' ability to maintain the high quality of their loans as well as their operating efficiencies. The efforts towards consolidation as well as the penetrating competitive spirit among banks will supplement the positive impact of loans growth on incomes. In the first quarter of CY05, the banking system has managed to double its profits comparing with the corresponding period last year. In this respect, the role of rapidly expanding loans portfolio was more apparent as the interest income increased substantially.

With the impressive achievements in the last couple of years, the task before the policymakers and managements of banks will be more challenging and daunting; to consolidate the gains as well as to lift the system to the international service quality levels. SBP complies with the majority of the Basel Core Principles for Effective Banking Supervision. The implementation of the Basel II Capital Accord in a phased manner is one of the top policy agenda of its future strategic plan. The gradual increase in the MCR will help in weeding out the weak institutions to make the financial system sounder and globally competitive. Another important policy measure will be to increase the outreach of the financial services to the underserved segments of the society to mainstream their capabilities for the benefit of the economy.

The role of senior managements of banks will be even more important in view of the rapidly changing environment. They will have to ensure a judicious mix of policies, which not only sustain the current momentum but also minimize risks associated with the ongoing credit spree. They will have to make the most of the prevailing favourable macroeconomic environment by tapping the ever-growing revenue generating activities with the simultaneous strengthening of internal controls and lifting of corporate governance standards. Risk management will have to be crafted on lines that better integrate multiple risk management procedures in business units across their organizations.

To conclude, there is an overall improvement in the operating environment and the banking system is expected to display even better performance in the days ahead.

2 Macroeconomic Environment

The overall macroeconomic environment remained robust, providing the essential support to the banking system to post outstanding performance. The economic growth, gaining strength from the positive developments in the preceding year, picked up strong momentum. The economy witnessed a strong GDP growth, which not only surpassed the growth target for FY04 but also grew much faster than the initial estimates for FY05; the GDP increased by 8.4 percent, much higher than the growth target of 6.6 percent.

A number of factors contributed to put the economy in top gear. The most important, however, was the manufacturing, which provided the main stimulus. The sector, aided primarily by the LSM sector, grew at a remarkable pace of 13.4 percent during the FY04 and is again proving to be a catalyst in achieving higher than targeted growth rate for the current fiscal year. Not surprisingly, LSM continued to dominate the industrial growth profile during the first three quarters of FY05 and expanded by 15.4 percent in FY05.

The agriculture sector, which received serious setback in FY04 because of natural calamities, also surpassed the target of 4 percent and achieved the growth rate of 7.5 percent (see **Table 2.1**). This commendable performance of the agriculture sector is the outcome of a number of positive developments e.g. improved *kharif* crop, healthy water balance, sustained higher prices for agricultural produce and easy availability of agricultural credit. The improved performance by this sector also bodes well for the banking system, as with the increased income level of farmers, the risk of losses on bank credit will be on the lower side. Moreover, it would further encourage the banks to extend more credit to this vital sector of the economy.

Table-2.1: Real Gross Domestic Product

Description	Growth Rate				
	FY01	FY02	FY03	FY04	FY05 T*
Agriculture	**-2.2**	**0.1**	**4.1**	**2.6**	**7.5**
Major Crops	-9.9	-2.5	6.9	2.8	17.3
Manufacturing	**9.3**	**4.5**	**6.9**	**13.4**	**12.5**
Large Scale	11	3.5	7.2	17.1	15.4
Services Sector	**3.1**	**4.8**	**5.3**	**5.2**	**7.9**
GDP at factor cost	**1.8**	**3.1**	**5.1**	**6.4**	**8.4**

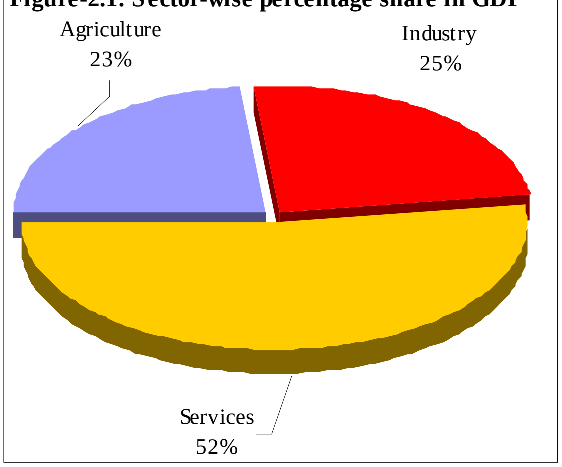
** Targets for FY05.*

Targets are from Annual Budget Statement 2004 and Annual Plan 2004-05.

Source: Annual Report FY 04, SBP

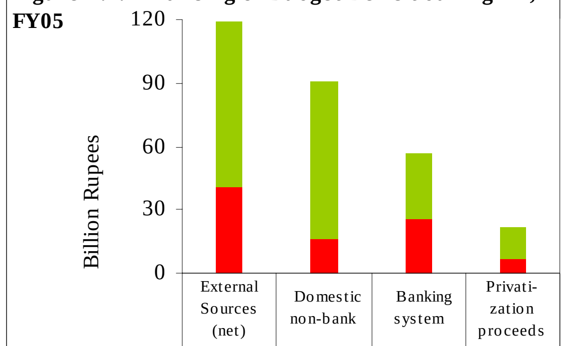
Services sector is the largest contributor to the economy (see **Figure 2.1**). Growth rate in services sector though decelerated marginally to 5.2 percent in FY04 against 5.3 percent in FY03. However, a remarkable recovery has been witnessed in FY05 with services sector growing by 7.9 percent. Increasing activities especially in telecommunication sector coupled with strong growth in the activities of the financial institutions has given a big boost to the services sector.

Figure-2.1: Sector-wise percentage share in GDP



The government over the last few years has been able to successfully reduce the budget deficit through well-controlled expenditures, improved revenue collection and wide ranging reforms in tax administration. Consequently, the burden on the banking system to finance the budget deficit also declined. The data for the first half of FY05, however, shows acceleration in current and developmental expenditures. Moreover, the freeze on Petroleum, Oil, Lubricants (POL) product prices as well as lower growth in GST receipts generated concerns on the fiscal side. As a result, the banking system had to contribute Rs25.4 billion during first half of FY05 against net retirement of Rs9.7 billion last year (see **Figure 2.2**).

Figure-2.2: Financing of Budget Deficit during H1, FY05

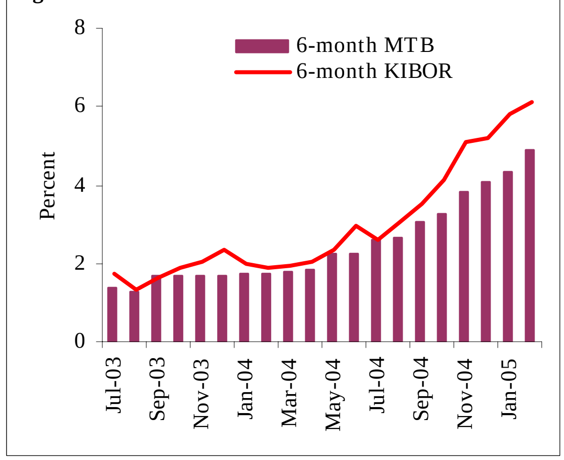


	External Sources (net)	Domestic non-bank	Banking system	Privati-zation proceeds
Budgetary Deficit targets	78.2	74.7	31.2	15.0
Budgetary financing during H1.	40.4	15.7	25.4	6.8

Since FY02 SBP followed an easy monetary policy, which proved successful in driving the growth in real GDP to over 6 percent by FY04. However, the increase in M2 along with supply shocks also started to generate inflationary pressures. This necessitated a shift in the monetary policy.

Moving against the market expectations of robust shift in monetary stance, SBP preferred a measured rise in interest rates so as to contain inflation without harming the pace of economic growth. The tilt towards tight monetary posture became discernible by May 2004. Between July 2004 and May 2005, SBP raised the benchmark 6-month T-bill interest rate by almost 565 bps to 7.88 percent, and started conducting open market operations (OMOs) more frequently (see **Figure 2.3**). The changed monetary policy stance has decelerated the pace of inflation.

Figure-2.3: KIBOR & 6-month MTB Rate



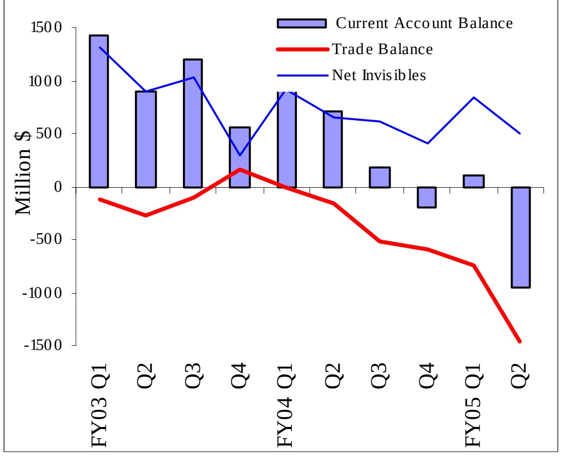
Low interest rates have not only stimulated the economic activity in the country but also benefited the banking system immensely, as it added substantially to the profitability of banks, through heavy capital gains as well as in the form of high credit disbursements, of late. However, with the rising interest rate environment the concerns pertaining to debt repayment capacity of the borrowers have started to appear.

The FY05 witnessed capital markets growing robustly. Karachi Stock Exchange (KSE) emerged as one of the fastest growing market in the region. The KSE-100 index registered remarkable surge (56 percent YoY basis) during first half of FY05, largely on account of increased investors' interest over new public offering with handsome premium to offer price. Notwithstanding the robust growth, March 2005 witnessed sharp decline in the KSE-100 index due primarily to the fall in the value of major blue chip shares.

The gradual appreciation of rupee against the US Dollar had already come to a halt by the end of FY04. Squeeze in current account surplus coupled with increase in the interest rate differential of Rupee and US$ developed pressure on local currency. First quarter of FY05 witnessed rather more visible depreciation of Rupee mainly engineered by the growing trade account deficit. However, the rupee started to gain after SBP supported the rupee by acting as net seller of dollars in the forex market.

The global economy in recent times has shown considerable resilience in spite of growing pressures in the form of high oil prices. The economic growth of around 5.0 percent, backed by the strong indicators of both the industrialized and emerging economies, was quite impressive and was of special significance for Pakistan. FY04 witnessed exports and imports growing by 13.8 percent and 20 percent respectively, widening the trade deficit by 173 percent YoY. Current account balance, though in surplus, has therefore shrunk. The decline on account of the suspension of Saudi Oil facility and decline in funds inflow for logistics support contributed towards this shrinkage as well. First half of FY05 witnessed deceleration in the growth of exports, while imports grew largely on account of inflated bill for oil imports. Consequently, the trade deficit widened to US$2.1 billion. This caused a deficit in the current account to the tune of US$884 million (see **Figure 2.4**).

Figure-2.4: Current Account Balance



During FY04 Pakistan's foreign exchange reserves reached US$12.3 billion. Despite SBP's efforts to stabilize the local currency through payment of oil bill out of its own reserves in the first half of FY05, the overall reserves remained stable as the workers remittances continued to pour in persistently. As of May 2005, total reserves, finally standing at US$12.4 billion, are quite sufficient to meet around 33.1 weeks of imports. This will serve to keep the investors' confidence high, promising further promotion of business activities in the economy.

Pakistan's external debt, with Public and Publicly Guaranteed debt being the major constituent, registered a marginal decline of US$45 million during the FY04. On the contrary, 4.1 percent increase has been witnessed in country's total debt liabilities, largely on account of rise in the value of Paris Club debt[1] and new flows of multilateral debt.

Keeping in view the outstanding performance depicted by major macro-economic variables in the wake of consistent economic policies, the economy seems to be on track. However, rising inflationary trends need to be contained for achieving sustainable growth of the economy.

[1] Yen and Euro appreciated vis-à-vis US dollar.

3 Corporate Sector

The performance and health of the Corporate Sector holds special significance for the banking system as loans to the corporate sector constitute more than half of the banking system's loan portfolio. The year 2004 was yet another landmark for the corporate sector as it produced the strong operating results, unprecedented for the last many years. This improvement was well shared among different sectors as most of the companies, except for some in the manufacturing sector, played an important part in adding value to the overall robust results of the sector.

Enhanced capacity utilization owing to increased domestic as well as foreign demand accompanying prudent cost savings and low interest rates translated into robust profits for the sector. This led to substantial growth in equity base, and since the growth in debt was not that strong, the corporate sector's leverage position registered significant decline to the lowest levels witnessed over the last few years. Improved debt servicing indicators, emerging from strong profits and lower interest charges, abate the concerns for loan losses.

The year under review was marked with strong build up in economic activity. In fact, new installations and Balancing, Modernization and Replacement (BMR) in textile sector, increased productivity in auto sector, cement sector doubling its capacity, infrastructure development in case of oil and gas distribution and marketing companies and increased value addition in many relatively small companies in sectors like paper and board and sports etc. boosted the business profile of the corporate sector. Despite the fact that the businesses, like in the previous years, kept relying mainly on their own funds for expanding operations, their demand for funds from the banking system also increased substantially as they resorted to take advantage of the low cost of funds. Consequently, their borrowings from the banking system increased by 44 percent to reach Rs873 billion from Rs606 billion in the last year (see **Figure 3.1**).

Figure-3.1: Growth in Corporate Financing

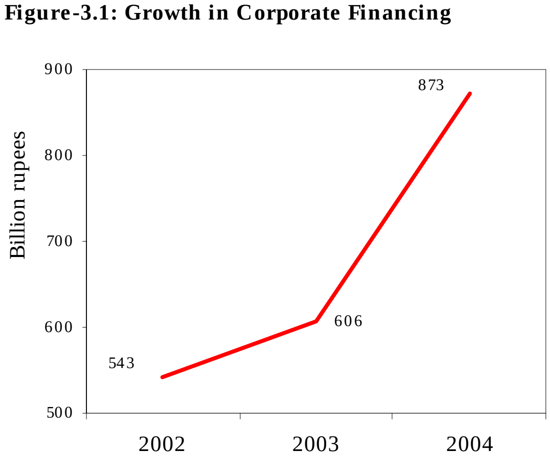
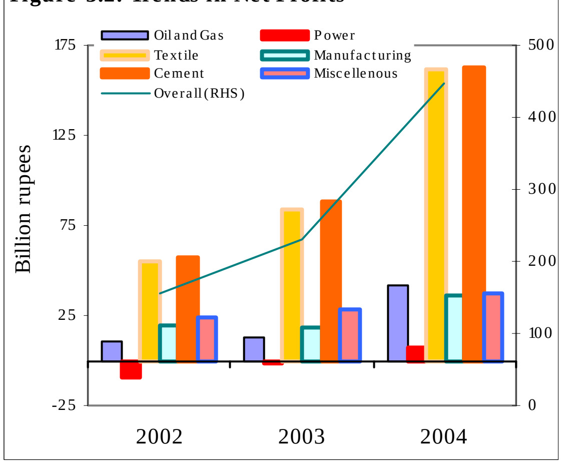


Figure-3.2: Trends in Net Profits



The expanded operations backed by strong demand materialized into robust profits for the sector. Net profits of Rs447 billion with 95 percent growth eclipsed the impressive performance of last year when they posted a growth of 46 percent (see **Figure 3.2**). Resultantly, ROA rose to 6.8 percent, highest during the last five years. This substantial increase in net earnings was underpinned primarily by strong profits made by textile and cement sectors. While oil and gas sector stood a distant third in contribution to overall corporate profits. Taken together these three sectors accounted for almost 87 percent of the overall corporate earnings. The rising ROE also highlights the remarkable performance of the corporates (see **Figure 3.3**).

Figure-3.3: Net Rate of Return on Capital

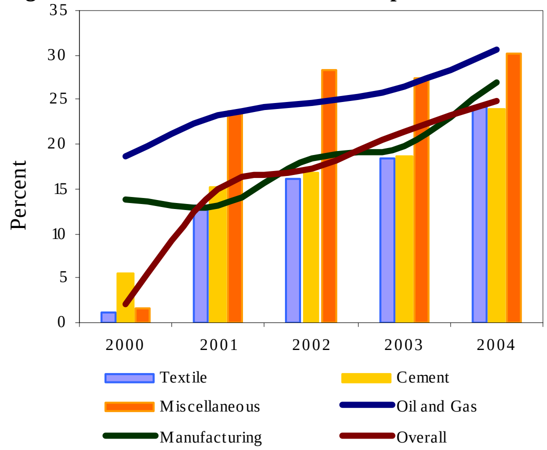
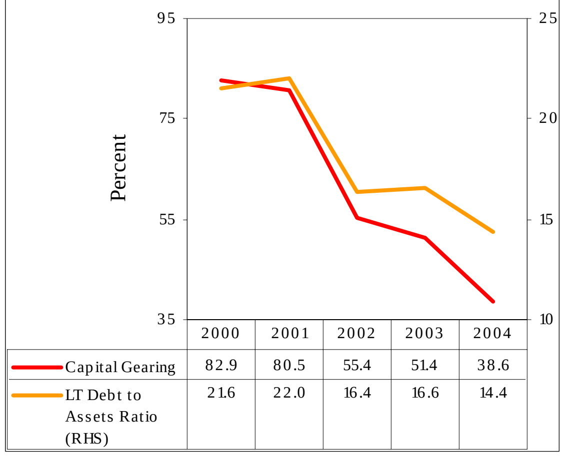


Figure-3.4: Capital Gearing of Corporate Sector



The strong profits over the last five years have placed the corporate sector in an unprecedented financial surplus. This surplus was well augmented by a general strategy of the sector to repatriate the funds for reaping the benefits of the favourable macroeconomic environment; thus diminishing the corporate sector's demand for external finance. A glance at capital gearing depicts corporate sector least encumbered with debt at the end of 2004 compared to the ratio in last five years (see **Figure 3.4**). The ratio eased to 39 percent against 51 percent in 2003, largely on account of vigorous equity expansion of companies engaged in oil and gas, textile and cement businesses in particular. Besides, a 5 percent fall in long-term debt of manufacturing sector has also contributed to a noticeable ease in the gearing.

Figure-3.5: Income Gearing and Effective Interest Rate of Corporate Sector

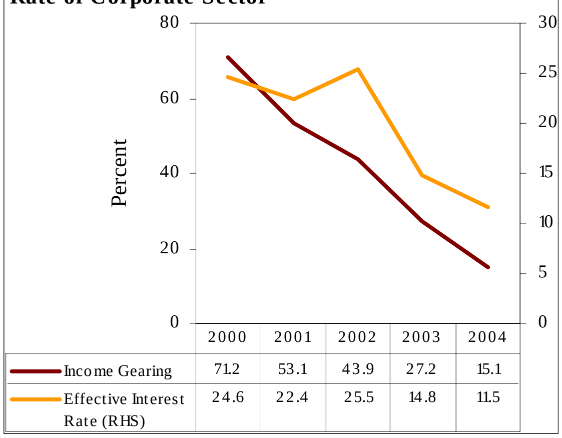
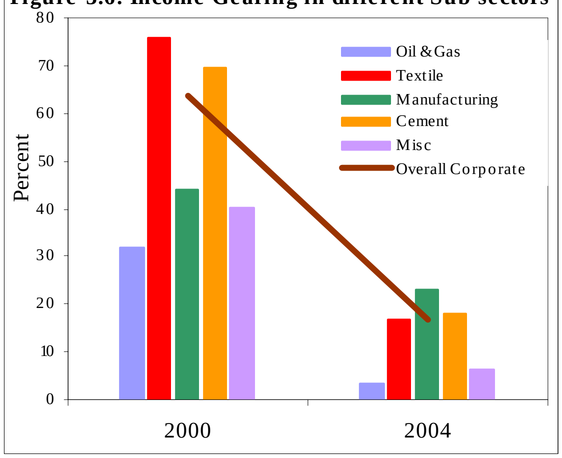


Figure-3.6: Income Gearing in different Sub-sectors



Since the year 2000, income gearing measured as a ratio of interest payments to earning before interest and taxes (EBIT) has continued to depict declining trends (see **Figure 3.5**). Consistent with the falling trends witnessed in the dependence on borrowed funds and their costs coupled with the sectors overall strategy to replace the costlier debt with cheaper one, interest payments of corporate sector have lessened in the year 2004, resulting in a slight fall in effective rate of interest as well. Evidently, increased profitability coupled with lower cost of borrowing resulted in fall in overall corporate sector income gearing to 15.7 percent against 27.2 percent in 2003. **Figure 3.6** represents income gearing at sub sector level with noticeable fall in income gearing in all sub sectors.

In conclusion, the corporate sector has been one of the highly responsive sectors of the economy. Responding positively to the favourable economic growth, the sector particularly Large-scale Manufacturing has added substantially to the overall economic growth on one hand and on the other hand with backward linkage, it has lent a helping hand in supporting the small and medium enterprises.

3.1 Performance of Top 20 Borrowing Groups

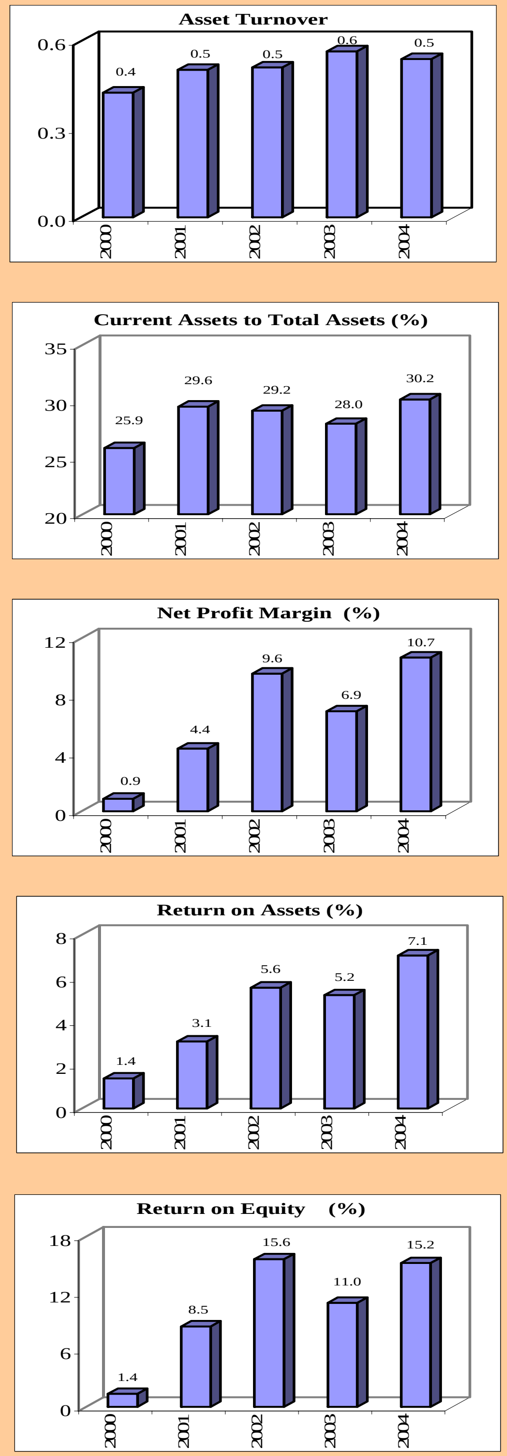
Examination of the financial health of the top twenty borrowing groups reveals 12.5 percent of total lending of all banks and DFIs placed with them. Amount overdue by 90 days and above is 1.4 percent of total funded exposure of banks and DFIs to these groups. Profitability of under-study business groups has been outstanding with return on assets posting 7.1 percent during 2004. These twenty business groups, comprising around 90 companies are engaged in textile, cement and power generation & distribution sectors.

Consolidated balance sheet of top-twenty borrowing groups witnessed robust expansion of 9.8 percent in aggregate asset base underpinned primarily by continuous profitable operations and investment friendly macroeconomic environment. Current assets as a percentage of total assets stood at 30.2 percent in 2004 (highest during the last five years). Likewise current liabilities drifting largely on the back of short term borrowings witnessed 12.8 percent growth against 3.5 percent in 2003. Short-term borrowings posted sharp growth of 30.6 percent in 2004-9.7 percent as a percentage of total assets-on account of increased working capital requirements.

As a matter of fact, increased capacity utilization, bumper cotton crop in case of textile sector, rapid growth in housing and construction in context of cement industry and above all favourable economic environment helped the under-study business groups to jump into the higher business orbit to add to their profitability. All these led to the 16.5 percent growth in equity of these groups.

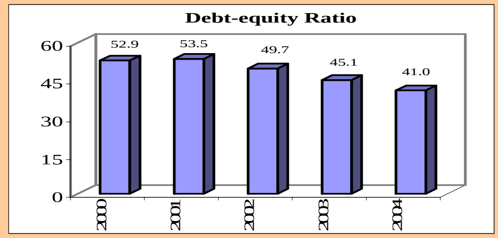
A noticeable upward shift has been witnessed in case of total revenues with 4.6 percent growth, due partly to increase in selling prices and partly to increase in the quantity sold. Cost of goods sold (COGS) on the other hand slightly declined to 77.3 percent of total sales in 2004 against 77.6 percent in 2003. Easy monetary stance adopted by SBP and therefore lower rate of interest helped reduce the financial charges to 5.4 percent of total sales against 7.1 percent of total sales in 2003. Above all, net profit margin at 10.7 percent indicates that the under-study business groups have been quite effective in controlling their costs.

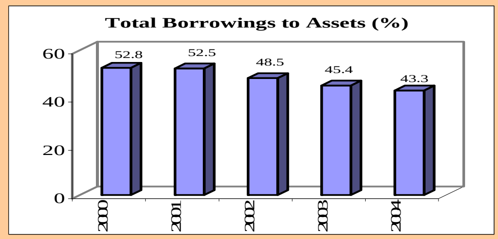
Key Performance Indicators

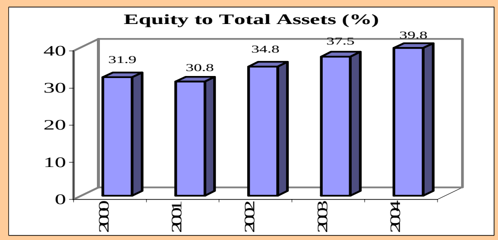


A significant fall in expenses therefore resulted in a substantial rise in profits before taxes (13.1 percent of total sales) against an average of 7.4 percent of total sales during the last four calendar years.

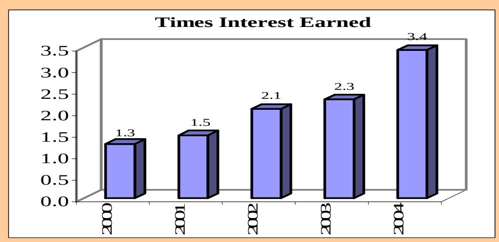
Financial leverage of top 20 borrowing groups registered remarkable changes in structural composition. Debt to equity ratio improved to 41:59 in 2004 from 53.5:46.5 in 2001. Furthermore, ratio of total borrowings to assets at 43.3 percent has been the lowest during the last five years while ratio of equity to total assets at 39.8 percent was the highest in the same period.

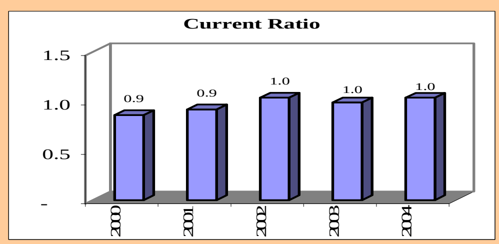


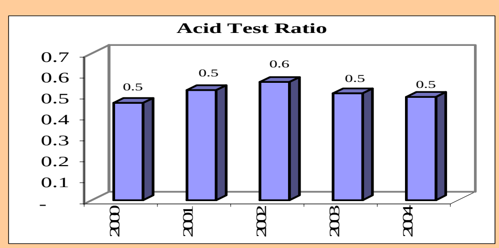




In spite of the lower interest rate environment, under-study top twenty borrowing groups have opted to fund their expansion plans out of shareholders equity, least utilizing the external sources of funds. There could be two reasons for this. Firstly, higher profitability as indicated by the ROA posting 7.1 percent in 2004, and the fact that under-study top twenty borrowing groups were efficiently using re-invested earnings to generate additional earnings, as evident from higher return on equity at 15.2 percent, thus generating a tendency of ploughing the profits back into the business. Top twenty borrowing groups therefore preferred equity rather than debt. Hence, the debt to equity ratio improved to 41:59 in 2004. Secondly, a tilt towards extending the scope of business as well as diversification of assets portfolio in consumer financing and SME sector etc has been witnessed on part of supply side of funds. Therefore, preferences regarding loans and advances changed, less in favour of corporate sector and more towards consumer financing due primarily to higher profitability involved, thus dragging down the debt to equity ratio.







The year 2004 witnessed further improvement in the creditworthiness of under-study business groups, amply signaled by the ratio of times interest earned (EBIT/interest) posting 3.4 times in 2004 against 2.3 times in 2003, lower interest rates as well as lesser amount of borrowing resulted in this remarkable development.

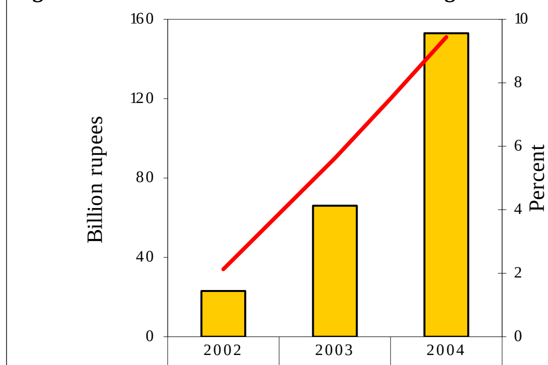
Liquidity position of top twenty borrowing groups gauged in terms of current ratio as well as acid test ratio remained flat in 2004. The current ratio (1:1) and acid test ratio (0.5:1) are in acceptable bands in the context of trading concerns but are on lower side for manufacturing concerns.

4 Household Sector

The year under review was very significant for the household[2] sector as it saw increasing access to financial services. The banks' growing interest in the household sector was underpinned by abundant liquidity as well as higher rate of return on financing to this sector. With the increasing number of banks willing to provide consumer financing and the credit culture for this type of financing still in its infancy, the fears about higher risk of defaults also started to crop up. These fears arose out of the possible highly leveraged balance sheets of households and the falling purchasing power as inflation started to assume serious proportions.

The level of debt[3] of the household sector has been increasing over the last few years. However, CY04, with a strong growth of 135 percent in consumer financing, witnessed more than two-fold rise in the total outstanding debt of household to the banking system (see **Figure 4.1**). Household debt to GDP ratio shown in **Figure 4.2** reflects the fact. Though the ratio has grown remarkably during the CY04, it still displays plenty of scope for lending to the household sector. This sharp increase came on the back of high demand for auto loans, which grew by 123 percent. The low interest rates with the competitive products offered by various institutions provided the stimulus for the high demand. The rise in auto lending also proved very favourable for the economy as the GDP growth received significant boost because of increased production by the automobile industry. Mortgage debt, which had been subdued in previous years increased about fourfold. The substantial rise in mortgage financing may be a noticeable paradigm shift for banks. Because of certain legal issues, banks were reluctant to engage in this type of financing. However, the policy-makers have remained focused on eliminating the irritants to encourage the banks to make even greater contribution to this vital segment of the economy.

Figure-4.1: Trends in Household Financing



	2002	2003	2004
HH Finance	22.6	65.6	152.6
%of Total Loans (RHS)	2.1	5.6	9.4

Figure-4.2: Household debt to GDP Ratio

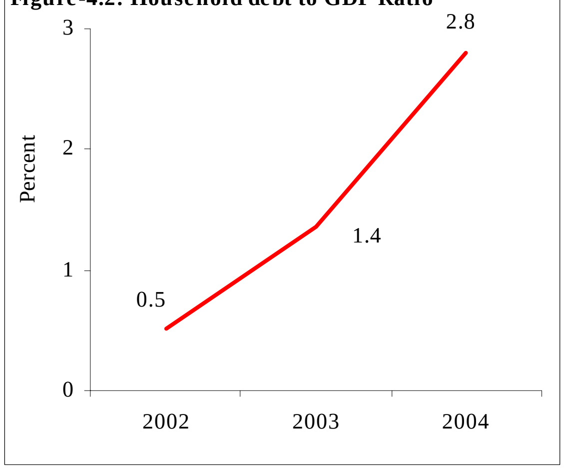
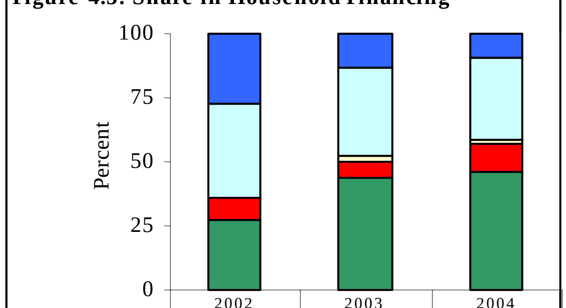


Figure-4.3: Share in Household Financing



	2002	2003	2004
Credit Cards	27.0	13.6	9.3
Auto Loans	36.9	33.9	32.5
Consumer Durable	-	2.4	1.1
Mortgage Loan	8.5	6.3	11.0
Personal Loans	27.7	43.8	46.2

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2 Means individuals

3 Formal debt from banks only

The recent lifting of ban on the maximum financing for mortgage lending would help further promote mortgage financing in the coming days. The share of consumer products reveals majority of loans concentrated in personal loans (see **Figure 4.3**). The personal loans exhibited strong growth during the year on account of the popularity of the personal loans scheme of a large bank. Recently, another large bank has also initiated a scheme for personal loans on almost similar lines.

As a consequence of its fast growth during the year, the share of consumer finance in the total loan portfolio of the banking system increased to 9.4 percent comparing with 2.1 percent in CY02 and 5.6 percent in CY03. The growing share of the household debt holds special significance for the financial stability of the system because of the benefits as well as risks involved. While the banking system would enjoy higher returns as well as diversification of its loans portfolio, any adverse shift in the households' repayment capacity might at the same time seriously undermine the financial soundness of the banking system. So far the incidence of NPLs has remained in comfortable zone and its systemic risk is marginal. The ratio of NPLs to total loans for consumer financing at 0.9 percent validates this argument. The reason for this low level of NPLs may be traced to low interest rate environment coupled with the banks' focus on customers in middle to higher income brackets whose debt servicing capacity is high. The anecdotal evidence further suggests that the household income and wealth have also strengthened over the last couple of years, which also contributed towards better debt servicing by them. Higher GDP growth as well as spike in asset values played an important role in increasing the households' income and wealth in this period. However, lending against inflated value of assets might backfire in case of fall in their value.

The banking system until recently has benefited greatly from the favourable macroeconomic environment with the low interest rate regime and has yet to go through full credit cycle of consumer financing. With the gradual increase in interest rates, the testing times seem to be approaching which will really test the effectiveness of the credit appraisal techniques employed in making consumer loans. The higher interest rates will not only lessen the attractiveness of consumer loans but would also pressurize the debt servicing capacities as most of the loans have floating rates.

The outlook for consumer financing hangs in balance and depends a great deal on the extent of rise in interest rates. Banks will have to continue upgrading their expertise in various consumer-financing products and also guard against any laxity in their credit appraisal techniques to keep the portfolio in healthy shape.

5 Financial Soundness of the Banking System

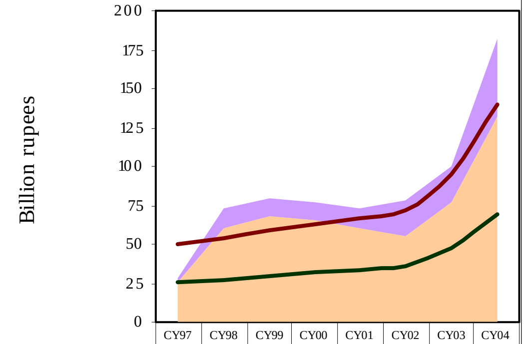
5.1 Solvency

The strong profitability and fresh capital injections, amidst the exceptional growth in asset base and introduction of capital charge for market risk, further fortified the solvency position of the banking system during the year under review. The fresh capital injections came as a result of the enhanced capital requirements by SBP[4], successful restructuring of one of the local private banks and the voluntary drive on the part of the banks to strengthen their capital base in order to grow in the increasingly competitive financial environment. With the introduction of capital charge for market risk, the banks' reliance on supplementary capital has also risen[5]. The issuance of subordinated term finance certificates and surplus on revaluation of shares led to increase in the supplementary capital. However, the share of supplementary capital in the overall qualifying capital is still low at 27.8 percent[6] (see **Figure 5.1.1**).

The required level of risk-based capital also registered considerable increase due to a surge in risk-weighted assets (RWA). The strong growth of credit to the private sector and the slow down in investment in government papers are some of the factors responsible for change in risk profile of banks. Resultantly, the ratio of RWA to total assets soared to 57.3 percent from 46.5 percent (see **Figure 5.1.2**).

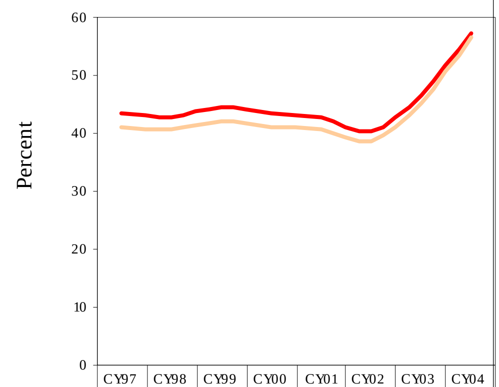
Nevertheless, the relatively stronger growth in the qualifying capital as compared to RWA led to improvement in the solvency indicators of the banking system (see **Figure 5.1.1**). The overall capital adequacy ratio of the banking system improved significantly to 10.5 percent from 8.5 percent in the previous year (see **Table 5.1.1**). Similarly, the other two indicators i.e. Tier I capital to RWA and balance sheet capital to total assets also improved over the last year.

Figure-5.1.1: Risk-based Capital Position



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
Supplementary Capital	2.9	11.8	12.1	11.3	12.0	23.5	23.3	50.8
Core Capital	25.4	60.7	67.8	65.1	60.5	55.2	77.0	131.7
Required Core	25.0	26.7	29.5	31.5	33.1	35.9	47.3	69.6
Required Total	50.0	53.4	58.9	63.1	66.2	71.8	94.7	139.3

Figure-5.1.2: RWA to Total Assets



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
All Banks	43.5	42.9	44.5	43.6	42.6	40.3	46.5	57.3
Comm. Banks	41.1	40.6	41.9	41.2	40.5	38.6	45.1	56.7

Table-5.1.1: Capital Adequacy Indicators

Percent	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
CAR								
PSCBs	-1.3	11.6	10.6	10.4	9.6	12.3	11.0	13.4
LPBs	11.9	11.4	10.7	9.2	9.5	9.7	9.0	10.1
FBs	14.6	15.6	18.6	18.0	18.6	23.2	23.0	17.4
CBs	6.0	12.5	12.2	11.4	11.3	12.6	11.1	11.4
SBs	-6.2	(1.4)	0.3	(3.3)	(13.9)	(31.7)	(28.2)	(9.0)
All banks	4.5	10.9	10.9	9.7	8.8	8.8	8.5	10.5
Tier 1 Capital to RWA								
PSCBs	-2.0	8.3	7.7	7.7	7.1	8.6	8.2	8.6
LPBs	11.4	10.2	9.3	8.1	8.4	6.6	7.1	7.5
FBs	14.4	15.4	18.4	17.9	18.6	23.0	23.0	17.1
CBs	5.5	10.5	10.3	9.8	9.7	9.7	9.1	8.6
SBs	-6.3	(1.6)	0.3	(3.4)	(13.9)	(31.7)	(28.7)	(15.0)
All banks	4.1	9.1	9.2	8.3	7.3	6.2	6.5	7.6
Capital to Total Assets								
PSCBs	0.3	4.9	3.8	4.6	3.7	5.6	6.1	8.2
LPBs	4.9	4.9	4.9	3.5	3.8	5.2	5.1	6.5
FBs	7.9	8.8	9.7	8.8	8.5	10.6	10.0	9.0
CBs	3.1	5.6	5.0	4.9	4.6	6.1	6.0	7.1
SBs	8.8	0.2	1.7	(1.1)	(10.3)	(23.0)	(9.5)	(11.3)
All banks	3.5	5.3	4.8	4.6	3.8	4.8	5.4	6.5

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[4] The banks have been required to raise their paid-up capital net of losses to Rs1.5 billion by Dec-04 and Rs2 billion by Dec-05.
[5] Includes both Tier II and Tier III capital.
[6] Supplementary capital (Tier II & III) can be maximum 50 percent of the overall capital.

The group-wise position shows that all the groups recorded improvement in their capital adequacy ratio except Foreign Banks (FBs) where growth in capital has not kept pace with the rise in their RWA. However, their ratio is still the highest among all the groups. Public Sector Commercial Banks (PSCBs) made the highest improvement in their capital adequacy ratio followed by Local Private Banks (LPBs).

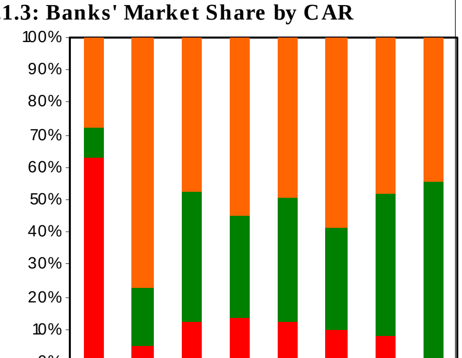
The financial soundness of the five largest banks, which represent more than 50 percent of the assets of the banking system, holds much significance for the solvency of the overall banking system. All the solvency indicators depict further improvement in the position of these banks. The overall capital adequacy ratio and tier I capital to RWA ratio of these banks rose to 10.9 percent and 7.3 percent from 8.7 percent and 6.1 percent respectively in the last year. The balance sheet capital to total assets ratio also went up to 7.3 percent from 6.1 percent. All the three indicators of these banks are well above the respective internationally acceptable benchmarks.

Table-5.1.2: Distribution of Banks by CAR

Nos.	Total	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
CY04	38	1	13	9	15

Due to increased focus on allocation of proper economic capital for their operations, the capital adequacy ratios of the banks started to show reduction in the dispersion. **Table 5.1.2** indicates that since CY02 banks have been trying to make-up for the shortfall in their risk capital to keep pace with the increase in risk profile. This view is also supported by a drop in the number of under capitalized banks from 4 to 1 and the number of banks holding excess capital from 21 to 15. The market share of under capitalized bank is now only less than one percent and virtually the whole banking system is now operating with *CAR* above the acceptable standard of 8 percent (see **Figure 5.1.3)**.

Figure-5.1.3: Banks' Market Share by CAR

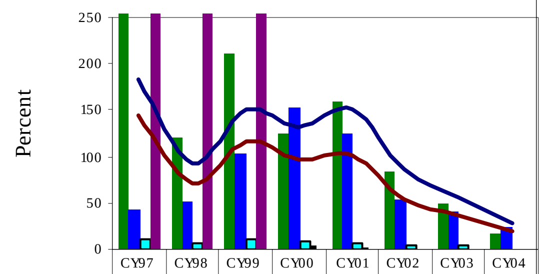


	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
10 percent and above	28.0	77.2	47.6	55.0	49.1	58.8	48.2	44.5
8 to 10 percent	8.7	17.8	40.0	31.6	38.7	31.1	43.8	55.1
Below 8 percent	63.3	5.0	12.4	13.4	12.2	10.1	8.0	0.4

The improved performance can also be gauged from the credit ratings of the banks (see **Box-5.1**). The latest available credit ratings of the banks reveal that out of the 43 banks/DFIs/MFBs, long-term ratings of 12 institutions improved, while 25 institutions maintained their previous ratings. Ratings of only 3 institutions have come down, where the reason for deterioration in two of them is mainly that the rating agencies have rated them on stand-alone basis discounting the Government guarantee. Better financial performance, good governance, increased emphasis on human resource development and enforcement of market discipline have resulted in improvement of corporate rating of almost all the financial institutions over the years.

For the last three years or so the banking system has not only been strengthening its capital base, but also reducing the level of threat to the capital from the incidence of NPLs. While the flow of non performing loans has largely been restricted, the banks continued to make provisions against the existing stock of NPLs. However, the recent surge in loans reflects an increase in risk appetite of the banking system. The banks must be cautioned, nevertheless, to institute proper risk management policies and frameworks before venturing into riskier propositions. It will not only ensure a stable growth pattern for the banks but the economy as a whole as well. The banking system, however, seems cognizant of the situation as is evident from the persistently falling net NPLs to capital ratios of different groups (see **Figure 5.1.4**).

Figure-5.1.4: Net NPLs to Capital



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	2,081.0	119.9	212.0	124.5	160.2	83.4	50.0	17.2
LPBs	43.3	51.4	103.5	153.5	125.2	54.8	40.5	24.1
FBs	10.0	7.1	9.9	9.0	5.8	4.7	3.3	(0.2)
SBs	380.0	11,139.0	1,502.3	-	-	-	-	-
CBs	143.6	72.1	117.4	96.7	100.7	54.2	37.5	19.2
All Banks	183.8	92.6	149.8	131.3	150.5	85.5	55.4	28.8

Box - 5.1

Credit Ratings of Banks / DFIs / MFBs

S. #	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								
1	First Women Bank Limited	PACRA	A2	BBB	Aug, 2002	A2	BBB+	Aug, 2003
2	National Bank of Pakistan	JCR-VIS	A-1+	AAA	April, 2003	A-1+	AAA	May, 2004
3	The Bank of Khyber	JCR-VIS	A-2	BBB	April, 2003	A-2	BBB	June, 2004
4	The Bank of Punjab	PACRA	A1	A	June, 2003	A1	A+	June, 2004
Local Private Banks								
5	Allied Bank Limited	JCR-VIS	A-1	A	Dec, 2004	A-1	A	May,2005
6	Habib Bank Limited	JCR-VIS	A-1+	AAA	April, 2003	A-1+	A+	April, 2004
7	Muslim Commercial Bank Limited	PACRA	A1+	AA	May, 2003	A1+	AA	June, 2004
8	United Bank Limited	JCR-VIS	A-1	A	June, 2003	A-1+	A+	June, 2004
9	Askari Commercial Bank Limited	PACRA	A1+	AA	June, 2003	A1+	AA+	June, 2004
10	Bank Alfalah Limited	PACRA	A1+	AA-	June,2003	A1+	AA	June, 2004
11	Bank Al-Habib Limited	PACRA	A1+	AA	June, 2003	A1+	AA	June, 2004
12	Bolan Bank Limited	JCR-VIS	A-3	BB+	June, 2004	A-2	BBB	Feb, 2005
13	CresBank	JCR-VIS	A-2	BBB+	Dec, 2003	A-2	BBB+	June, 2004
14	Faysal Bank Limited	JCR-VIS	A-1	AA-	Feb, 2003	A -1	AA	Feb, 2004
15	KASB Bank Ltd.	JCR-VIS, PACRA	A-3	BB+	April, 2003	A2	BBB+	April, 2004
16	Metropolitan Bank Limited	PACRA	A1+	AA+	June, 2003	A1+	AA+	June, 2004
17	Meezan Bank Limited	JCR-VIS	A-1+	A+	Jan, 2003	A-1+	A+	June, 2004
18	NIB (NDLC-IFIC Bank) Ltd.	PACRA	N/A	N/A	N/A	A2	A-	July, 2004
19	PICIC Commercial Bank Limited	JCR-VIS	A-1	A	Feb, 2003	A-1	A+	June, 2004
20	Prime Commercial Bank Limited	PACRA	A1	A	June, 2003	A1	A+	June, 2004
21	Saudi Pak Commercial Bank Ltd.	PACRA	N/A	N/A	N/A	A3	BBB	June, 2004
22	SME Bank Ltd.	JCR-VIS	A-3	BB+	June, 2004	A-2	BBB	March,2005
23	Soneri Bank Limited	PACRA	A1+	AA-	June,2004	A1+	AA-	March,2005
24	Union Bank Limited	PACRA,	A-1	A+	June, 2003	A-1	A+	June, 2004
Foreign Banks								
25	ABN-AMRO Bank	Standard & Poor's	A-1+	AA-	July, 2003	A-1+	AA-	April, 2004
		Moody's	P-1	Aa3		P-1	Aa3	
		Fitch-IBCA	F1+	AA-		F1+	AA-	
26	Al-Baraka Islamic Bank	PACRA	A1	A	June, 2003	A1	A-	June, 2004
27	American Express Bank	Standard & Poor's	N/A	N/A	June, 2003	A-1	A+	June, 2004
		Moody's	P1	A2		P-1	A2	
		Fitch-IBCA	F1	A-		F-1	A+	
28	Bank of Tokyo-Mitsubishi Limited	Standard & Poor's	A-2	BBB+	April, 2003	A-2	A-	June, 2004
		Moody's	P-1	A2		P-1	A2	
		Fitch IBCA	F1	A-		F1	A-	
29	Citibank N.A.	Standard & Poor's	A-1+	AA	May, 2003	A-1+	AA	April, 2004
		Moody's	P-1	Aa1		P-1	Aa1	
		Fitch IBCA	F1+	AA+		F1+	AA+	
30	Deutsche Bank AG	Standard & Poor's	A-1+	AA-	April, 2004	A-1+	AA-	Sep, 2004
		Moody's	nil	nil		nil	nil	
31	Habib Bank AG Zurich	JCR-VIS	A-1+	AA+	April, 2003	A-1+	AA+	June, 2004
32	Hong-Kong Shanghai Banking Corp. (Non HK$)	Standard & Poor's	nil	A+	Jan, 2003	nil	A+	March, 2004
		Moody's	A1	Aa3		A1	Aa3	
		Fitch-IBCA	nil	AA-		nil	AA-	
33	Oman International Bank	JCR-VIS	A-2	BBB	April, 2003	A-2	BBB	June, 2004
34	Standard Chartered	Standard & Poor's	A-1	A	July, 2003	A-1	A	July, 2004
		Moody's	P-1	A2		P-1	A2	
		Fitch-IBCA	F1	A+		F1	A+	
Specialized Banks								
35	Punjab Provincial Cooperative Bank	JCR-VIS	A-3	BB+	June, 2003	A-3	BB+	Feb, 2004
36	Zarai Taraqiati Bank Ltd.	PACRA	A-1+	AAA	April, 2004	A2	BBB+	April, 2005
Development Finance Institutions								
37	Pak Kuwait Investment Co. (Pvt.) Ltd.	PACRA	A1+	AAA	Nov, 2003	A1+	AAA	June, 2004
		JCR-VIS	A-1+	AAA	June, 2004	A-1+	AAA	May, 2005
38	Pak Libya Holding Company	PACRA	A-1+	AA-	Sept, 2003	A1+	AA-	June, 2004
39	Pak-Oman Investment Company	JCR-VIS	A-1+	AA+	June, 2003	A-1+	AA+	June, 2004
40	Pakistan Industrial Credit & Investment Corp.	PACRA	A1+	AA-	Nov, 2003	A1+	AA	June, 2004
41	Saudi Pak Industrial & Agricultural Inv. Co.	JCR-VIS	A-1+	AA+	April, 2004	A-1+	AA+	April, 2005
42	Investment Corporation of Pakistan	PACRA	A1+	Nil	March, 2004	A1+	AA	March, 2005
Microfinance Banks								
43	The First Microfinance Bank Ltd.	JCR-VIS	A-1+	A+	Sept, 2003	A-1+	A+	June, 2004

5.2 Profitability

For the third consecutive year, the banking system earned strong profits as the increase in economic activity gave significant boost to the demand for bank credit and fee earning services. The net profit of the banking system surged to Rs32.9 billion from Rs25.1 billion in the previous year (see **Table 5.2.1**). Besides increased business volume, the major contributing factors for this improvement were the favourable change in assets and funding-mix and decreasing incidence of NPLs and tax charges.

As the increase in profitability was mainly volume-driven and capital base of the banking system also registered significant growth, the return on assets and equity at 1.2 percent and 19.5 percent respectively remained almost at the previous year's level (see **Table 5.2.2**). However, the composition of income underwent significant improvement over the last year and the strength of overall profit and loss account registered marked improvement; net interest income sufficiently covering the total operating expense and provision charges (see **Figures 5.2.1 & 2**).

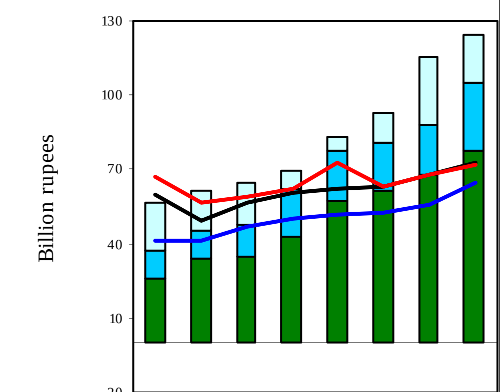
Table-5.2.1: Profitability of Banking System

(Billion Rs)	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
Profit before tax								
PSCBs	(22.9)	(3.0)	(3.3)	3.9	0.2	10.9	16.1	14.3
LPBs	4.9	3.3	3.9	(0.6)	5.0	11.9	23.8	30.7
FBs	7.4	4.6	4.6	3.7	5.0	6.6	7.4	7.2
CBs	(10.6)	4.9	5.2	7.0	10.3	29.4	47.4	52.1
SBs	(0.2)	(9.2)	1.8	(2.5)	(9.2)	(10.4)	(3.3)	(2.6)
All Banks	(10.8)	(4.2)	7.0	4.5	1.1	19.0	44.1	49.6
Profit after tax								
PSCBs	(21.4)	4.9	(8.3)	1.8	(4.6)	4.8	9.4	8.0
LPBs	1.8	1.4	1.7	(3.5)	2.0	6.4	14.8	21.7
FBs	3.4	1.1	1.7	1.4	2.4	4.2	4.6	5.8
CBs	(16.2)	7.4	(4.9)	(0.2)	(0.2)	15.3	28.7	35.5
SBs	(0.2)	(9.2)	1.8	(2.6)	(9.5)	(12.4)	(3.7)	(2.6)
All Banks	(16.4)	(1.8)	(3.1)	(2.8)	(9.8)	2.9	25.1	32.9

Table-5.2.2: Profitability Indicators

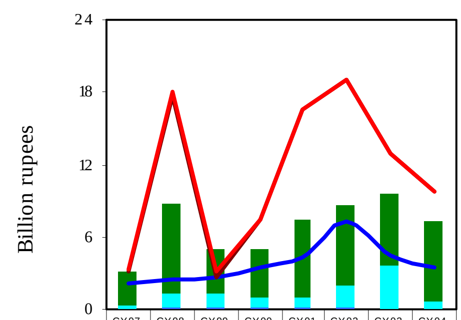
(Percent)	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
After Tax ROA								
PSCBs	-3.1	0.7	-1.0	0.2	-0.5	0.6	1.0	1.3
LPBs	0.5	0.4	0.4	-0.7	0.4	0.8	1.4	1.2
FBs	1.4	0.4	0.7	0.6	0.8	1.5	1.5	2.0
CBs	-1.3	0.5	-0.3	-0.01	-0.01	0.8	1.2	1.3
SBs	-0.2	-9.4	1.7	-2.3	-8.8	-12.1	-3.2	-2.6
All Banks	-1.2	-0.1	-0.2	-0.2	-0.5	0.1	1.1	1.2
After Tax ROE *(based on Equity plus Surplus on Revaluation)*								
PSCBs	-255.0	24.0	-24.0	4.9	-12.2	11.5	17.3	18.0
LPBs	10.9	7.3	8.1	-17.4	10.3	17.3	26.2	20.1
FBs	17.2	5.1	7.1	6.1	9.1	15.2	14.9	21.7
CBs	-36.2	12.0	-6.2	-0.3	-0.3	14.3	20.5	19.8
SBs	-2.0	-211.6	179.1	-	-	-	-	-
All Banks	-30.7	-2.7	-3.9	-3.5	-12.6	3.2	20.5	19.5

Figure-5.2.1: CBs P&L Composition



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
Other Non-Int. Inc.	19.4	16.2	16.8	7.3	5.2	11.8	27.6	19.0
Fee-based & currency dealing Inc.	11.0	11.1	12.6	19.7	20.6	19.7	19.7	27.6
Net Int. Inc.	26.3	34.2	35.0	42.6	57.2	61.4	68.1	77.7
All exp. + Extraordinary charges	67.3	56.5	59.2	62.6	72.8	63.4	68.0	72.2
Op. Exp. + Prov.	59.6	49.6	56.4	60.5	62.5	62.8	67.8	72.7
Op. Exp.	40.9	41.3	46.7	49.8	52.0	52.7	56.2	64.4

Figure-5.2.2: Specialized Banks' P&L Composition



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
Net Int. Inc.	2.8	7.5	3.6	3.9	6.4	6.8	6.0	6.6
Other Non-Int. Inc.	0.3	1.1	1.2	0.9	0.7	1.7	3.6	0.6
Fee-based & currency Dealing Inc.	0.1	0.2	0.2	0.2	0.2	0.2	0.0	0.0
All exp. + Extraordinary charges	3.3	18.0	3.1	7.5	16.6	19.1	13.0	9.8
Operating Exp. + Provision	3.2	17.6	2.7	7.5	16.6	19.1	13.0	9.8
Operating Expenses	2.2	2.5	2.6	3.5	4.4	7.3	4.5	3.5

The year 2004 is marked with strong growth in lending. This growth was more pronounced in the latter months and was accompanied by shift in the asset mix away from investment as well. The lending rates in the earlier part of the year followed a stable-to-declining trend and on average stayed lower than in 2003. They started to follow the rising government papers' return only in the most recent months. The dampening impact of lower rates however was compensated by volume expansion (see **Table 5.2.3**). Total interest income grew by 5 percent which is quite passive as compared to growth and enrichment of earning assets. This passive growth in income was compensated by decline in interest expenses by 11 percent as the return on deposits more or less followed the trend in returns on loans and remained lower than in previous year. Besides, deposits mix underwent a significant shift away from remunerative to non-remunerative deposits. The cumulative effect of changes in interest income and expense resulted in 14 percent increase in net interest income; **Table-5.2.4** gives a brief of the sources of this increase. These developments are also reflected in interest rate spread and Net Interest Margin; both indicators came down slightly (**see Figure 5.2.3**).

Net interest income growth was accompanied by decline in non-interest incomes which declined by 7 percent and contributed 36 percent of gross income (40.8 percent in 2003). This decline, however, resulted from squeeze in one-off trading gains while all other core income components showed significant improvement, adding strength to the quality of income. Last year's declining interest rates scenario and the industry's general strategy to invest in fixed rate government securities for reaping capital gains yielded heavy trading incomes contributing 15.8 percent of gross income. This year increasing trend in returns on government papers reversed the pattern and capital gains remained low – 6.9 percent of system's gross income and 18.4 percent of pre tax profit. This is well reflected in **Figure 5.2.4** that shows composition of commercial banks gross income.

Fee based incomes with the year-on-year growth of 42.6 percent showed the most significant improvement. This growth was in tandem with the increased business activity in the economy. The increased foreign trade had the ameliorating effect on the currency dealing income which surged by 33.1 percent, even though increased competition in the market kept pressure on exchange rate bid-ask spread. On the back of improved economic conditions for the last three years or so, corporate sector is posting strong operating results; accordingly banks' equity investments are fetching increasing dividend income. This year dividend income rose by 7.5 percent, making up 3.2 percent of gross income.

Table-5.2.3: Sources of Change in Interest Income on Loans

(Billion Rs)	Interest Income in Last Year	Change Due to Rate Variation	Change Due to Volume	Interest Income for the Year
CY01	81.5	8.0	6.5	96.0
CY02	96.0	(10.7)	1.8	87.1
CY03	87.1	(29.5)	9.3	66.9
CY04	66.9	(10.0)	21.6	78.5

Table-5.2.4: Sources of Change in Net Interest Income (NII)

(Billion Rs)	NII in Last Year	Interest Income Rate Variance	Interest Income Volume Variance	Interest Expense Rate Variance	Interest Expense Volume Variance	NII for the Year
CY01	46.5	(10.2)	27.0	9.1	(8.7)	63.7
CY02	63.7	(40.8)	23.2	34.3	(12.2)	68.1
CY03	68.1	(61.4)	29.5	50.2	(12.3)	74.2
CY04	74.2	(16.1)	21.8	12.7	(8.2)	84.3

Figure-5.2.3: Interest Rate Spread NIM

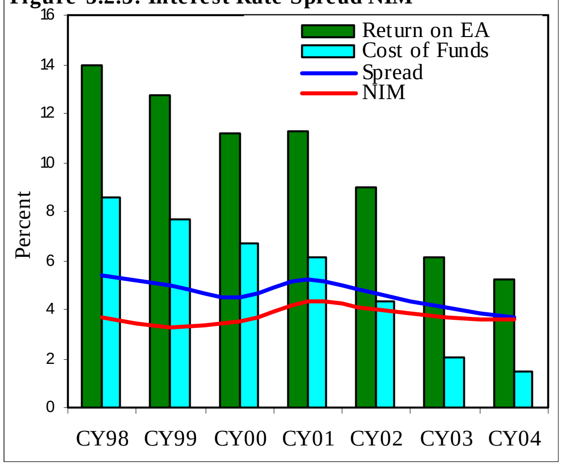
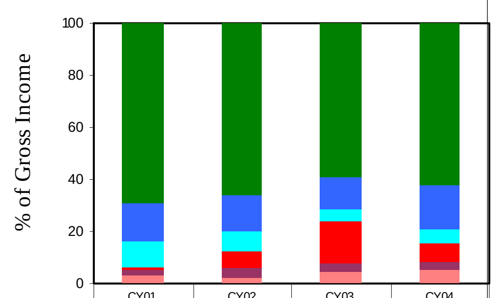


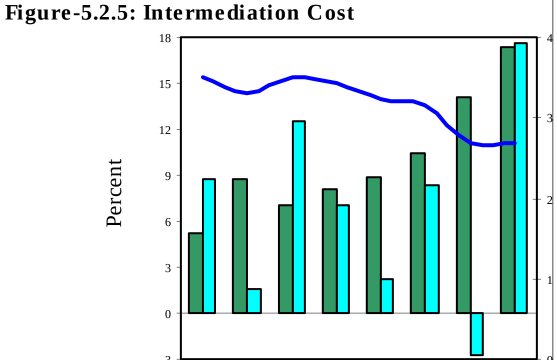
Figure-5.2.4: Sources of CBs Gross Income



	CY01	CY02	CY03	CY04
Net Interest Income	68.9	66.1	59.0	62.5
Fee Based Income	14.6	14.2	12.7	16.8
Currency Dealing Income	10.2	7.0	4.3	5.4
Gain on Sale of Securities	0.7	6.2	16.4	6.5
Dividend Income	2.3	4.4	3.4	3.4
Other Income	3.3	2.1	4.2	5.4

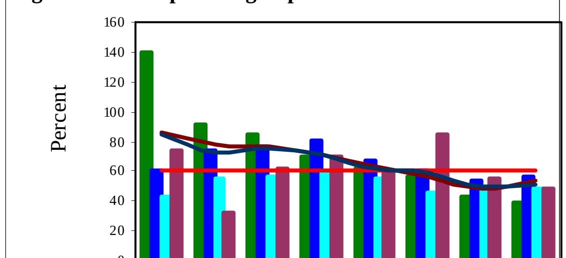
Banks, especially the medium sized local private banks, are following expansionary policy. While this policy has significantly boosted earnings, this has also burdened their administrative cost bill. Non-interest expenses which grew at a passive rate during last year mainly due to controlled growth in large banks, registered a growth of 8.2 percent this year. This growth was even more pronounced in the case of commercial banks i.e. 14.6 percent, as one of the large banks recorded exceptional increase. Since this growth in operating expenses was accompanied by even stronger expansion in earnings and fund base, the efficiency indicators of cost income ratio and intermediation costs remained more or less stable at 51.6 percent (vis-à-vis acceptable benchmark of 60 percent) and 2.7 percent respectively. On the cost income ratio (operating expense to gross income) all the sub sectors of the system were well within acceptable level of 60 percent (see **Figures 5.2.5 & 5.2.6**).

Figure-5.2.5: Intermediation Cost



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
Growth in Avg. Funds	5.2	8.8	7.1	8.1	8.8	10.4	14.1	17.4
Growth in Admin. Exp.	8.8	1.5	12.5	7.1	2.3	8.4	-2.8	17.6
Intermediation Cost (RHS)	3.5	3.3	3.5	3.4	3.2	3.2	2.7	2.7

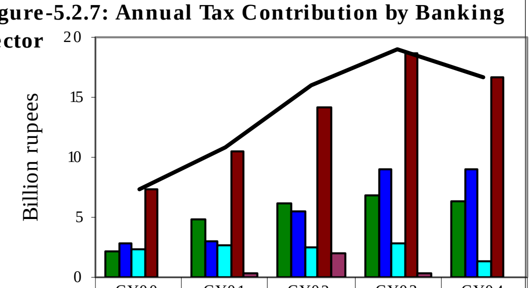
Figure-5.2.6: Operating Exp. to Gross Income



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	140.0	92.1	84.7	70.1	62.3	56.9	42.8	39.4
LPBs	60.9	73.8	76.6	80.9	67.3	60.0	53.2	56.3
FBs	43.6	55.5	57.0	59.4	54.5	45.4	48.3	49.0
SBs	74.6	32.2	62.2	70.5	59.0	84.7	55.6	47.9
Bench Mark	60.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0
CBs	85.8	78.5	76.9	71.6	62.7	56.7	48.6	53.6
All	85.2	72.7	75.8	71.6	62.4	59.1	49.1	51.6

Banking system has been showing significant improvement in asset quality for quite sometime. It has been successful not only in stemming infection but its efforts to reduce the level of NPLs have brought encouraging results. These developments are also having ameliorating effects on the banks' profitability; provision charges for infected assets having followed a declining trend; this year these charges further reduced by 18.9 percent and took up 11.1 percent of gross income (14.5 percent in 2003).

Figure-5.2.7: Annual Tax Contribution by Banking Sector

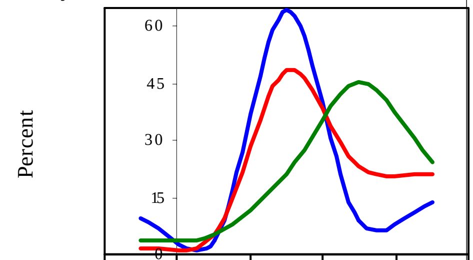


	CY00	CY01	CY02	CY03	CY04
PSCBs	2.2	4.8	6.1	6.8	6.3
LPBs	2.8	3.0	5.5	9.0	9.0
FBs	2.3	2.7	2.5	2.9	1.4
CBs	7.3	10.5	14.1	18.7	16.7
SBs	0.1	0.3	1.9	0.4	0.0
All	7.3	10.8	16.1	19.0	16.7

The banking system has remained subject to the tax rate even higher than corporate tax rate. These higher rates were working as a negative incentive to investment for improvement and innovation. Realizing this anomaly, the government initiated a policy to rationalize the tax rates for banks in a phased manner. The rates are being reduced 3 percent each year and are planned to reach the rates for non-bank corporates by 2007. Influenced by the lower tax rates there has been significant investment going on in the sector for instituting new technologies to enhance scope of services and improving efficiencies. Besides, the reduced tax rates have significantly added to the solvency of the banking system by increasing the amount of retained earnings, while at the same time tax contribution by the industry since 2000 has more than doubled (see **Figure 5.2.7**). This year with the further slashing of tax rate, the tax charges for the industry as percent of pre-tax profit came down to 33.6 percent from 43.2 percent in last year, (ratio for in-the-profit banks comes to 31.9 percent in 2004, 39.5 percent in 2003).

As the banking system on aggregate basis improved its profitability, this strengthening was widely shared among the individual banks also. The frequency distribution of banks and their total assets as shown in the **Figure 5.2.8** indicates this development. An overall movement towards the right i.e. higher ROA brackets shows the overall improvement in individual banks performance.

Figure-5.2.8: %age Breakdown of Banking System's Total Assets by ROA



	O and below	0 to 0.5	0.5 to 1	1.0 to 1.5	1.5 and Over
No. of Banks CY02	6	4	12	6	12
No. of Banks CY03	7	4	5	9	15
No. of Banks CY04	6	2	11	12	7
CY02 (%)	9.6	3.6	64.4	9.0	13.5
CY03 (%)	1.7	5.5	48.7	23	21.1
CY04 (%)	3.9	5.2	21.3	45.3	24.3

Outlook

The economic outlook for the coming year is likely to remain positive. The expansion of bank credit, though, in the face of current rising interest rate scenario and SBP's monetary stance to curb the rising inflation trend, may not be able to maintain its current steam. The banking sector has already achieved a loan-dominated, high-return asset mix that would significantly invigorate the interest income in the coming months. The enlivened economic activity is likely to keep the demand for banks' fee earning services high and the maturing of secondary market for securities would maintain the level of trading gains. On the cost side, the system has so far been able to pass on the effects of declining returns by paying even sub-inflationary returns on deposits. This phenomenon is not very promising both for the system and the economy at large. In the coming days, the system may have to face the pressure to revisit its current strategy. Another even more significant factor that could put drain on earnings is any deterioration in the assets quality. The system has witnessed exceptional growth in the lending portfolio. Though banks have significantly improved their controls and procedures over the last few years, the need for an ever vigilant monitoring of the portfolio remains. Besides, a pro-active building up of reserves for losses in this benign period would be advisable to counter any cyclical pattern in the economic activity.

5.3 Prudential Stability of the Recent Increase in Banks' Profits

The Pakistani banks have posted strong profits and their returns during the last couple of years have surpassed most of the other sectors of the economy. This exceptional increase in ROE and the fact that this improvement could originate from sources other than improvement in efficiencies (i.e. by adopting less prudent funding policy) warrant a further dissection of the improvement in returns. The forthcoming paragraphs discuss the two possible sources of change in ROE, i.e.:

1. Operating Efficiency, and
2. Policy on the funding structure

A brief of this framework is given in **Box – 5.2**.

Box - 5.2

Sources of Change in Return on Equity

The two broad sources of change in ROE viz. operating efficiency and policy as to the funding structure are further broken into the three components each. The following three indicators analyze the banks' operating performance. A rise in these indicators generally contributes towards the improvement in ROE and their rise is considered a healthy sign.

Net Margin (Profit After tax to Operating Profit before Provision): This measures the performance of banks on maintaining their margins. An improvement in ROE through the increase in the margin is a health sign. However, the contributions of the credit risk, extraordinary charges, and tax provisions require further analysis.

Operating Efficiency (Operating Profit before Provision to Gross Income): This measures the operating efficiency of the banks in containing the costs and directly complements the cost income ratio.

Productivity of the Risk-Adjusted Assets (Gross Income to Risk Weighted Assets): This measures the value added by the banks. A rise in the ratio is a healthy sign.

Banks can improve their ROE by adopting a less prudent policy as to their funding structure deteriorating the financial stability i.e. by adopting funding policy that compromises quality and quantity of equity and resorts to excessive risk taking. In this regard, the following three indicators have been identified to measure any shift in their funding structure. A rise in these indicators generally contributes directly towards the improvements in return, but damages the financial stability.

Risk Profile of Assets (RWA to Total Assets): Banks can improve their returns by simply taking on more risky stance in their assets profiling. The ratio measures the risk appetite of banks, and an increase shows a rise in the appetite.

Leverage (Assets to Total Regulatory Capital): This ratio measures the degree of banks' dependence on third party funds for carrying on business. A higher ratio acts counter to the financial stability and generally further spurs the risk appetite.

Quality of the Regulatory Capital (Total Regulatory Capital to Equity): The ratio indicates the banks policy towards meeting the regulatory capital requirements through equity or core capital vis-à-vis non-core capital i.e. hybrid instruments, subordinated loans, and revaluation surpluses. An increase in the ratio indicates deterioration in financial structure.

This entire framework can be summed up in the following equation:

$$ROE = \frac{PAT}{OP} X \frac{OP}{GI} X \frac{GI}{RWA} X \frac{RWA}{Assets} X \frac{Assets}{TRC} X \frac{TRC}{Equity}$$

PAT = Profit after Tax
OP= Operating Profit before Provision
GI = Gross Income
RWA = Risk Weighted Assets
TRC = Total Regulatory Capital

The ROE of Pakistani commercial banks has improved from negative in CY01 to 19.8 percent in CY04. A further analysis of the causes of this improvement shows an encouraging trend. For simplicity, the different constituents of ROE have been analyzed by basing them on CY02 levels.

Operating Efficiency

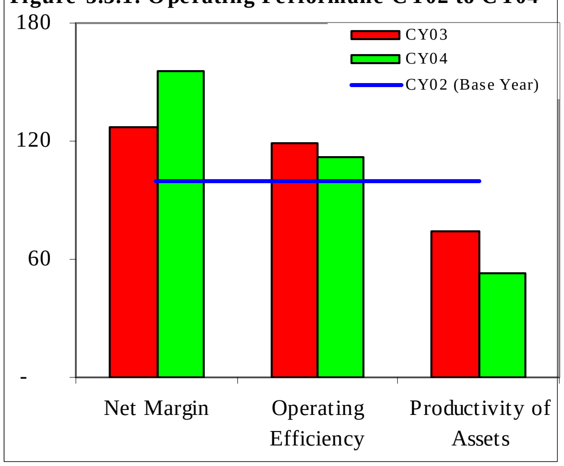
Net Margin: The margin has shown the most significant improvement over the past couple of years. Based on CY02 level, it has risen by more than 50 percent by CY04. A further dissection of the margin for its contributing factors shows that this improvement is largely contributed by the reduction in provision and tax charges and marginally through extra-ordinary gains.

Operating Efficiency: The operating efficiency also shows signs of improvement though this improvement is not as pronounced as that in net margin. The operating efficiency based on CY02's scale of hundred rose to 119 in CY03 as the commercial banks were quite successful in containing the operating expenses and at the same time improving the revenues. But in CY04, as the growth in revenues, mainly due to stabilization of trading gains, was less strong and the operating expenses grew at faster pace, the index fell back to 111.

Productivity of Assets: The productivity of the assets has come under most significant strain exerting a dampening impact on ROE. Based on the index of 100 in CY02 the indicator slid down to 74 in CY03 and still lower to 53 by CY04. However, this decline in productivity needs to be put in the right perspective. Since CY02 assets base of Pakistani banks has shown the phenomenal growth while the returns on them were touching the historical lows, thus underlying not only the growth in banks' earnings but also the turn around in the economy.

Figure 5.3.1 describes the developments in the factors relating to operating performance.

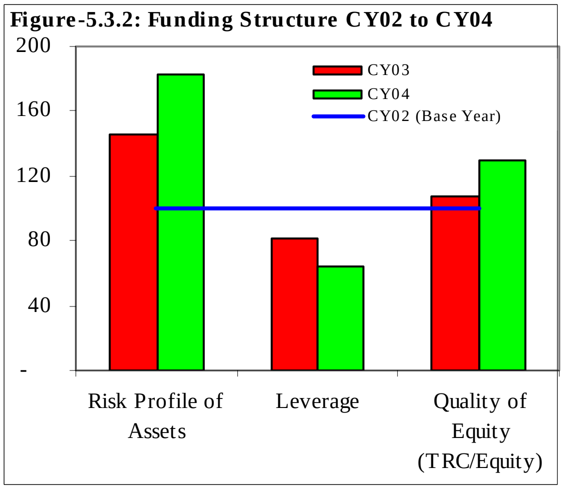
Figure-5.3.1: Operating Performane CY02 to CY04



Funding Structure Policy

Risk Profile of Assets: Since CY02, when the banks' asset base was excessively skewed towards the risk free investment in government papers and the system was pursuing overly conservative policy, the risk profile of the banks has increased significantly. This rise in risk profile has contributed positively towards the improvement in ROE. The index numbers shows the increase from CY02 base of 100 to 183 in CY04 (see **Figure 5.3.2**).

Figure-5.3.2: Funding Structure CY02 to CY04



Leverage: The banking system has significantly reduced the leverage over the last couple of years as the index number fell to 64 by CY04 (see **Figure 5.3.2**). This reduction has come on the back of improved profitability and the drive on the part of the banks to increase their equity base so as to support their increased business activity. This was further augmented by SBP's policy to enhance the MCR. While this reduction in leverage has dampened the ROE, this bodes well for the overall solvency of the system.

Quality of Capital: The quality of capital shows deterioration though contributing positively towards the ROE. Since CY02, the banks' dependence on non-core capital has increased moderately; the index number has risen to 129 by CY04 from CY02's base of 100 (see **Figure 5.3.2**). While some banks started to make increased use of TFCs for meeting the capital requirements in a rapidly growing business scenario, this phenomenon has also to do with the banks' initiative to generate long term funds to match the long term investments. Even the core capital to RWA ratio for the commercial banks remains well above the overall benchmark of 8 percent.

Figure-5.3.3: Contribution to Changes in ROE CY02 to CY04

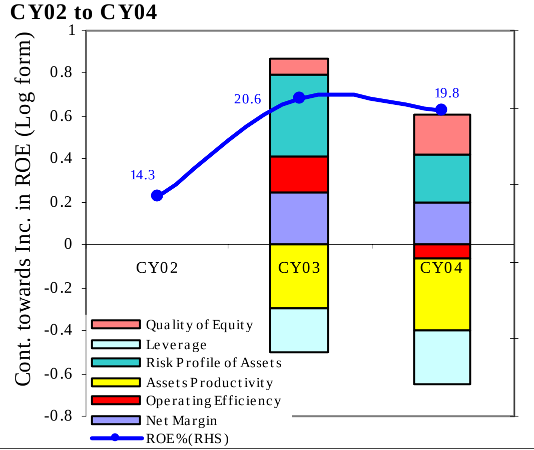


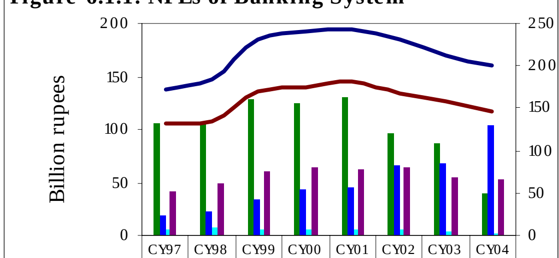
Figure 5.3.3 summarizes the above discussion and gives a brief of the contribution by each identified factor towards year-on-year improvement in ROE. The main contributions towards the improvements have been improvement in margin (especially the reduction in tax and credit risk charges) and the increased risk profile. This latter development generally signifies a deterioration that could potentially impair the financial stability. But in Pakistani context this development has its own peculiar perspective. It signifies the revival of the lending based conventional banking that was substantially subdued a couple of years back. On the other hand contribution due to deterioration in quality of equity, increased dependence on non-core capital, is not a healthy sign. This deterioration, however, is more than compensated by the reduced leverage and increased support of owners' own funds that, though put squeezing impact on the ROE, has positive impact on the financial stability. This dampens the issue of moral hazard of excessive risk taking and provide increased cushion to absorb business losses, thus adding to the depositors' confidence. Another factor that contracted the ROE has been the decline in the assets' productivity. The system has faced one of the historically low returns on earning assets. These low returns have remained instrumental in the expansion of banks' base of earning assets, thus contributing towards higher profits and eventually improved solvency. Besides, they played a critical role in recent upturn in the economic activity that will benefit the industry as well as the society in coming years.

6 Risk Assessment of Banking System

6.1 Credit Risk

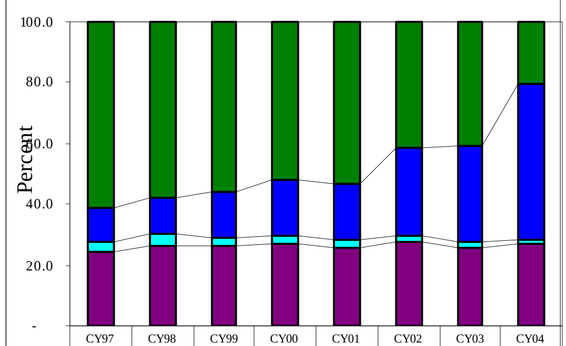
The financial reforms aimed at financial stability during the last decade have started bearing fruit, especially in the last three years. The most important measure of the system's credit risk is the burden of NPLs, which was continuously increasing up till 2002, but from then onward, due to various steps taken by SBP as well as banks, the stock of NPLs has been consistently declining. The year 2004 was also a period of robust economic activity backed by very impressive and broad-based growth of 38.3 percent in advances. However, in the rising interest rate scenario, it holds special connotations for the banking system's credit risk because the ability of borrowers, especially that of consumer sector, to repay may be greatly impaired.

Figure-6.1.1: NPLs of Banking System



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	106	106	129	125	130	96	86	40
LPBs	19	22	35	43	46	67	67	103
FBs	6	7	7	7	6	5	4	3
SBs	42	49	61	65	63	64	54	54
CBs(RHS)	131	134	170	175	181	168	157	146
All(RHS)	173	183	231	240	244	232	211	200

Figure-6.1.2: Group-wise Share in NPLs



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	61.4	57.8	55.7	52.1	53.1	41.3	40.6	20.1
LPBs	10.7	12.0	15.1	18.1	18.7	28.9	31.9	51.8
FBs	3.6	3.6	2.9	2.7	2.5	2.2	1.9	1.3
SBs	24.3	26.6	26.3	27.1	25.7	27.6	25.6	26.9

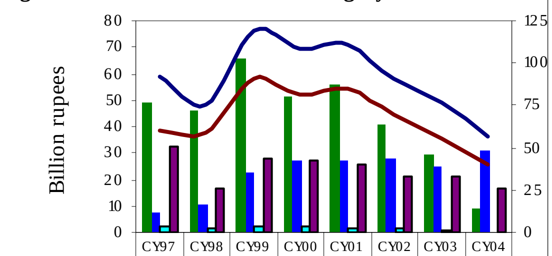
During the year under review, the NPLs of the banking system declined by around Rs11 billion or 5 percent (see **Figure 6.1.1**). The major reasons for the declining trend in the NPLs are the privatization of banks and improved market discipline, which have stemmed the flow of fresh NPLs as credit decisions are now based primarily on commercial considerations. Besides, focused recovery drives, promulgation of recovery laws and establishment of Corporate and Industrial Restructuring Corporation (CIRC) etc have also played important role in addressing the issue of NPLs. All the groups within the banking system experienced a reduction in the NPLs over the last year, ignoring the effect of category shift of HBL from PSCBs to LPBs. However, on its privatization, the shift of HBL to local private banks has changed the respective share of PSCBs and LPBs in the NPLs of the banking system (see **Figure 6.1.2**).

To gauge the level of credit risk of the banking system, net NPLs is a more appropriate indicator. Over the last few years, the net NPLs have been consistently declining in the wake of decreasing gross NPLs and there has been more emphasis on increasing the quantum of provision against NPLs. In 2004, the net NPLs of the banking system decreased by Rs19 billion or 25 percent. PSCBs[7] and LPBs[8] managed to reduce their net NPLs by Rs9 billion and Rs5 billion respectively, whereas FBs brought down their net NPLs to zero (see **Figure 6.1.3**). The NPLs coverage ratio has also significantly improved in the period under review. From just 47 percent

[7] Including HBL
[8] Excluding HBL

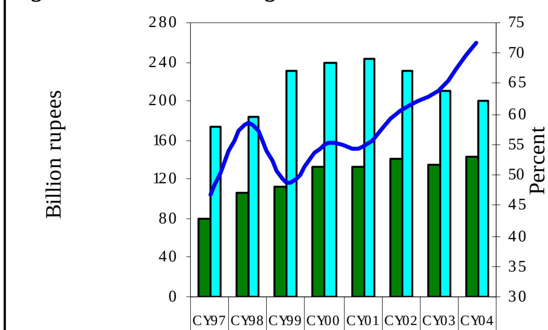
in CY97, it has now reached 72 percent as of end of CY04 and the remaining 28 percent are covered by collaterals held by banks (see **Figure 6.1.4**). The new Prudential Regulations (PRs) have prescribed accelerating discounting factors to be applied on collaterals in each coming period, resulting in more provisioning requirement and hence, the ratio of provision to NPLs is expected to improve further.

Figure-6.1.3: Net NPLs of Banking System



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	49	46	66	51	56	41	29	9
LPBs	8	10	23	27	27	28	25	31
FBs	2	2	2	2	2	1	1	0
SBs	32	17	28	27	26	21	21	17
CBs(RHS)	60	59	91	81	85	70	55	40
All (RHS)	92	76	119	108	111	91	76	57

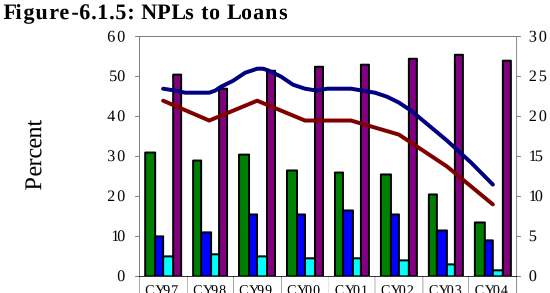
Figure-6.1.4: Provision against NPLs



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
Provision	81	107	112	132	134	140	135	143
NPLs	173	183	231	240	244	232	211	200
Provision to NPLs (RHS)	46.6	58.6	48.6	55.0	54.7	60.6	63.9	71.6

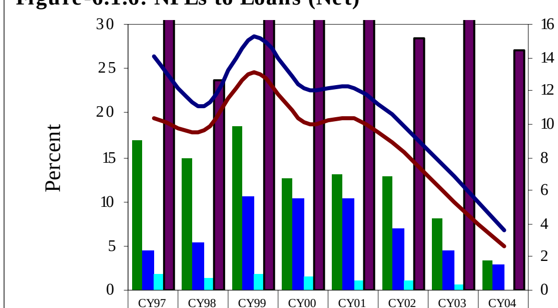
The reduction in NPLs coupled with substantial growth in advances led to marked improvement in the key indicators like NPLs to loans and net NPLs to net loans. Overall, the NPLs to gross loans ratio improved to 11.6 percent from 17.0 percent in the last year (see **Figure 6.1.5**). The ratio of net NPLs to net loans has also improved appreciably from 6.9 percent to 3.6 percent (see **Figure 6.1.6**). These ratios for commercial banks give even better picture. LPBs and FBs were the major contributors for this improvement as they witnessed a more pronounced amelioration in their ratios.

Figure-6.1.5: NPLs to Loans



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	30.8	29.0	30.7	26.3	25.9	25.5	20.4	13.3
LPBs	10.2	11.1	15.5	15.4	16.3	15.4	11.3	9.0
FBs	5.0	5.3	5.1	4.7	4.3	3.8	3.1	1.6
SBs	50.6	47.2	51.6	52.4	53.0	54.7	55.6	54.1
CBs (RHS)	22.1	19.5	22.0	19.5	19.6	17.7	13.7	9.0
All (RHS)	23.5	23.1	25.9	23.5	23.4	21.8	17.0	11.6

Figure-6.1.6: NPLs to Loans (Net)



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	17.0	15.0	18.5	12.7	13.1	12.8	8.1	3.4
LPBs	4.6	5.5	10.7	10.3	10.4	7.0	4.5	2.8
FBs	1.8	1.4	1.9	1.7	1.1	1.1	0.7	(0.0)
SBs	44.1	23.6	32.8	31.6	31.5	28.5	32.5	27.0
CBs (RHS)	10.3	9.6	13.1	10.1	10.3	8.3	5.3	2.6
All (RHS)	14.1	11.1	15.3	12.2	12.1	9.9	6.9	3.6

The impact of declining NPLs over the last few years is also reflected in incremental gross NPLs to gross advances and incremental net NPLs to net advances ratios showing the figures of negative 2.4 percent and negative 4.1 percent respectively (see **Table 6.1.1**).

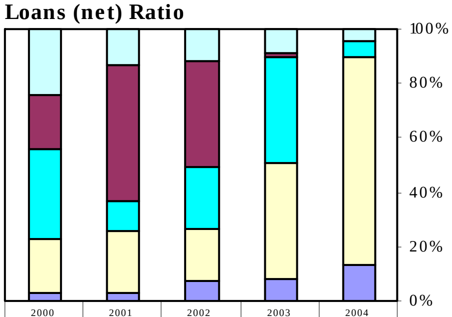
The outcome of the above stated positive developments is becoming visible in the form of consistent decline in the incidence of NPLs. The incidence of NPLs, which is a useful measure to uncover the lost portion of bank income due to NPLs, came down to 1.78 percent from 3.37 percent in the last year. Among the groups, PSCBs were the most successful in reducing incidence to 1.94 percent from 4.49 percent in 2003. Though all the groups managed to reduce the incidence of NPLs, FBs enjoy the lowest incidence i.e. 0.2 percent among all groups. In this respect, the specialized banks are worst-off with the incidence of NPLs coming to 19.07 percent, despite showing an improvement over the last year.

Table-6.1.1: Incremental NPLs Indicators

(Billion rupees)	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
Incremental Gross NPLs								
PSCB	49.6	(0.4)	22.9	(3.5)	4.4	(34.0)	(9.6)	(45.8)
LPBs	5.4	3.4	12.8	8.6	2.3	21.2	0.5	36.1
FBs	3.8	0.4	(0.1)	(0.1)	(0.4)	(1.0)	(1.3)	(1.4)
CBs	58.8	3.4	35.6	5.1	6.3	(13.8)	(10.4)	(11.0)
SBs	4.1	6.6	12.1	4.2	(2.3)	1.2	(9.9)	(0.4)
All banks	62.9	10.0	47.8	9.3	4.0	(12.6)	(20.3)	(11.4)
Incremental Net NPLs								
PSCB	37.1	(3.0)	18.9	(14.7)	5.1	(15.2)	(11.6)	(20.2)
LPBs	3.6	2.4	12.3	4.8	(0.2)	0.6	(2.6)	5.6
FBs	3.1	(0.5)	0.7	(0.2)	(0.6)	(0.2)	(0.5)	(0.9)
CBs	43.9	(1.0)	32.0	(10.1)	4.2	(14.8)	(14.7)	(15.4)
SBs	3.7	(15.6)	11.0	(0.6)	(1.6)	(4.4)	(0.3)	(4.0)
All banks	47.6	(16.6)	42.9	(10.7)	2.6	(19.3)	(15.1)	(19.4)
Incremental Gross NPLs to Gross Loans (percent)								
PSCB	270.1	(2.1)	42.4	(6.1)	17.6	26.8	(20.3)	38.4
LPBs	17.9	22.6	49.2	14.9	(230.3)	13.8	0.3	6.5
FBs	16.3	21.8	(2.3)	(0.7)	(7.7)	11.9	12.0	(3.8)
CBs	82.1	9.2	42.9	4.1	21.1	(72.6)	(5.3)	(2.3)
SBs	208.7	33.0	121.3	70.1	38.0	(123.0)	50.0	(20.8)
All banks	85.4	17.6	48.7	7.2	16.8	(69.8)	(11.3)	(2.4)
Incremental Net NPLs to Net Loans (percent)								
PSCB	631.6	(17.0)	37.6	(32.5)	19.5	14.1	(25.5)	21.5
LPBs	12.8	16.8	49.9	8.7	6.4	0.4	(1.6)	1.1
FBs	13.9	(59.9)	16.7	(2.1)	(13.0)	2.9	5.4	(2.4)
CBs	77.3	(3.2)	40.3	(9.3)	15.5	(82.6)	(7.6)	(3.3)
SBs	234.6	713.4	81.6	(46.4)	33.2	62.6	3.4	240.0
All banks	81.6	(54.4)	46.3	(9.7)	11.5	(177.0)	(8.2)	(4.1)

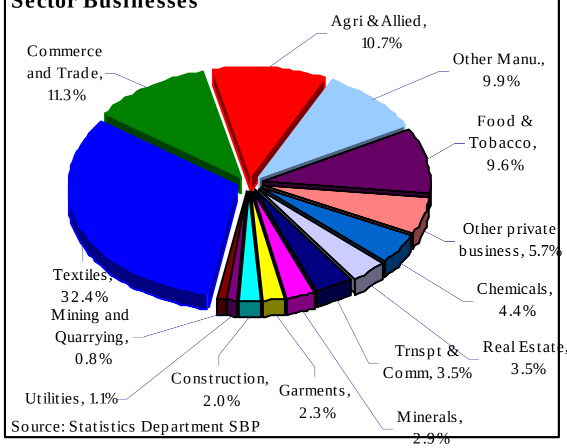
The position of individual banks has also improved in terms of credit risk management. At present, 31 banks representing 90 percent of the banking assets have their respective NPLs to Loans (net) ratios below 5 percent, as compared to 23 banks representing 51 percent of banking assets in the same category a year ago (see **Figure 6.1.7**).

Figure-6.1.7: %age Breakdown of Total Assets by NPLs to Loans (net) Ratio



	2000	2001	2002	2003	2004
15 and above	24.3	13.5	11.7	9.1	4.2
10 to 15	20.2	49.7	38.8	1.0	-
5 to 10	32.5	11.0	23.2	39.2	6.1
0 to 5	20.1	22.9	18.9	42.7	76.9
0 and below	2.9	2.8	7.4	7.9	12.9

Figure-6.1.8: Concentration of Loans to Private Sector Businesses



Source: Statistics Department SBP

The focus of banks' credit policy should be on the diversification of their loan portfolio as any undue concentration in any particular counterparty, industry, economic sector, country or region may undermine their operations. The industry-wise distribution of loans to private sector businesses shows concentration in textile sector (see **Figure 6.1.8**). No doubt, this over-concentration is largely the consequence of overwhelming share of this sector in the economy; it nevertheless exposes the banking system to any adverse shift in the fortune and performance of this sector. This inevitably calls for proper loan diversification, and portfolio segmentation through judicious allocation of loan funds into broad categories of corporate, SME, and consumer loans, as well as setting performance standards, risk tolerance level, and business goals for each concentration.

The banks, of late, have started to explore hitherto less served sectors of SMEs and consumer finance more vigorously, which is a positive step towards the loan diversification. The low occurrence of NPLs, particularly, in case of consumer financing, is very encouraging; the recent increase in interest rates, though, has started to generate concerns about probability of future defaults. The position so far appears satisfactory, as the sector's contribution to the overall NPLs is mere 0.8 percent showing little change despite the rise in its share in total loans of the banking system to 9.4 percent from 5.6 percent in the year 2003 (see **Table 6.1.2**). Consequently, the ratio of NPLs to loans of the consumer finance sector works out to 0.8 percent. The SME sector accounts for 16.7 percent of total NPLs of the banking system against its share of 17.5 percent in overall loans. The NPLs to loans ratio works out to 10.6 percent which, looking forward, is following an improving trend. Further, with the improving credit culture and stronger performance of SMEs given the conducive environment, their ability to service debt is likely to improve. In spite of the increasing interest in consumer financing and SMEs, the banks channeled majority of their funds to the corporate sector, which led to a further increase in the share of this sector to 54 percent from 52 percent in 2003. Despite the faster growth in loans, the share of this sector in total NPLs has witnessed a downward trend since June 2004, which is a healthy sign and shows improving credit appraisal standards of banks as well as the better debt servicing capacity of this sector.

Table-6.1.2: Segmentwise Infection of Loans Portfolio as of 31-12-2004

(Domestic Operations) (Rs In Billions)

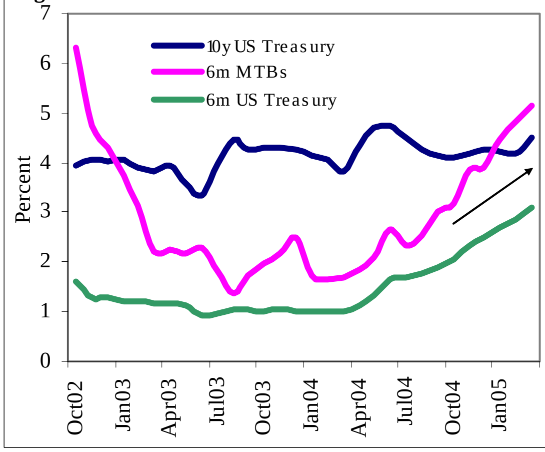
Sector	Amount Outstanding	Share %	NPLs	Share in Overall NPLs	NPLs as % of Outstanding
Corporate	873.0	53.9%	95.6	53.0%	10.9%
SMEs	284.0	17.5%	30.1	16.7%	10.6%
Agriculture	119.3	7.4%	45.6	25.3%	38.2%
Consumers	152.6	9.4%	1.4	0.8%	0.9%
Credit Cards	*14.1*	*0.9%*	*0.3*	*0.2%*	*2.2%*
Auto Loans	*49.6*	*3.1%*	*0.4*	*0.2%*	*0.9%*
Consumer Durables	*1.6*	*0.1%*	*0.1*	*0.1%*	*6.2%*
Mortgage Loans	*16.7*	*1.0%*	*0.1*	*0.0%*	*0.4%*
Others	*70.5*	*4.4%*	*0.5*	*0.3%*	*0.7%*
Commodity Finance	122.1	7.5%	1.4	0.8%	1.1%
Staff Loans	40.8	2.5%	0.6	0.3%	1.4%
Others	28.6	1.8%	5.7	3.2%	20.0%
Total	**1,620.4**	**100%**	**180.4**	**100%**	**11.1%**

The only threat to consumer sector currently emanates from the recent rise of interest rates, which is likely to hamper their debt repayment capacity, and the SME and corporate sectors may also face problems because this development will increase their cost of production. The sustained liquidity position and the profitability indicators of corporates as well as rising income levels suggest that the possibility of any large scale squeeze in credit expansion and increase in NPLs is remote. Now with the private sector banks dominating the banking system, which driven by commercial considerations is expected to further strengthen their credit appraisal techniques, the likelihood of default on the scales experienced in the past, is expected to remain low.

6.2 Market Risk

The interest rate and equity price risk persisted to follow a rising pattern during the year. The building economic pressures from both the international and national fronts have led to a gradual but substantial rise in interest rates (**Figure 6.2.1**). This has adversely affected the bottom line of some of the banks, particularly those with large chunk of fixed income securities.

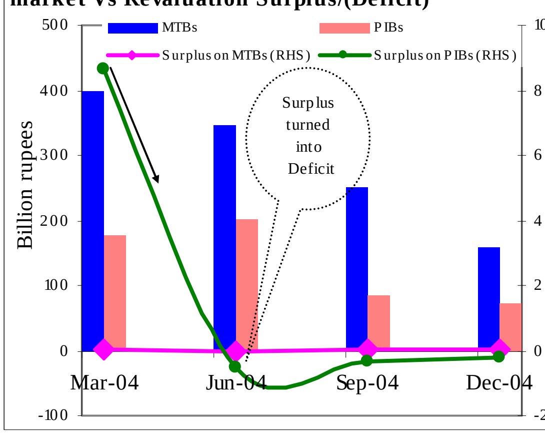
Figure-6.2.1: Yields on 6m MTBs Vs US Treasuries



This rising interest rate scenario invokes higher **interest rate risk** by changing the underlying value of assets and liabilities due to changes in the present values of cash flows. This *repricing risk* is high in the long term fixed income securities. Two new tenors of Pakistan Investment Bonds (PIBs) namely; 15 years and 20 years maturity, launched in the first month of the CY04, were expected to add to the risk profile of the banks. However, as the exposure in these securities is not that significant, their impact on the economic value of the banks' assets stayed small. Duration, a measure of price sensitivity of the fixed income securities towards the changes in interest rates, of all the securities, though continue to fall due to the rise in interest rates but the level is still quite high. The weighted average Macaulay's duration of all the PIBs stands at 4.52y by the end of the year 2004 (Dec-03: 5.2y). The scrip-wise weighted duration as percentage of its maturity period for the 3y, 5y, 10y, 15y and 20y PIBs stayed at 34 percent, 53 percent, 56 percent, 54 percent and 43 percent respectively. This shows that the duration of 10y bond in terms of its maturity is highest, which signifies its price sensitivity.

Since the secondary market yields on PIBs and Market Treasury Bills (MTBs) followed a gradual rise across all the maturities, the piled up surplus on the revaluation of these fixed income securities has been continuously depleting over the year. The situation aggravated when this overall surplus turned into deficit at the end of the second quarter of the CY04 **(Figure 6.2.2)**. The banks with large chunk in longer tenor securities had no choice but either to sell the securities and book losses or carry deficit on their books. Some of the banks were more prone to this risk. In line with the international standards, banks were required to categorize their investment portfolio into Held for Trading (HFT), Available for Sale (AFS) and Held to Maturity (HTM) categories by the end of third quarter. Since these standards do not require the revaluation of HTM portfolio, banks with higher deficits and inactive trading positions preferred to lock their more risky portfolio under this category. In doing so, they no doubt have cleaned their books by not marking to market their portfolio under HTM category, but at the same time they would have to compromise on the

Figure-6.2.2: PIBs and MTBs subject to mark to market Vs Revaluation Surplus/(Deficit)



lower returns till the maturity of these assets. This is because most of the liability side carries shorter repricing period and if the returns on the liability side rise, the banks would be left with lower returns. Moreover, such banks are forgoing the higher returns prevailing in the market especially when the new financial products are finding lucrative returns.

Figure-6.2.3: Shift in Yield Curve

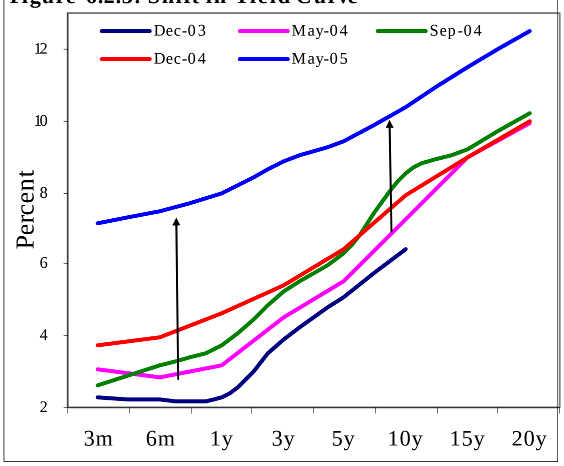
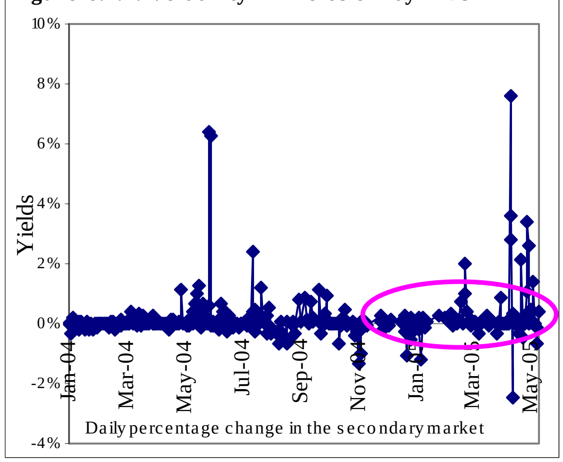
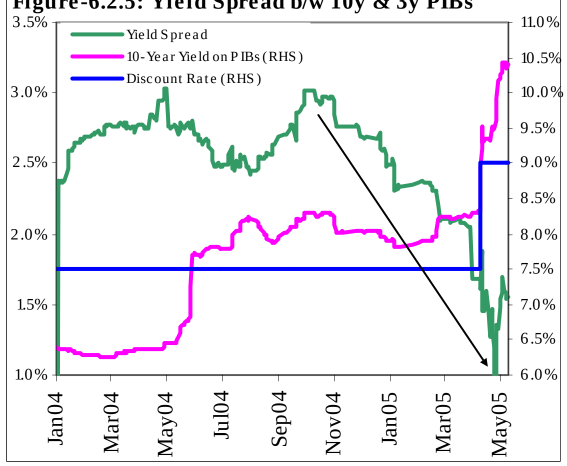


Figure-6.2.4: Volatility in Yields of 10y PIBs



While the rise in interest rates was gradual and continuous over CY04, this shift in the yield curve was more pronounced in the first five months of CY05. During the CY04 the yield curve was steeper at the end of the third quarter (**Figure 6.2.3)**, which raises the concern for the *yield curve risk* whereby the higher increase in interest rates on the longer tenor securities would lead to a greater fall in the economic value given that the repricing mismatches are on the higher side. However, despite the clear signals of economic recovery, the percentage change in the yields of the long term PIBs turned negative by the end of the last quarter **(Figure 6.2.4**) of CY04 and it continued to persist till the first quarter of the CY05. Moreover, the spread between the 10y and 3y PIBs fell considerably (**Figure 6.2.5**). Therefore, the yield curve somewhat flattened in that period. This gave some room for the banks to offload their portfolio at better prices. The situation reversed when the significant shifts in the yield curves resulted in considerable increase in the yields till May-05. Overall, the large shift in the yield curve since CY03 has made the long-term asset management a challenging task for the banks.

Figure-6.2.5: Yield Spread b/w 10y & 3y PIBs



This upward shift in the yield curve bears a positive impact on the price sensitivity of these fixed income securities. Price Value of a Basis Point (PVBP), a measure of price sensitivity, for all such securities has been eased off over the year. Accordingly, there has been comparatively lower fall in the value of such securities with a certain rise in interest rate. Using the duration as a measure of price sensitivity, **Figure 6.2.6** shows the comparative price sensitivity of such securities as of Mar-04 and Dec-04 to a rise in interest rates by 3 percentage points. Though it has come down from its previous level, the price sensitivity is still significant for the 10y, 15y and 20y PIBs. At the end of CY04, the weighted average fall in the prices of overall PIBs portfolio stayed at 11.86 percent for the said rise in interest rates. As for MTBs the weighted average fall in the prices is lower at 0.88 percent for the same rise in interest rates due to their lower repricing period.

Figure-6.2.6: Fall in Value of PIBs with 3 percentage point rise in Interest Rates

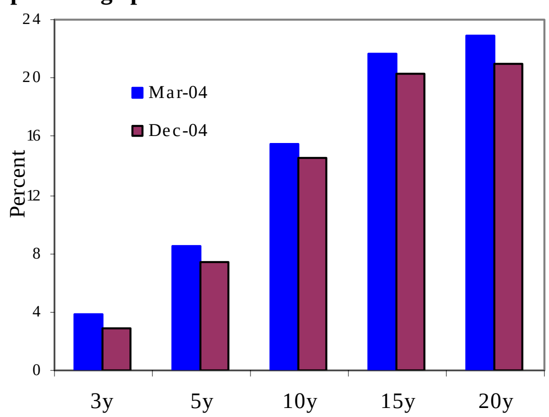
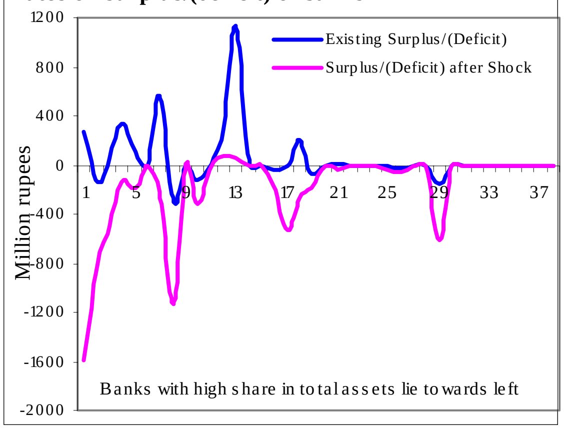
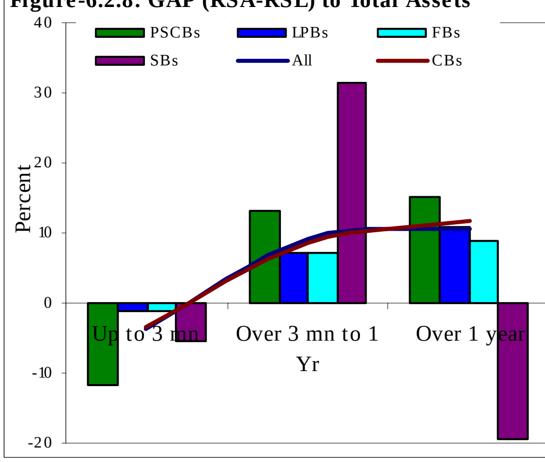


Figure-6.2.7: Impact of 3%age point rise in interest rates on surplus/(deficit) of banks



The analysis of the bank wise exposure in PIBs and MTBs as of December 31, 2004 reveals that the impact of this 300bps rise in interest rates on the revaluation of Available for Sale securities is expected to be quite significant (**Figure 6.2.7**), as the current surplus booked on these securities would turn into deficit. Moreover, one cannot ignore the embedded losses on the instruments that are not marked to market due to the past rates movements. And surely its impact would add to the severity as most of the risky portfolio has been categorized under the Held to Maturity category and there has been significant increase in the yields.

Figure-6.2.8: GAP (RSA-RSL) to Total Assets



Shift in the yield curve affects the overall economic value of a bank's assets and liabilities hence the bank's economic value of equity (EVE) gets impacted. The impact is unpleasing when the changes in interest rates cause deterioration in the EVE. The banks are running negative gaps in the shorter-term buckets. However, overall repricing GAP between the rate sensitive assets and the rate sensitive liabilities of all the banks remained positive for over one year bucket (**Figure 6.2.8**). This liability sensitive position would cause significant fall in the economic value of equity under the current rising interest rate scenario. Since the overall duration gap DGAP, a measure of change in the EVE, for all the banks stayed largely positive, the interest rate exposure seems to be quite significant.

The increasing sophistication in the risk management favours the introduction of derivative products, which remained the most widely used instruments for managing the market, credit and other forms of risks. In our market these products are at preliminary stage and to avoid the risks associated with the derivatives, the banks were required to get approval from SBP for every individual transaction. Now when the banks have been allowed to become the Authorized Derivatives Dealers (ADDs) and Non Market maker financial Institutions (NMIs) on meeting certain prescribed criteria, the risk of trading, investing and competing in the market has gone up. This would no doubt develop an over the counter (OTC) market for the derivative products, which may provide better solution of the risks when used for hedging those risks, but at the same time it could be quite risky if used as a vehicle for pure position-taking.

Figure-6.2.9: 10y Yields Vs Rs/$ Exchange Rate

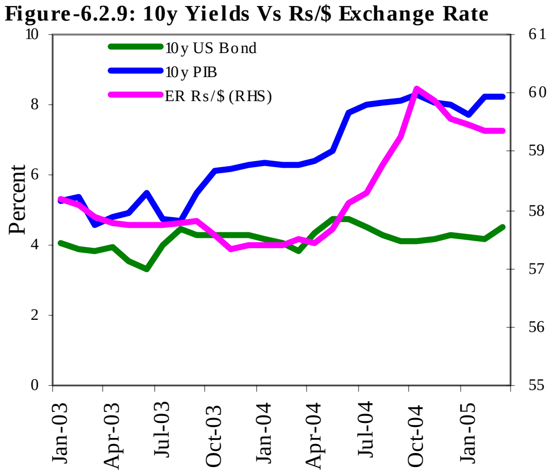
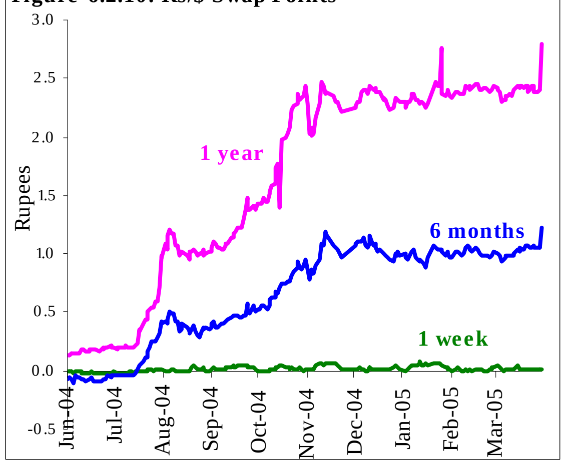


Figure-6.2.10: Rs/$ Swap Points



The exchange rate risk arises when the change in exchange rates affect the value of the institution's assets and liabilities. As for the direct exchange rate risk, which arises due to the foreign currency assets and liabilities, the banks' exposure seems to be lower as foreign currency assets significantly exceed the liabilities and the rupee has been losing its value during CY04. The rupee dollar exchange rate witnessed greater volatility during 2004**.** The increasing interest rate differential (**Figure 6.2.9**) coupled with deteriorating external account balance due to widening of trade gaps continued putting pressures on the exchange rate. The strain on exchange rate was more pronounced during the second half of CY04 as the importers wanted to lock in their payments early. The rupee dollar swap points that remained negative for the most part of CY03, turned positive (**Figure 6.2.10**). It was the time when most of the banks were running negative net open positions through short sellings (**Figure 6.2.11**). This caused the exchange rate

Figure-6.2.11: NOP Vs Rs/$ Exchange Rate

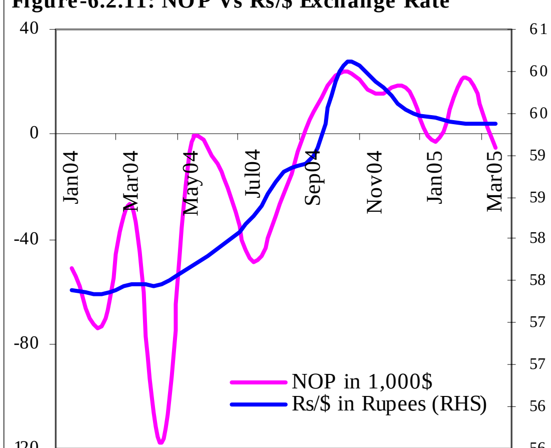
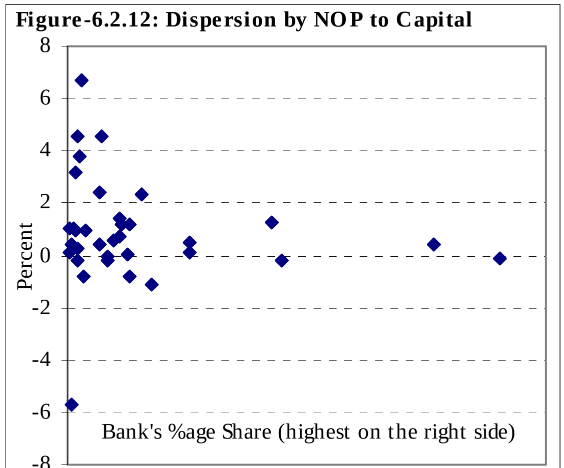


Figure-6.2.12: Dispersion by NOP to Capital



exposure for these banks. However, during the third quarter of CY04 the banks managed to maintain long net open position (NOP). Though the NOP of all the banks was well within the limits by the end of CY04, some banks were still carrying short net open position (**Figure 6.2.12**); however, the exposure was insignificant. Nevertheless, this depreciation in exchange rate may lead to rising indirect exposure, whereby the borrowers' ability to repay the foreign currency loan could be impaired with the rising rupee dollar exchange rate.

Equity price risk stems from the stock market volatility and the associated potential for losses arising due to a fall in the market price of the stocks. The stock market was performing exceptionally well all through CY04. However, in the first quarter of CY05 it has witnessed a much expected downfall in the index value and largely intensified the concerns relating to the direct as well as indirect exposure of the banks in equities (see **Figure 6.2.13**). It is clear that the stock market was standing at an illusive height and it was quite realistic to expect a downtrend in the market. While the banks had already streamlined their direct exposures in equities to comply with the cap imposed by SBP, it was the indirect exposure through badla financing that was standing at an average of Rs12 billion throughout the CY04 and the first quarter of CY05 due to the lucrative badla rates. However, the stock market correction has resulted in heightening uncertainty, leading the banks to act prudently and rationalize their high indirect exposures as well.

Figure-6.2.13: KSE-100 Index Monthly Average

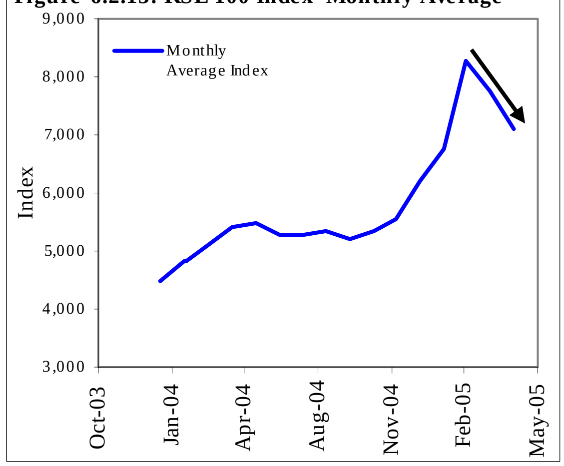
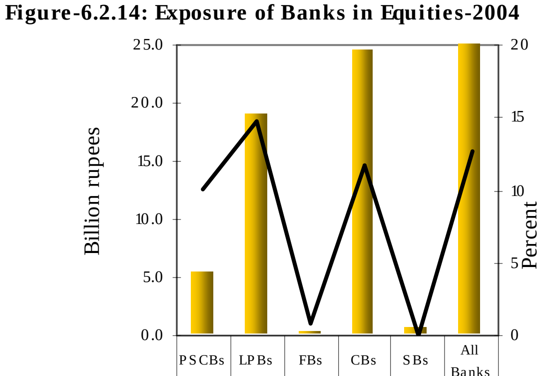
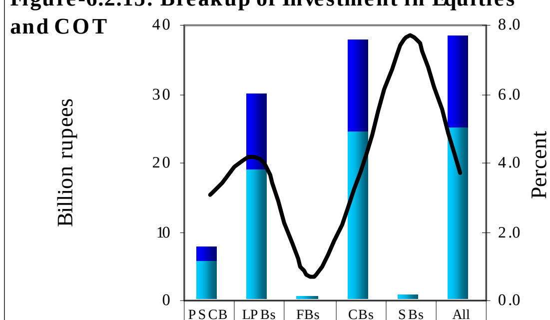


Figure-6.2.14: Exposure of Banks in Equities-2004



	PSCBs	LPBs	FBs	CBs	SBs	All Banks
Actual Exposure	5.4	18.9	0.2	24.5	0.5	25.0
Exposure to Capital (RHS)	10.0	14.8	0.8	11.7	0.0	12.7

Figure-6.2.15: Breakup of Investment in Equities and COT



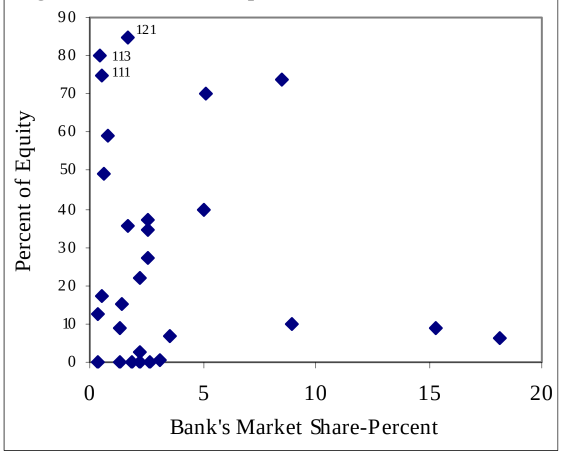
	PSCB	LPBs	FBs	CBs	SBs	All
COT	2.2	11.0	0.0	13.2	0.0	13.2
Investment in Shares	5.4	18.9	0.2	24.5	0.5	25.0
Invst. In shares to total Invst (RHS)	3.1	4.1	0.7	3.7	7.7	3.7

As an obvious consequence of the increasing market volatility and to regularize their equities exposure to the specified limits, the absolute direct exposure of the overall banking system declined in CY04 to Rs25 billion[9] from Rs31.6 billion in CY03. This coupled with rise in capital base, led the equity exposure to capital ratio to improve from 23 percent to 13 percent during the year under review (**Figure 6.2.14**). Although the total investment of the banking system as a whole declined, the offload in the equities investment was rather pronounced. This is manifested

[9] Market value of investment in shares (other than investment in subsidiaries and associated undertakings)

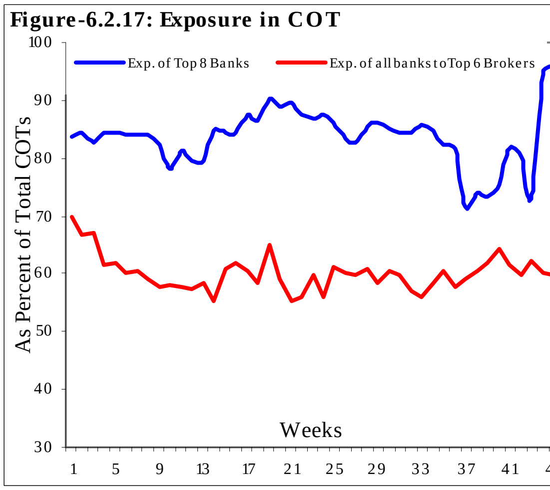
in the declining share of equities investment in the total investment portfolio of the banks to 3.7 percent from 4 percent in CY03 (**Figure 6.2.15**).

Figure-6.2.16: Total Exposure of Banks- Q1 CY05



The group-wise position of the banking sector reflects that the banks have finally taken into account their high direct exposures. This is evident from the equities exposure of all the banking groups being less than 15 percent. LPBs have rationalized their exposure which is a good sign as they represent the major portion of the banking system. Bank-wise, whilst most of the banks have cut their high exposures both direct and indirect, there are a few banks which remain highly risk prone due to higher indirect exposure in relation to their equity base (**Figure 6.2.16**)[10]. This is manifested in the fact that the share of only 8 banks in the Carry Over Transactions (COT) of the overall banking system remained substantially high in the vicinity of 80 percent (**Figure 6.2.17**)[11]. Though the market share of these banks is not substantial in the overall banking system, they are highly susceptible to risk at their individual end (see **Box-6.1**). The broker wise exposure shows a dwindling pattern; however, higher exposure on a few brokers is quite repercussive and exposes the banks to concentration risk. These banks need to rationalize their exposure in order to avoid any adverse consequences.

Figure-6.2.17: Exposure in COT



On the regulatory side, SBP requires the banks to maintain their exposures[12] upto a maximum of 20 percent of their capital. Currently, only one bank is slightly above this limit. To regularize the indirect exposures in the stock market, an action based plan for phasing out the COT has been devised by the regulators. Accordingly, the Banks/DFIs having substantial exposures in COT financing, are encouraged to extend margin financing facilities to their clients. This will help them in effective deployment of their funds released gradually from COT financing. Further, it will facilitate the smooth transition from COT to margin financing, hence minimizing the associated risks.

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[10] The exposure includes investment in shares at cost, investment in COT and others.

[11] The concentration of COTs to 8 banks and 6 brokers has been taken as percent of total COTs of the banking system from June-04 to Apr-05.

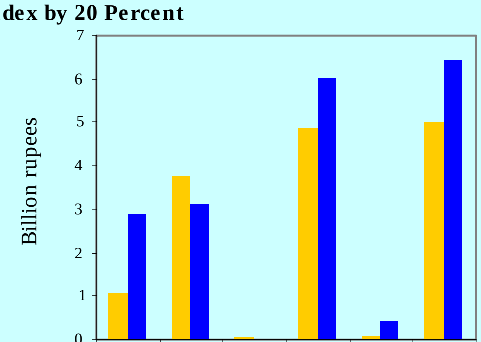
[12] The exposure includes the investment in shares (at cost) net of the strategic investments and investment in subsidiaries. However, for the Islamic banks the allowed exposure is 35 percent of equity.

BOX – 6.1

Resilience of Banks towards Stock Market Volatility

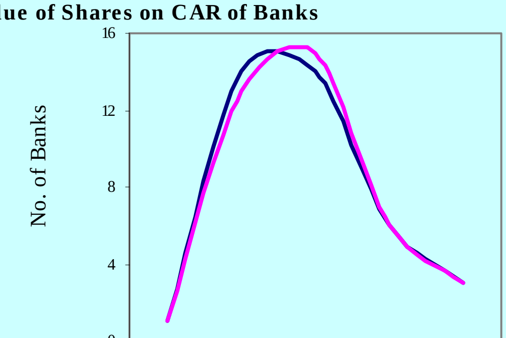
The stock market volatility holds special risk connotations for its participants. An overly optimistic market sentiment can move the index up; however, such speculative upward movement in the market is always prone to sudden fall. The same goes for the recent down trend in the KSE. The KSE-100 index performed exceptionally well till the first half of March-05. The index rose steadily all through CY04 and crossed the major barriers until it reached the 10,000 level. However, the index experienced a sudden fall in the second half of the March 2005 and since then has exhibited erratic movements, with frequent ups and downs. A closer look at the KSE-100 index reveals that there was a gain of 4086 points from the beginning of the CY05 till mid March-05, and then came an erosion of 2918 points till mid May-05. This was due to the exceptionally high market volatility. While the hike in the market was due to a few stocks, the decline in the market was broad based. Since the banking system in Pakistan is exposed to the stock market volatility, through direct investment in shares and indirect exposure through badla financing, hence it is of special interest to the regulators to test the resilience of the banking system towards the stock market volatility. The stock market volatility suggests that the chances for further decline remain plausible. Empirically, the maximum decline in the stock market index since Dec-03 was 9 percent based on monthly averages. Further decline in the index value is possible; hence it is imperative to quantify the actual risk exposure of the banks. As a test for the resistance of the banks against the potential losses, the investment holding of the banks in equities has been discounted by 20 percent. As any market decline shall first erode the surplus of these banks, therefore, it is important to see the relative strength of the surplus to bear such losses. Over the year, the surplus of the banks against the shares has fallen in absolute terms in direct proportion to the fall in the equity investment. The surplus position reveals that four banks are already carrying deficit against the shares, hence their risk exposure is substantial. LPBs are quite prone to the equities risk as their surplus may fall short of the expected fall in the investment value (**Figure 6.2.18**). FBs have no surplus available against their equities holding, however, their contained exposure in equities lends comfort. Bank-wise, 22 banks carrying 37 percent market share in the banking system shall have their surplus converted into deficit given a 20 percent fall in the market value of investment in shares. As the banking sector is dominated by the five large banks, therefore their equities investment being 63 percent of overall equities investment of the banking sector is largely determinant of the shock that the banking sector might undergo. Four of these banks have sufficient surplus to provide support against the market movements, whereas one bank could suffer a hit on equity beyond the shock rate applied in the study.

Figure-6.2.18: Impact of Adverse Movement in KSE-100 Index by 20 Percent



	PSCB	LPB	FB	CB	SB	All
Fall in the Value of Shares	1.1	3.8	0.0	4.9	0.1	5.0
Surplus on Shares	2.9	3.1	0.0	6.0	0.4	6.5

Figure-6.2.19: Impact of 20 Percent Fall in Market Value of Shares on CAR of Banks



	Below 8	8 to 10	10 to 20	20 to 100	above 100
Revised CAR	1	14	14	6	3
Actual CAR	1	13	15	6	3

When the decline in the value of investment in shares is calibrated in the capital adequacy of the banks, all the banks with after-shock deficits experienced some fall in their respective capital adequacy ratios. It is important to mention here that before shock, the CAR of all banks, except one is well above the benchmark. Hence the resilience of the banking system is already strong against such shock. There is, however, some adjustment in the number of banks falling in various capital adequacy brackets. One bank in the 10 to 20 percent bracket has now shifted to the lower bracket of 8 to 10 percent (**Figure 6.2.19**). Overall capital adequacy position of the banks is not strained though.

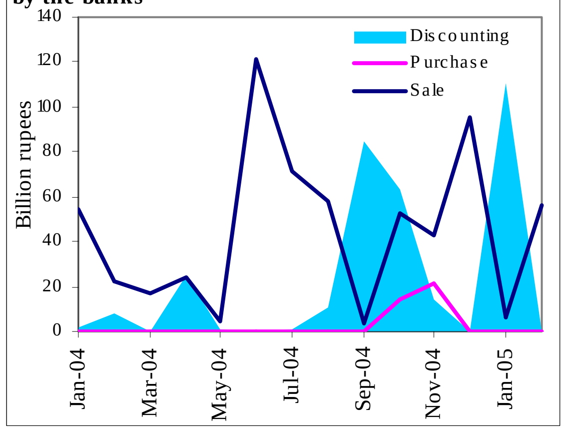
The current stock market scenario suggests that the news from the corporate sector shall remain the dominating factor in determining the market direction in future. Moreover, the past record reflects strong relationship between the liquidity flows and interest rates; hence the banks should take into account the liquidity and the interest rate scenario which could further test the stock market in future. Also, barely 25 to 30 stocks account for most of the trading volume that makes investments in equities highly susceptible to any decline in the value of these stocks. However, the regulatory pressures continue to keep the risks in check. The recent stock market decline has led to the strengthening of regulations governing stock market trading by the regulators. In consideration of the tight liquidity situation, SBP removed the restriction on the banks' badla financing* imposed in February 2005. The indirect exposure of the banks shall largely be taken care of by the replacement of COT with the margin financing by August 2005, providing the banks a prudent and secured mode of trading in the stock market and strengthening their resilience towards the stock market volatility. What is required is that the banks should enter into other markets and diversify their risk base in compliance to the exposure limits set by the regulatory authority.

** Vide BPD Circular No.5 of 2005, the banks/DFIs were required to cap their COT exposure, in each share, at the existing level as on February 25, 2005.*

6.3 Liquidity Risk

The rising inflationary pressure has forced SBP to allow a rise in interest rates, relatively more aggressively in recent months. The rising demand for the private sector credit and the frequent liquidity mop ups by SBP, especially during the last quarter of CY04, have drained much of the excess rupee liquidity from the interbank market. Moreover, the building pressure on exchange rate due to the deteriorating external account balances has also put strain on the dollar liquidity. Consequently, while during the last year, the management of excess liquidity was a challenge, both the funding liquidity risks as well as the market liquidity risks have now become a concern.

Figure-6.3.1: OMOs by SBP Vs Discounting availed by the banks



The growth in the money supply, that gained momentum since CY02 to accelerate economic growth, has been kept in check during CY04 to counter the inflationary pressures. These efforts to moderate the inflationary tendencies gained pace during the last quarter of the year. The significant rise in the interest rates followed by frequent OMOs led to frequent visits of the banks to SBP discount window (**Figure 6.3.1**). The discount rate though remained intact during the CY04 readjusted back to 9 percent owing to the upward shift in the yield curve in April, 2005.

Of the target liquidity ratios, the loan to deposit ratio has gained around 10 percentage points to 65.9 percent (**Figure 6.3.2**) on account of higher than expected growth in the private sector credit. However the level is not ominous for the liquidity. Liquid assets in terms of total assets also dropped significantly to 36.5 percent. The actual statutory reserves held by the banks as percentage of the required also experienced a fall (**Figure 6.3.3**).

Figure 6.3.2 Liquidity Indicators

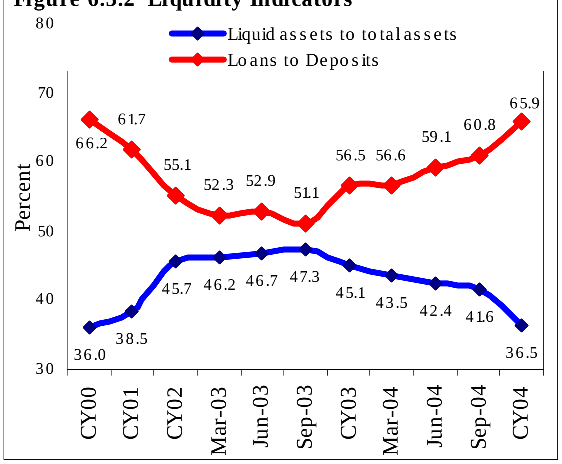
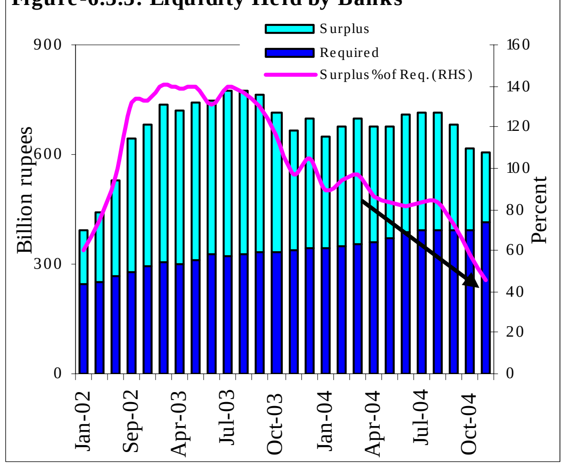
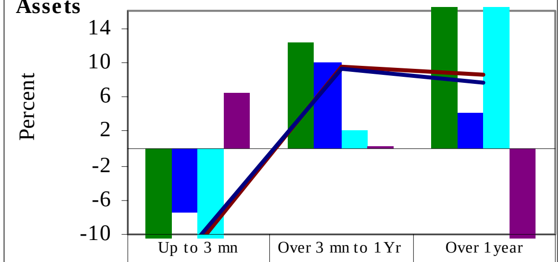


Figure-6.3.3: Liquidity Held by Banks



The *funding liquidity risk* that deals with meeting the cash outflows, seems to be on higher side as the liquidity cushion for the three months bucket is negative (**Figure 6.3.4**). The exposure is high in PSCBs. This calls for the need of asset-based liquidity. However, for the longer term structure, the liquidity coverage ratio remained largely positive. This signifies that the banks are carrying the liability sensitive position, whereby the liabilities mature early than that of assets. This is the natural outcome of the banks' previous moves of locking in their assets in longer term fixed income securities. The positive liquidity cushion in the longer maturity bucket can provide a save only when sufficient *market based liquidity* is available so that the banks can unwind their large exposures in the longer-term assets. The higher marketability risk led to the rise in the required yields. Hence the bid-ask spreads, a measure of market based liquidity, followed a rising pattern even for the on-the-run securities (**Figure 6.3.5 & 6**), which signifies that the sale of such securities would take place with the higher difference in prices. The depleting surplus on the revaluation of these securities, which turned to negative by the mid of CY04 supports this phenomenon. This rising pattern in the spreads adds to the concern in liquidating such securities. The concern seems to elevate since the policy announcement of categorizing the investment into three of the Held for Trading (HFT), Available for Sale (AFS) and Held to Maturity (HTM) Securities has restricted the sale of the securities under the last category. Consequently, to avoid the risk of revaluation deficit, the banks opted to lock more of the PIBs and MTBs in this category (**Figure 6.3.7**).

Figure-6.3.4: GAP (Assets - Liabilities) To Total Assets



	Up to 3 mn	Over 3 mn to 1 Yr	Over 1 year
PSCBs	-21.4	12.2	17.4
LPBs	-7.6	9.9	4.3
FBs	-10.5	2.1	17.3
SBs	6.4	0.1	-17.8
CBs	-10.9	9.6	8.5
All	-10.3	9.3	7.6

Figure-6.3.5: Secondary market bid-ask rate spread - MTBs

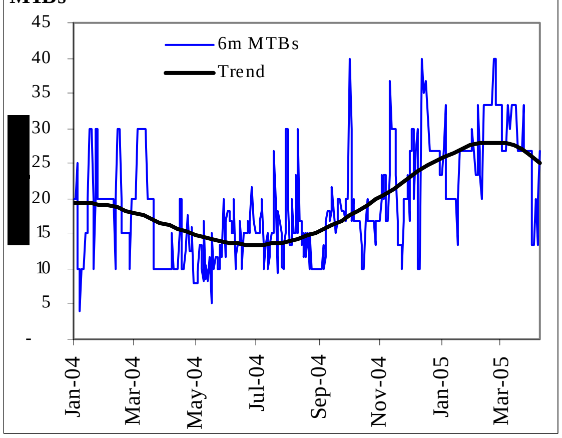


Figure-6.3.6: Secondary market bid-ask rate spread - PIBs

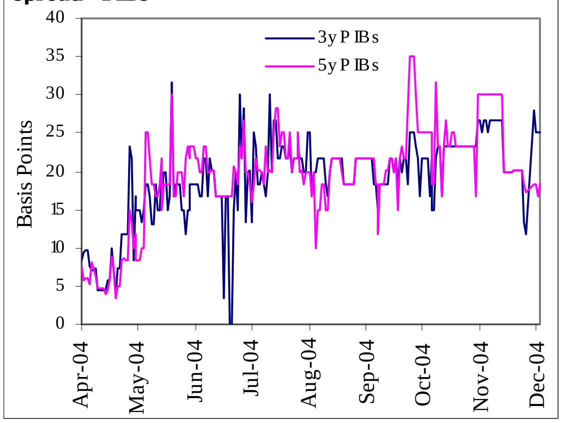
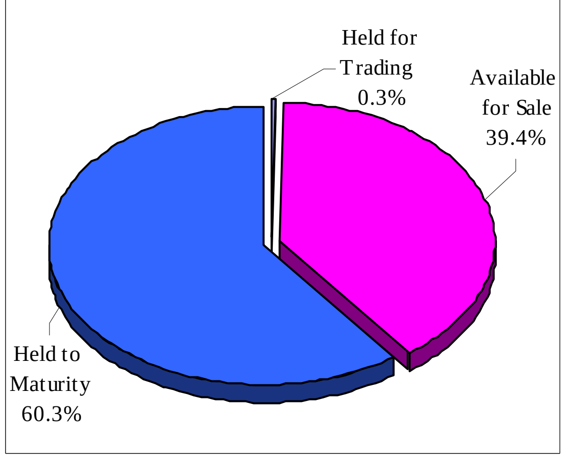


Figure-6.3.7: Investment in PIBs



This has no doubt squeezed the secondary market trading of these securities. Moreover, the market witnesses the trading activity away from PIBs to MTBs as the banks have more than 60 percent of their PIBs portfolio under Held to Maturity category. This move by the banks has brought down the market-based liquidity. Moreover, SBP's move of accepting less than the amount of maturing MTBs in the auctions to ensure gradual rather than a sharp rise in interest rates also affected the market activity in the last quarter of the CY04. However, for the future the market activity has been restored by accepting a big chunk of funds and doing frequent OMOs. This volatility in the market activity signifies greater threat to market based liquidity.

Figure-6.3.8: Exchange Rate (E/R) Vs Forex Reserves

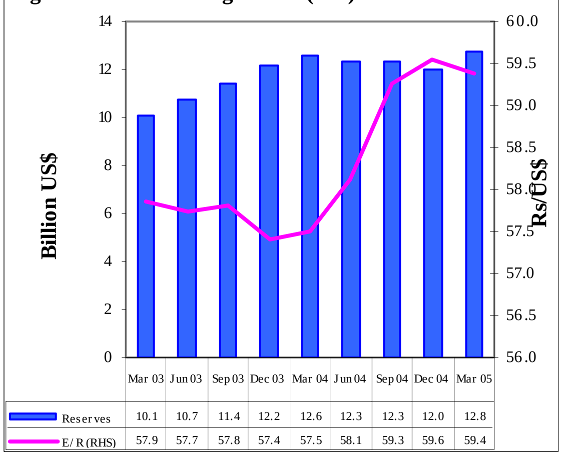
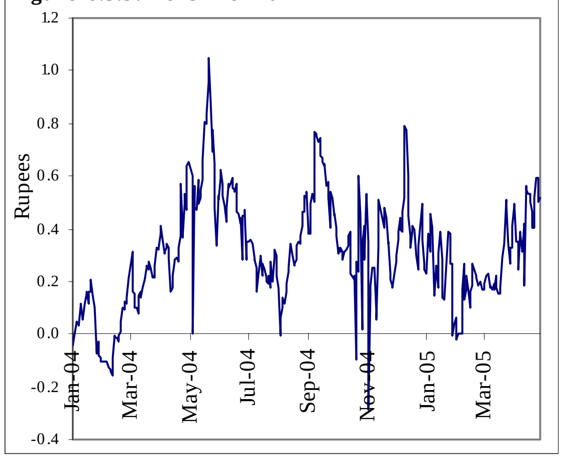


Figure-6.3.9: Kerb Premium



Rupee has been losing its value against US dollar during CY04 due to increasing demand for dollar for making huge payments of oil and machinery imports. The exchange rate that was at Rs57.40/$ at the end of December 2003 went up to Rs60.10/$ by October 2004. The kerb market premiums were high during this period (**Figure 6.3.8 & 9**). However, the systematic intervention of SBP in the forex interbank market gave support to the weakening rupee. SBP's efforts to contain the exchange rate volatility resulted in the fall of SBP's liquid foreign exchange reserves, despite some major inflows from external agencies. However, the level of overall reserves did not fall much because the rise in FE-25 deposits and some prepayments of foreign currency loans by the customers of banks have resulted in almost equivalent rise in the foreign exchange reserves of the commercial banks. The commercial banks have adequate liquid foreign exchange reserves to meet the demands of the importers and the foreign exchange assets of the commercial banks exceed the foreign exchange liabilities. However, if the trade deficit further rises and, in the absence of excess forex liquidity with SBP, the kerb premiums also shoot up, dollar based liquidity would be a concern for the banks.

6.4 Operational Risk

Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. Recent incidents in the financial world suggest that the losses arising out of operational issues could be huge. However, the issue worrying the regulators and supervisors worldwide is that it is quite difficult to quantify the operational risk as compared with credit and market risks due to non-availability of historical loss data in the financial sector. There is not enough data to help build models to quantify the operational risk with a reasonable precision for different kinds of banks and financial institutions.

In the developed markets, though efforts are being made to collect data on operational losses, yet the need for data regarding internal loss events can not be neglected because it is this data that truly reflects the operational risk in the organization’s business line and environment. However, for rare and catastrophic events (Low Frequency – High Impact), external data can be used and internal models can be calibrated accordingly. In Pakistan, unfortunately not much has been done for collection of Internal Operational Loss Data. Methodical OpRisk management is a rare concept. SBP, in an effort to collect data of banks and DFIs, has recently started receiving detailed information on any attempted or actual frauds/forgeries/dacoities. However, SBP has been collecting information on frauds and forgeries in the banks for a few years and an analysis of the data available depicts mixed trends. Both the number and amounts of frauds & forgeries are on the rise (see **Figure 6.4.1**) but the amounts involved at the year end as percentage of previous 3 years moving average gross income are declining (see **Figure 6.4.2**). Three years moving average gross incomes are used as a proxy for volume of operations. Since the year 2002, the amounts outstanding pertaining to cases of frauds and forgeries are on the decline.

Figure 6.4.1 Frauds & Forgeries in Banks

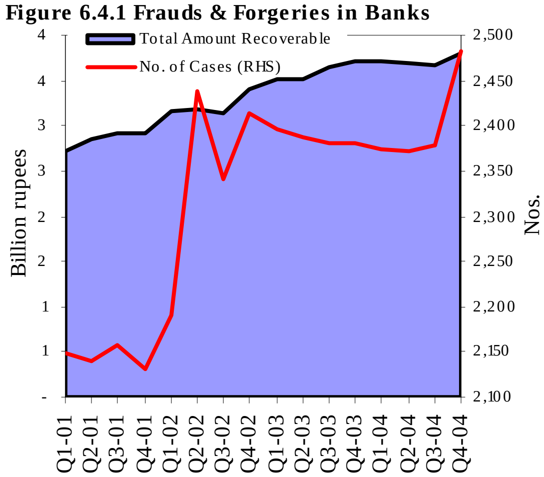
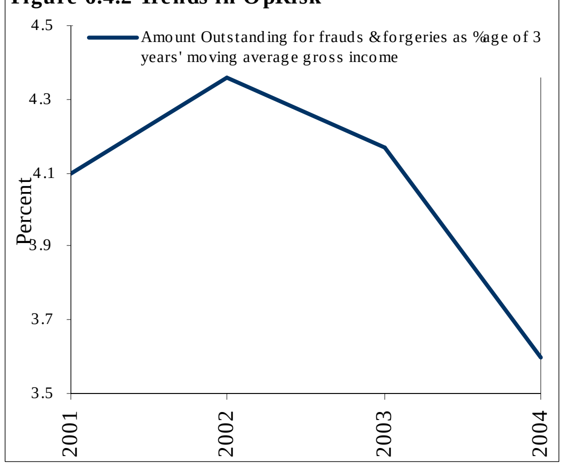


Figure 6.4.2 Trends in OpRisk

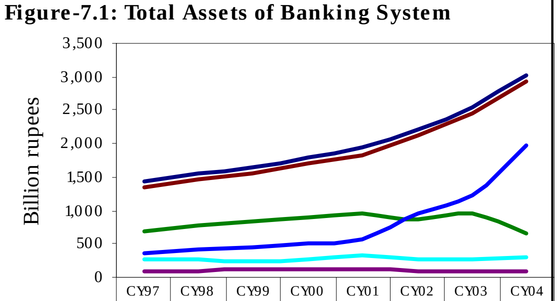


For the time being, due to the data constraints and lack of expertise in operational risk quantification in the banks, SBP will allow banks to adopt *Basic Indicator Approach* to calculate capital charge for OpRisk, but in the long run, the historical loss database would need to be developed to enable the banking industry to come up with OpRisk quantification models that would in turn facilitate the banks to go for more advanced approaches.

7 Assets and Funding Structure

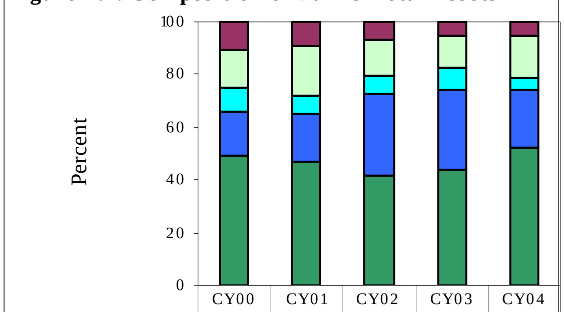
Total assets of the banking system displayed strong growth during the year under review. Considering the growth patterns observed in recent years, the rise in total assets by 19.7 percent is unprecedented (see **Figure 7.1**). Deposits, which increased at the rate of 21.9 percent, remained the driving force behind this exceptional growth. A substantial support also came from equity, which spurred mainly by the enhanced minimum capital requirement and healthy profits, increased by Rs58 billion. With the gradual rise in interest rates and growing economic activities, the banking system refocused on lending activities. This revived interest in lending gathered remarkable momentum as loans portfolio saw a growth of 38.5 percent in the year 2004. Resultantly, loans share in total assets went up significantly (see **Figure 7.2**).

Figure-7.1: Total Assets of Banking System



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	697	789	844	902	947	878	959	650
LPBs	373	405	449	513	566	967	1212	1,980
FBs	269	263	253	281	324	280	267	304
CBs	1,339	1,458	1,545	1,696	1,836	2,125	2,438	2,933
SBs	97	98	109	112	106	98	100	104
All	1,436	1,556	1,654	1,808	1,942	2,223	2,538	3,036

Figure-7.2: Composition of Banks' Total Assets

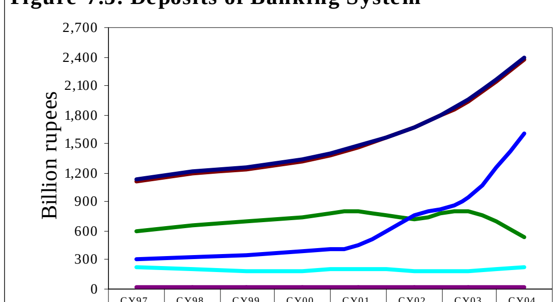


	CY00	CY01	CY02	CY03	CY04
Other Assets	10.4	9.4	6.4	5.2	5.1
Cash & Bank Balances	14.7	18.7	14.0	12.5	16.1
Lending to FIs	8.9	7.0	6.6	7.7	4.7
Investments	16.8	18.1	31.5	31.0	22.2
Advances	49.1	46.9	41.4	43.6	51.9

Since majority of the banks now fall in the local private banks (LPBs) group, the contribution of this sector to the overall assets growth remained the highest. The fast growth coupled with the inclusion of HBL, following its transfer to private management in the early 2004, led to a significant rise in the overall share of LPBs in the total assets of the banking system to 65.2 percent from 47.8 percent last year. As a corollary to this group shift, the share of public sector commercial banks (PSCBs) declined to 21.4 percent from 37.8 percent in the year 2003. The remaining PSCBs, however, kept building their balance sheets as their total assets increased at the rate of 20 percent, only second to LPBs. Foreign banks and specialized banks also managed to increase their total assets by 13.9 percent and 3.9 percent respectively.

A further analysis shows the declining concentration of assets as the five big banks[1], despite growing at a rapid pace, lost further ground to the relatively smaller size banks. Their share in total assets declined to 56 percent from 58.9 percent in 2003 and 60.8 percent in 2002. This demonstrates growing competition in the market which is expected to promote better financial services.

Figure-7.3: Deposits of Banking System



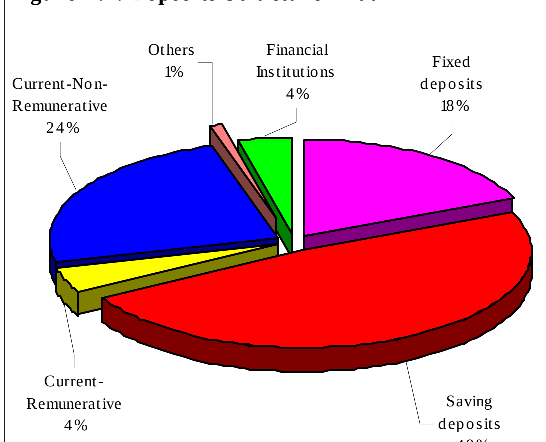
	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	597	659	701	744	795	722	799	545
LPBs	304	327	355	394	454	757	954	1603
FBs	221	213	183	187	208	183	192	227
CBs	1122	1199	1239	1325	1457	1662	1945	2375
SBs	13	11	14	16	18	16	17	17
All	1135	1210	1254	1341	1475	1678	1962	2392

Deposits of the banking system, with an increase of Rs430 billion in the year under review, broke all the previous records of increase during a single year (see **Figure 7.3**). This exceptional growth in deposits was underpinned by persistent inflow of workers' remittances. Moreover, deposits usually grow in tandem with credit and as the economic activites picked up so did the credit demand, leading to multiple expansion in deposits of the banking system.

The role of LPBs has been crucial in the growth of the financial sector of Pakistan. Their share in the total deposits of the banking system increased to 67 percent from 48.6 percent last year. The privatization of HBL as well as fast growth of the rest of the banks in LPBs caused this substantial increase in the share. Isolating the impact of HBL's inclusion, the rest of LPBs increased their deposit base by 27.6 percent which amply shows their growing penetration in the financial system. Their remarkable growth owes significantly to the overall reform process as not only the large public sector banks joined their ranks as a result of privatization but also because of the conducive environment afforded to them by the successful policy actions of the authorities.

The retreat of the public sector commercial banks was the logical outcome of the reform measures. This is reflected by the decline in the deposit share of this group of banks to 22.8 percent from 40.7 percent in 2003. Of this share too, 19.5 percent is held by the largest bank which has started to produce very healthy results in recent times. Foreign banks also succeeded in accumulating more deposits at the rate of 18 percent. However, their share in the total deposits of all banks declined fractionally to 9.5 percent from 9.8 percent because of the relatively faster growth witnessed by LPBs. Specialized banks hold a small share of 0.7 percent which also declined despite the fact they increased their deposits during the year: the reason again is the rapidly increasing size of LPBs. Moreover, the specialized banks continue to rely on borrowings for funding their lending activities.

Figure-7.4: Deposits Structure - 2004

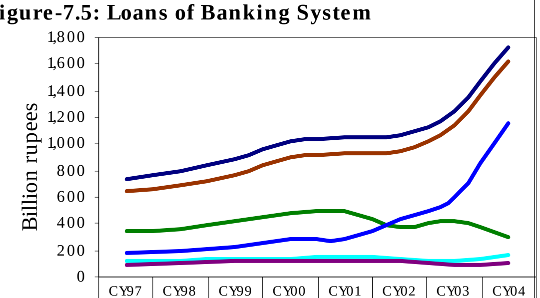


Interest rates, following SBP's efforts to reign in the rising inflation, showed a gradual uptrend in 2004. However, the rise in rates was calculated and gradual. The overall real return to depositors remained negaitive due to higher inflation rate. Hence, the structure of deposits depicted only a little change since the last year. Saving deposits with comparatively lower share of 48.4 percent (CY03:51.7 percent) continued to hold the largest chunk (see **Figure 7.4**). The share of non-remunerative current accounts increased to 24.2 percent from 21.6 percent in 2003 as they experienced the maximum acceleration of 36.4 percent. Fixed deposits which have been declining since 2002 also started to rise in response to a slight uptick in return on longer term deposits. However, the share of this type of deposits remained flat at 18.5 percent of all deposits because of relatively faster growth in other deposits. Moreover, banks' growing interest in longer term financing is forcing them to issue longer term deposits at relatively attractive rates. This should help push up the share of fixed deposits.

Total **borrowings** of the banking system decreased by Rs9.7 billion which shows that, despite the gradual rise in interest rates and frequent recourses to SBP's 3-day Repo facility, overall liquidity condition of banks remained comfortable throughout the year. As discussed above, almost all the banks continued to enjoy persistent inflow of deposits which helped them to meet growing credit demand. Moreover, the banks had been carrying a substantial load of liquid funds accumulated over the last couple of years which also saved them from any liquidity constraint. The break-up of total borrowings reveals that fall in repo borrowings by Rs47.6 billion mainly caused the decline in total borrowings. Export refinance borrowings, on the other hand, increased by Rs25.2 billion which is in line with the buoyant export performance during the year under review. The higher demand for export refinance, which is at their highest level since 1997, persisted throughout the year 2004 despite the gradual increase in export refinance rate which generates optimism about improvement in export earnings in the coming months.

An extraordinary increase of Rs478 billion or 38.5 percent in the **loans** portfolio of the banking system during the year 2004 surpassed even the impressive growth of Rs179 billion or 17.1 percent achieved during the last year (see **Figure 7.5**). While the growth indicated strong pick-up in economic activities, with the brighter prospects of national output exceeding its targeted path, the concerns related to inflationary tendencies as well as asset price bubbles, with a potential to create asset quality problems for banks, also started to crop up. However, a number of factors combined to make this remarkable growth inevitable. They included the growth momentum attained by the economy, persistence of excess liquidity restricting any significant rise in lending rates, declining interest in the government papers etc. This exceptional loans growth can also be seen in the perspective of unremitting policy measures and vigorous pursuit of the reform agenda as well as the improving geo-political environment which also contributed significantly in producing strong optimism among the business community about the future course of the economy.

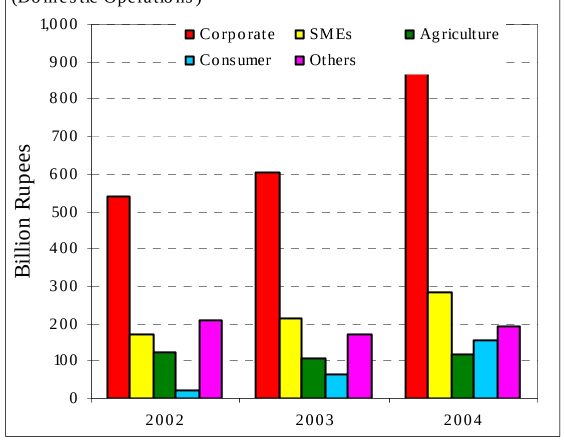
Figure-7.5: Loans of Banking System



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04
PSCBs	345	365	419	476	501	374	422	302
LPBs	183	198	224	282	281	435	597	1156
FBs	124	126	129	138	143	135	125	162
CBs	652	689	772	896	926	945	1143	1620
SBs	83	103	118	124	118	117	97	99
All	735	792	890	1020	1044	1062	1241	1719

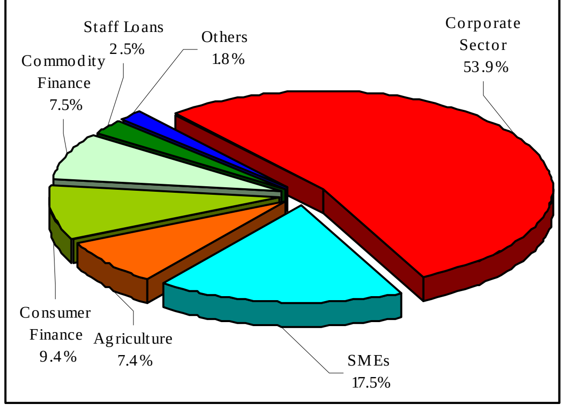
Despite the increasing interest of banks in financing to the SMEs, consumer and agriculture sectors, the major portion i.e. 58 percent of the loans growth went to finance the corporate sector. This too was obvious considering the pivotal role of the LSM sector in pushing up the GDP growth in recent years. With the rising demand for the goods produced by this sector, the corporate sector's appetite for funds also increased leading to an increase of 44 percent in total outstanding loans to this sector (see **Figure 7.6**). Accordingly, the share of the corporate sector in total loans of all banks also increased to 53.9 percent from 52.2 percent in 2003 (see **Figure 7.7**). Among the other sectors, consumer finance remained in the limelight. This sector by registering an increase of 132.6 percent absorbed around 19 percent of the loans growth of the banking system during the year under review. Likewise, the share of this sector in the outstanding loans portfolio of all banks also increased to 9.4 percent from 5.7 percent in the year 2003. The rapid expansion in

Figure-7.6: Sector-wise Loans Trends
(Domestic Operations)



consumer finance was helped by the low interest rate regime as well as intense competition among the banks to enhance their market share. The greater activity was observed in personal loans and auto loans categories. Mortgage loans also witnessed a substantial increase considering their low level in the year 2003. With the onset of the year 2005, interest rates have started to move up at a faster pace generating concerns relating to increase in default on these loans. The growth prospects for the consumer financing depend a great deal on the future behaviour of interest rates as well as the debt repayment capacity of households which in turn will be determined by their income trends.

Figure-7.7: Loans by Type of Borrowers-CY04
(Domestic Operations)



Because of its far-reaching influence in boosting economic activities, the regulators have been attaching special importance to the small and medium enterprises (SMEs). For this purpose, efforts to create conducive environment and necessary infrastructure have also been in progress to encourage banks to venture more vigorously into this sector. The year 2004 saw significant success on this front as the banking system's financing to SMEs also increased substantially by 32.1 percent. Despite this fast increase, the share of this sector declined to 18 percent from 19 percent in the overall credit because of relatively faster increase in financing to the corporate and consumer sectors. Another sector which has also caught attention of banks is the agriculture. This sector after experiencing a fall in lending in 2003 managed to recover and posted an increase of 14 percent. The increase, as was the case with SMEs, was not fast enough to push up its share in overall lending; which declined to 7 percent from 9 percent in 2003. The encouraging prospects for this year's harvest as well as improvement in the farmers financial condition and hence their credit worthiness, might induce banks to extend more loans to this sector.

Another important indicator of the growing outreach of banks is the significant increase in the number of borrowers (see **Table 7.1**). The growth pattern for the last quarter of the year shows an increase of 4.7 percent which is quite significant and holds special connotations with regard to provision of services to the larger sections of the society.

Table-7.1: Sector-wise number of Borrowers

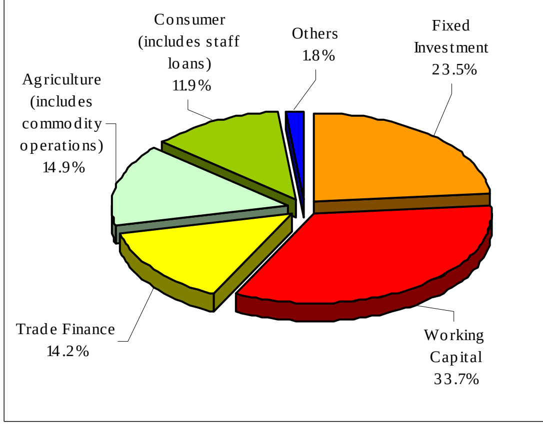
Sectors	No of Borrowers		Change	
	Sep-04	Dec-04	Number	Percent
Corporate Sector	18,218	19,333	1,115	6.1
SMEs	99,010	106,248	7,238	7.3
Agriculture	1,565,946	1,503,827	(62,119)	(4.0)
Consumer Finance	1,409,925	1,619,207	209,282	14.8
Commodity Financing	2,073	3,207	1,134	54.7
Staff Loans	74,589	72,633	(1,956)	(2.6)
Others	75,563	73,735	(1,828)	(2.4)
Total	**3,245,324**	**3,398,190**	**152,866**	**4.7**

Domestic operations covering both public and private sector borrowers

A significant rise in lending for fixed investment was another noticeable feature of the loans growth during the year. This category of loans increased by 36.4 percent which is quite remarkable and is a good omen both for productivity and the future lending potential of the banking system. Increase in capacity would serve as a catalyst to increase the industry's need for working capital finance. This is already becoming visible as the working capital registered an increase of 55.6 percent since the year 2003. Since the banking system mainly caters to the working capital needs of the industry, this type of loans also occupy the dominant share of the total loans followed by the loans for fixed investment (see **Figure 7.8**).

A glance at the group-wise break-up of loans find LPBs holding 67.2 percent of the total loans portfolio of the banking system. The share corresponds to their overwhelming size which became larger with the privatization of HBL. However, the inclusion of HBL is not the only reason for the rapid increase in their share. LPBs, excluding HBL, also increased their lending sharply as is evident by a growth of 47 percent in their loans portfolio. PSCBs, though lost their share because of the HBL's impact, also grew at a rapid pace of 40.3 percent over the year. Rapidly growing loans of LPBs also caused a decline in the share of foreign banks to 9.4 percent from 10.1 percent in 2003. This happened despite the fact that this group of banks saw a strong growth of 29.6 percent in their loans portfolio. The specialized banks were the laggards as they experienced a nominal growth of 2 percent in loans. This is due to the fact that one of them is undergoing restructuring process, while the share of other two providing agriculture loans is being crowded out by commercial banks as the latter's interest in agriculutral financing has risen.

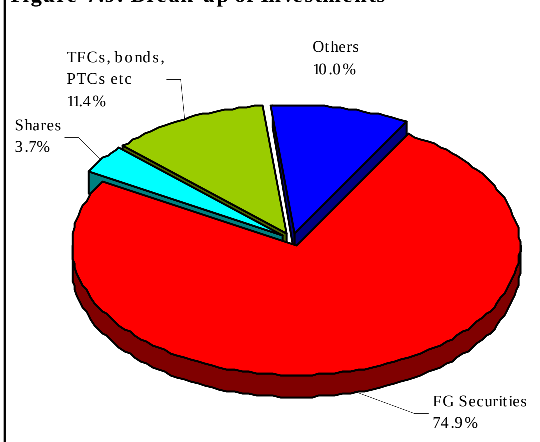
Figure-7.8: End-Use Distribution of Bank Loans-CY04 (Domestic Operations)



The loans trend in the coming months hinges a great deal on the interest rate movement as well as the prevailing liquidity conditions. Going by the recent trends, it is expected to slow down as the interest rates have begun to show a relatively faster increase in response to SBP's efforts to check the further hike in inflation. However, the strength of slow down will depend a great deal upon the business sentiment which so far remains sanguine in view of strong demand pressures. Moreover, the wheel of the economy is also moving very fast and if this momentum sustains, the current strong demand for loans would maitain the tempo, albeit, at a slower pace.

The rising interest rates had a more visible impact on **investments** of the banking system which declined by 14.3 percent as compared with the rise of 12.4 percent in 2003. Apart from the rising yields, which started to erode the value of securities portfolio, the sharp rise in loans also diverted substantial funds from investments. The disaggregated analysis shows a substantial fall in the government securities which plunged by around 22 percent in contrast to the increase of around 10 percent in 2003. Investment in shares also declined apparently due to the restriction imposed on the maximum level of investments in shares. However, investment in TFCs/bonds/PTCs etc continued to rise which demonstrates growing interest in long-term capital market instruments as the corporate sector continued to display strong performance and macroeconomic forecasts for the future looked encouraging.

Figure-7.9: Break-up of Investments



Despite the sharp fall, government securities continued to hold the largest share of the banking system's total investments (see **Figure 7.9**). However, the share declined to 75 percent from 82 percent in the year 2003. Likewise, the share of equity investments also fell whereas that of TFCs/bonds/PTCs increased since the last year.

The break-up of government securities shows that MTBs were mainly responsible for the steep fall in government securities as they alone accounted for about 93 percent of the fall in these securities. On the other hand, the banking system kept their interest alive in PIBs which increased by around 1 percent over the year. Whereas these securities offer higher risk free return, at the same time they expose the banks to the risk of fall in their value with the rise in interest rates. Therefore, the banks' policy for locking such a high proportion of funds into such securities might backfire in an environment of rising interest rates.

LPBs, with the HBL in their fold, now hold 68.7 percent of the total investments of the banking system followed by PSCBs with 25.6 percent, foreign banks with 4.6 percent and specialized banks with 1.1 percent. Isolating the impact of the HBL's category shift, the overall share of the different groups in total investments remained almost intact. The percentage share of the government securities in total investments by LPBs and PSCBs, however, declined over the last year as they channelled more funds towards loans and also became wary of the decline in the value of their securities due to the rising interest rate.

8 Overseas Operations of Pakistani Banks[13]

Four large Pakistani banks have traditionally been engaged in overseas branch operations. A couple of years back, two more banks entered the international arena, raising the tally to six. However, the share of these new entrants in the total overseas assets, which constitute around 8 percent of the banking system, remains miniscule (see **Figure 8.1**). Barring Latin America, Pakistani banks have presence in almost all the regions of the world. However, their major share i.e. around 60 percent of total overseas assets resides in Middle East region (see **Figure 8.2**).

Figure-8.1: Bank-wise Share in Overseas Assets-CY04

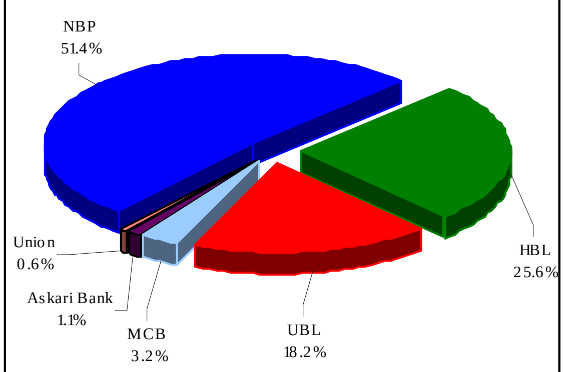


Figure-8.2: Geographical Distribution of Banks' Overseas Assets, CY04

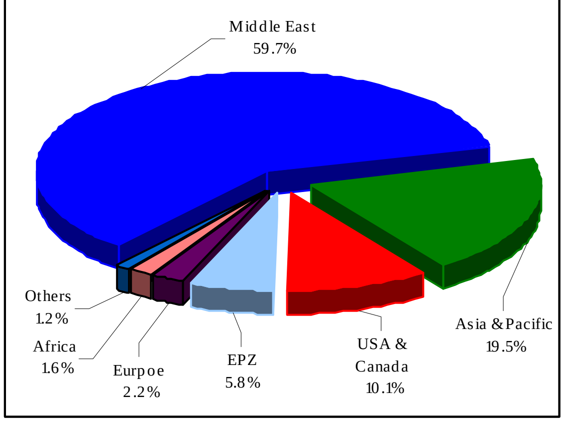
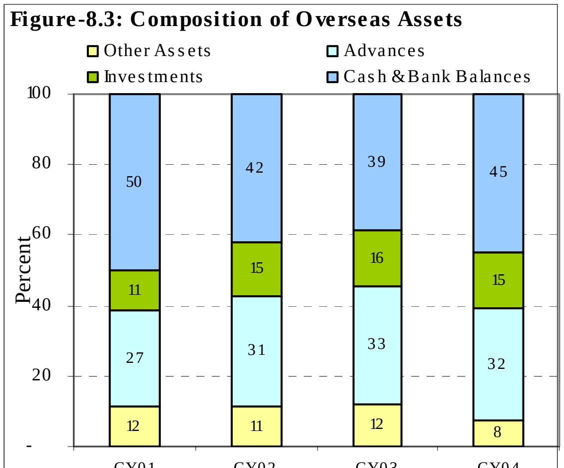


Figure-8.3: Composition of Overseas Assets



On aggregate basis, the Pakistani banks are following more of a conservative approach, as interbank placements and balances constitute the major share of their assets portfolio while lending remains modest (see **Figure 8.3**). This is having a moderating impact on profitability: a pre tax ROA of 1.4 percent on overseas operation vis-à-vis overall ROA of 1.9 percent for commercial banks. But assets quality indicators, on the other hand, suggest a position slightly less favourable than that for domestic operations, an infection ratio of 19.1 percent vis-à-vis commercial banks' global ratio of 9.0 percent. These NPLs are, however, provided to the reasonable extent, well depicted by net NPLs to net loans ratio of 3.4 percent. Whereas the indicators are showing improvement, the situation has the peculiarities with regard to specific banks and countries of operation; EPZ (export processing zone) and UAE deliver the most significant deteriorating impact. Together, these two centers account for more than three fourth of the overseas NPLs, though they contribute only around 40 percent to the overseas loan portfolio.

The business strategies, patterns of asset profiling, scope of operations and consequently the resultant performance indicators, vary from bank to bank and country to country. These peculiarities are especially marked for the dichotomy of developed and developing markets as the different sets of paradigms influence the banks' strategic goals.

[13] Branch operations

Therefore, the forthcoming paragraphs focus on the overseas operations of Pakistani banks in the context of developing and developed markets.

Pakistani Banks in Developing Markets:

Three-fourth of the Pakistani banks' overseas assets is invested in developing economies-predominantly the Middle East region. These economies still have many developing sectors, less matured banking sector, and (especially the Middle East) have sizeable Pakistani community. All these factors contributed towards a favourable operating environment for Pakistani banks. They are doing more of a conventional banking with greater focus on lending. Loans form around 38 percent of asset base and are showing a persistent growing trend (see **Table 8.1**). This approach naturally has positive impact on the banks' earnings and asset quality. This overseas segment has ROA of 1.5 percent higher than that in developed economies and also carries higher burden of infected portfolio with net NPLs to net loans ratio of 3.7 percent. However, the major part of infected portfolio comes from UAE and EPZ that is overhanging for quite some time as it mainly emanates from pre-reform era. This infected portfolio, though, is showing a persistent decline as net NPLs to net loans ratio has came down from 26.5 percent in CY00 to 3.7 percent by the end of CY04.

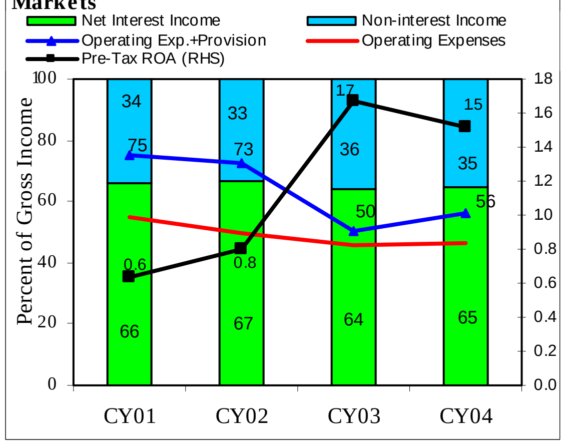
Table-8.1: Composition of Overeas Assets & Liabilities in Developing Markets

(Percent of Total Assets)	CY01	CY02	CY03	CY04
Cash and Bank Balances	52	41	38	38
Loans	30	34	36	38
Investment	13	18	18	17
Other Assets	6	7	8	7
Total Assets (Billion Rs)	212	178	178	198
Deposits	68	68	70	69
Borrowings	7	11	9	10
Other Liabilities	20	15	12	13
Capital	5	6	8	9

Trade finance and facilitation is the hallmark of the banks' overseas operations. The individual bank's strategy is disparate-ranging from a focus on the top segment Pakistani blue chips and reliance on interbank placement to a policy where some banks focus on mid segment clientele and consumer banking on selective basis.

The income structure of this segment of the overseas operations reflects that the sources of income are well diversified into interest and non-interest incomes and are showing gradual growth. And this composition of income has remained quite stable for the last few years. With improvement in asset quality indicators, provision charges which have remained a major drag on the bank's earnings are also receding. These charges together with operating expenses are being met adequately by net interest income. Operating expenses have shown controlled growth, while healthy gross income is contributing towards a cost income ratio well within the acceptable level of 60 percent (see **Figure 8.4**).

Figure-8.4: P&L Composition in Developing Markets



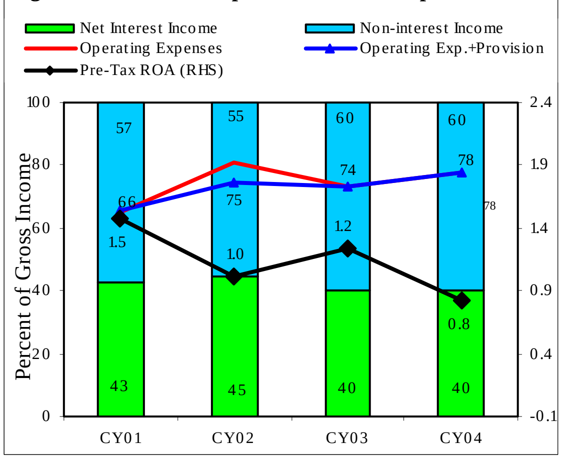
Developed Markets

Table-8.2: Composition of Overeas Assets & Liabilities in Developed Markets				
(Percent of Total Assets)	CY01	CY02	CY03	CY04
Cash and Bank Balances	46	43	40	65
Loans	13	21	21	13
Investments	3	7	10	11
Other Assets	37	29	29	11
Total Assets (Billion Rs)	50.1	45.0	40.9	66.8
Deposits	50	44	58	65
Borrowings	6	5	5	3
Other Liabilities	34	40	24	23
Equity	9	10	13	9

One-fourth of the Pakistani banks' overseas assets resides in developed markets[13]. These markets are characterized by stiffer regulatory requirements, tough competition, and fully matured economic segments with fewer opportunities to build lending clientele. Therefore, the main focus of the Pakistani banks in these markets remains trade finance and interbank placements. Lending remains subdued and mainly relates to trade finance activities and interbank placements (see **Table 8.2**). The asset base which was following a declining trend over the past few years shows considerable increase at the end of CY04. However, this increase was mainly transitory in nature, occurring in respect of SBP's deposits for onward payment to multilateral agencies.

Since the lending activities are mute, the asset quality of Pakistani banks' operations in developed markets is quite remarkable. Net NPLs to net loans ratio stands as low as 0.5 percent and shows improving trend (2.7 percent in CY01).

Figure-8.5: P&L Composition in Developed Markets



The peculiarity in the business strategy that banks are following in the developed markets is well reflected in the income patterns of these operations also. Non-interest income contributes the major share of the banks' income base, and as the lending activities remain minimal, the contribution of net interest income remains low. Mainly due to this constrained income base, operating expenses as percentage of gross income stay high at 78 percent. The low profit margin, however, gets consolation from strong asset quality as there are no provision charges, leaving ROA in reasonable range (see **Figure 8.5**).

As is apparent from the above discussion, the overseas operations of Pakistani banks have been confined to limited areas and their potential so far has remained more or less sub-optimal; both in terms of their ability to generate diversified sources of income, as well as establishing a noticeable presence in the different markets. With the impressive results in the domestic market, the time seems to be ripe for them to penetrate the hitherto untapped and growing financial markets of the world with renewed vigor. This would not only be helpful for the foreign trade of the country but would also provide the banks to take advantage of the vast opportunities offered by the fast growing economies like China.

[13] Pakistani banks have presence in USA, Europe, Japan , Hong Kong, and Singapore

9 Performance of Islamic Banking

The fact that the Islamic banking is witnessing robust growth and has emerged as a practical alternative for providing financial services, has been substantiated by various indicators for CY04. During the past year, the prominent local and foreign banks have increased the number of branches offering Islamic banking services. The total branch network of Islamic banking industry has risen to 48 from 17 a year ago, with the number of licensed Islamic Banking Institutions (including conventional banks offering Islamic financial services through their selected branches) now standing at 11 (see **Table 9.1**). Besides, the number of full fledged Islamic Banks has now increased to three viz. Meezan Bank, AlBaraka Bank and the recently licensed Bank Islami Pakistan Limited which is expected to start its commercial operations by end 2005. The banks having license for Islamic banking branches include Muslim Commercial Bank Ltd, Bank of Khyber, Bank Alfalah Ltd, Habib Bank AG Zurich, Standard Chartered Bank, Metropolitan Bank Ltd, Habib Bank Limited, Soneri Bank Ltd and Bank Al Habib Ltd. The network is expected to expand at a much faster pace in future as SBP has allowed a number of banks to enter into negotiations for Islamic banking licenses. It is interesting to note that the conventional banks are increasingly realizing the huge potential market backed by the untapped and steadily growing appetite for Islamic banking products; hence the drive for entering this market is purely based on business considerations.

Table-9.1: Islamic Banking Players

	Dec-02	Dec-03	Dec-04
No. of Islamic Banks (IBs)	1	1	2
No. of Branches	6	10	23
No. of conventional banks operating Islamic Banking Branches	-	3	9
No. of Islamic Banking Branches (IBBs)	-	7	25

With the expanding branch network, the Islamic Banking operations witnessed steady growth. A glance at sources and uses of funds (see **Table 9.2**) reflects marked improvement. The total assets of the Islamic banking System (IBS) have grown at a substantially high rate and now stand at 3.5 times of 2003 level. At end 2004, the total balance sheet footing of the IBS expanded to Rs44 billion from Rs13 billion in 2003. However, it is important to note that there was substantial asset growth in overall banking sector as well; hence the share of IBS remained somewhat contained at 1.5 percent. Parallel to the growth in assets, the deposit base also rose to 3.5 times of its previous year level and now stands at Rs30 billion in absolute terms. Most of these funds were routed to the financing side. The increase in the number of Islamic banking participants viz. the conversion of AlBaraka Islamic Bank into Islamic Bank mainly lead to this overall impressive growth, hence the full fledged Islamic Banks continue to carry major chunk in all the respective heads.

Table-9.2: Sources and Uses of Funds (Million rupees)

	2003		2004	
	Amount	Percent	Amount	Percent
SOURCES:				
Deposits	8,397.1	65.0	30,184.8	68.4
Borrowings	1,899.0	14.7	6,559.1	14.9
Capital & other funds	1,993.7	15.4	5,123.1	11.6
Other liabilities	624.8	4.8	2,276.1	5.1
	12,914.6	**100.0**	**44,143.0**	**100.0**
USES:				
Financing	8,652.2	67.0	27,535.5	62.4
Investments	1,242.3	9.6	2,007.0	4.5
Cash, bank balance, placements	1,978.5	15.3	11,899.7	27.0
Other assets	1,041.7	8.1	2,700.8	6.1
	12,914.6	**100.0**	**44,143.0**	**100.0**

A look at the sources and utilization of funds shows that the deposits remained the prime source of funds. While financing absorbed a major chunk of these funds, the share of investments in the total asset portfolio remained very low containing the market risk of Islamic banks. On the other hand, the credit to deposit ratio of the overall IBS remained high, as more than 90 percent of the deposits were consumed by the financings. This high credit deposit ratio could hold liquidity concerns; however, adequate credit quality provides much relief. The deposit structure has undergone some reshuffling during the year; the share of non remunerative current account has increased to 26 percent from 10 percent in CY03. The awareness amongst the general public as well as the business community regarding Islamic banking has increased which stands as the possible explanation for the increase in the share of individuals' current accounts. Consequently, the share of cash and bank balances also increased in total assets of the IBS (see **Table 9.2**). Despite this increase in current accounts, the savings deposits continue to show predominance at 41 percent of total deposits. Fixed deposits remained second at 28 percent of the total deposits (see **Figures 9.1 & 2**).

Led by this impressive overall growth, the financial soundness of the Islamic banking has

Figure-9.1: Composition of Deposits

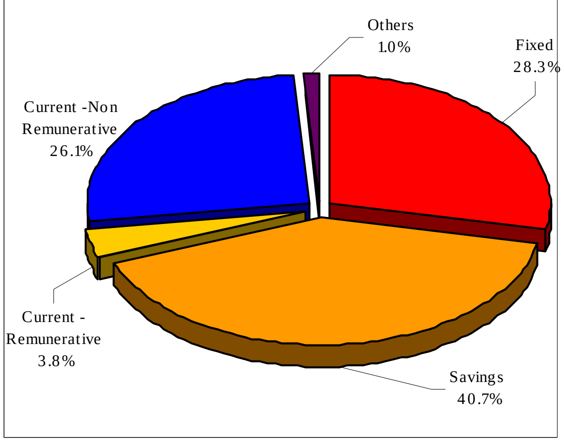
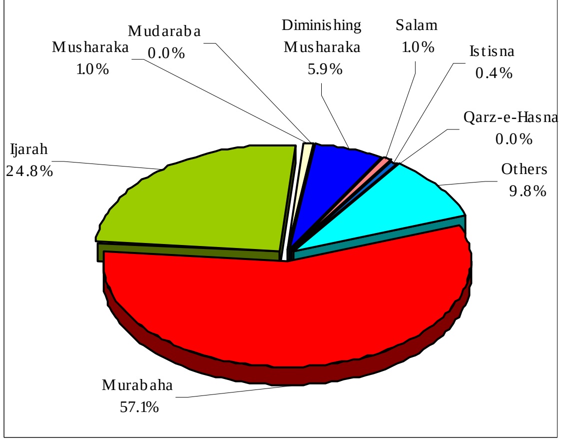


Figure-9.2: Modes of Financing



amplified. The upsurge in capital base of the Islamic banking system is quite notable as it has more than doubled since 2003; however the assets have built up at an accelerated rate translating into a fall in the capital to total assets ratio to 12 percent from 15 percent in 2003. This decline in the ratio is attributable to the fact that the Islamic Banking is in its early years of progression, where the efforts on part of participants to increase financial intermediation are quite pronounced hence the expansion in asset and deposit base is rather obvious. Nevertheless, the capital provides quite an adequate coverage to the credit risk as the Net NPFs (non performing financing) to capital ratio is meager at 0.9 percent. Given the major share of financings in the total assets, the capital position gets comfort from asset quality. Moreover, the Capital Adequacy Ratio has been complied with both by the Islamic Banking Branches and the Islamic Banks.

As regards asset quality, stringent credit appraisal has contained the credit risk of the Islamic banking system (see **Table 9.3**). The non performing financing to total financing ratio which was very low at 0.7 percent in CY03 has slightly gone up but remains less than one percent.[14] While the Islamic banks continue to increase their financing portfolio, this increase in NPFs appears trivial. The peculiar nature of the Islamic banking and the Shariah based modes of financing, whereby any late payment penalty recovered from the borrowers shall be spent for charitable purposes, serves as a sufficient condition for the banks to observe extra vigilance in credit appraisals and ensure timely recovery. While on the one hand, it has kept the infection ratios low, it has also reduced

Table-9.3: Key Performance Indicators

Indicator	2003	2004
NPFs to total financing	0.7%	0.9%
Net NPFs to net financing	0.0%	0.2%
Provision to NPFs	100.0%	82.3%
Net Markup Income to total assets	1.7%	1.4%
Non Markup Income to total assets	2.2%	1.4%
Operating Expense to Gross Income	54.6%	65.3%
ROA (average assets)	2.2%	1.2%
Growth in Assets	84.5%	241.8%
Growth in Deposits	64.6%	259.5%
Growth in Financing	147.0%	218.2%

[14] The NPFs primarily belong to the operations of Albaraka Islamic Bank before conversion and NPLs of Societe Generale inherited by Meezan Bank.

the concerns relating to the banks venturing into this relatively under-exploited area, in terms of the skills and expertise required for credit appraisals compared to what they have been following for years in the conventional banking system. This was mainly due to the policies of the regulator and overall efforts on part of the stakeholders to enhance in-house capacity of the banks.

The profits of IBS have increased in absolute terms after recording a growth of 57 percent. It must be appreciated that the Islamic banking is growing at an accelerated rate; therefore the growth in assets far exceeds the income growth resulting in a decline in profitability indicators when measured in terms of total assets (see **Table 9.3**). This is reflected in the return on average assets that has slightly dipped to 1.2 percent in CY04 from 2.2 percent in the previous year. The common sized income statement further substantiates the growing financial intermediation in Islamic banks and increased focus on the income from core activities. The net mark up income now stands improved both in absolute terms and as percentage of mark-up income. However, the decline in the non mark up income in terms of markup income and the high operating expenses of the IBS precluded the profits to keep the pace. This is attributable much to the expansionary stage of Islamic banking; hence the high operating expenses are quite justifiable (**Table 9.4**). However, the Islamic banks should reduce their operating expenses to reap higher profits.

Table-9.4: Income Statement

(Million rupees)

	2003		2004	
	Amount	Percent	Amount	Percent
Markup Income	406.4	100.0	1,081.0	100.0
Markup Expense	188.5	46.4	483.7	44.8
Net Markup Income	217.9	53.6	597.2	55.2
Provision Expense	(15.8)	(3.9)	36.0	3.3
Non Markup Income	287.4	70.7	596.0	55.1
Operating Expense	276.0	67.9	779.0	72.1
Profit Before Tax	245.0	60.3	378.2	35.0
Tax	27.0	6.6	36.2	3.4
Profit After Tax	218.0	53.6	342.0	31.6

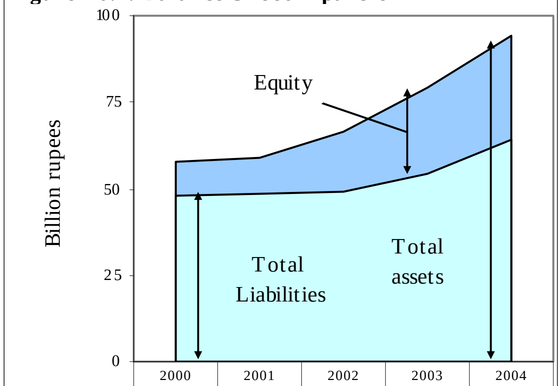
The Islamic banking industry, despite its remarkable growth during the last year, is still in its formative years; hence careful nurturing and development to make a noticeable impact on the global financial market is indispensable. The prime challenges for the upcoming years include enhancement and up gradation of intellectual capital development and the development of a diversified product range and risk mitigation tools and techniques. In this regard, the beginning of CY05 has already seen the launch of first Pakistani International Islamic bond, named Sukuk. This was principally the result of the overall effort to deepen the capital and financial market in Pakistan and will go a long way in shaping the overall character of the Pakistani Islamic Financial Industry as a vital constituent of the international Islamic financial industry.

10 Development Finance Institutions

The year 2004 was another productive year for DFIs in terms of asset growth, capital strengthening and profitability. The year was also significant, as the DFIs saw resurgent demand for their loans. Consequently, their profits, despite witnessing a marginal decline, improved in terms of quality. Solvency indicators also got further strength from profits as well as capital injection.

The total assets of the DFIs registered significant expansion of 19 percent (see **Figure 10.1**). This growth came on the back of healthy increase in deposits as well as simultaneous rise in equity. Despite the rapid increase, the share of DFIs continued to constitute around 3 percent of total assets of banks and DFIs taken together.

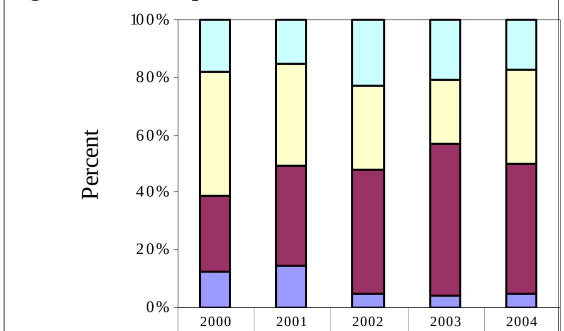
Figure-10.1: Balance Sheet Expansion



	2000	2001	2002	2003	2004
Total Assets	57.6	58.7	66.3	79.2	94.4
Total liabilites	48.0	48.3	48.9	54.2	64.3

Among assets, major increase was witnessed in advances. However, the asset and funding mix of the DFIs remained unconventional as investments and borrowings continued holding dominant share in assets and funding sources respectively. However, the changing interest rate scenario as well as growing demand for loans caused a decline in the share of investments to 45 percent from 53 percent of total assets in the preceding year (see **Figure 10.2)**. Following their fast growth, the share of loans increased appreciably from 22 percent in the CY03 to 32 percent in the CY04. However, the share is still on lower side considering the nature of DFIs' business. Investments, in turn, comprise mainly of shares.

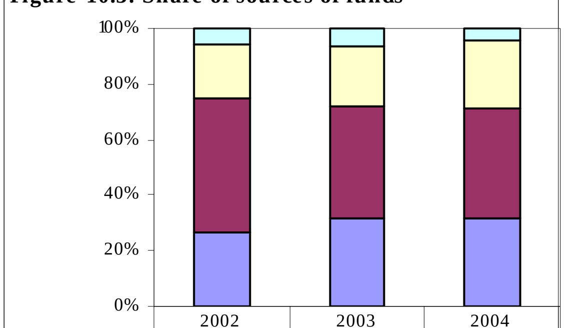
Figure-10.2: Composition of Assets



	2000	2001	2002	2003	2004
Other Assets	18.1	15.1	22.8	20.5	17.6
Loans	43.1	35.7	29.0	22.3	32.1
Investments	26.1	34.5	43.0	52.8	45.1
Cash & Bank Balances	12.7	14.7	5.2	4.4	5.1

No doubt, deposits provided the main stimulus to the balance sheet expansion by growing at a strong pace, their share at 35 percent of total liabilities remained slim and reliance on borrowed funds continued to remain substantial. The low share of deposits arose because of the limitations in deposits mobilization, which led the DFIs to explore the borrowing sources. Consequently, total borrowings make up the largest head with 50 percent share in total liabilities and 39.3 percent in all sources combined together (see **Figure 10.3**). Borrowings from financial institutions stood at Rs32.8 billion in CY04 compared to Rs27.0

Figure-10.3: Share of sources of funds

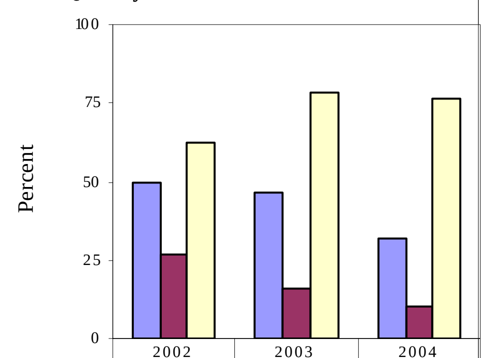


	2002	2003	2004
Other liabilites	5.8	6.5	4.6
Deposits	19.0	21.4	24.2
Borrowings	48.9	40.6	39.3
Equity	26.3	31.5	31.9

billion in CY03 reflecting a growth of 21.4 percent. Such an excessive reliance of DFIs on borrowings at floating rate from financial institutions[15] raises concerns regarding the sustained availability of these funds. The market conditions over the last couple of years remained very favourable with excess liquidity, which helped DFIs to mobilize funds at fairly easy terms. The conditions appear to be changing with the gradual monetary tightening and rising interest rates. This could pressurize the balance sheets of DFIs causing a squeeze in their operations. Therefore, DFIs need to diversify their resource base to reduce reliance on borrowings. For this, the DFIs will have to be innovative in structuring and marketing their deposit instruments at competitive terms, not only to sustain the smooth availability of funds but also to keep the cost on lower side.

Loan portfolio of the DFIs displayed encouraging trend as it increased at a remarkable pace breaking the logjam witnessed over a number of years. Percentage share of loans and advances in earning asset portfolio has grown to 35 percent in CY04 compared to 25 percent in CY03. Increase in loan portfolio of DFIs is attributable to expansion in client base, cross-marketing of financial products, increased demand for long term credit on account of stronger growth momentum of LSM, active project rehabilitation and rise in consumer and lease financing. Stepping up their efforts for the expansion of loan portfolio, some of the DFIs have established their branch offices in some other major cities, which have proved quite helpful in expanding their loan portfolio.

Figure-10.4: Quality of Loans



	2002	2003	2004
NPLs to total loans	49.4	46.5	31.9
Net NPLs to net loans	26.9	16.0	10.0
Provision to NPLs	62.4	78.1	76.3

Asset quality of DFIs kept the improving trend. Total non-performing loans (NPLs) witnessed slight improvement in CY04. In absolute terms, the NPLs in CY04 stood at Rs12.1 billion against Rs12.6 billion in CY03, reflecting a decrease of 4.1 percent. This along with increase in loans had a salutary impact on the infection ratios. Resultantly, NPLs to loans ratio improved to 31.9 percent in CY04 against 46.5 percent in CY03 and Net NPLs to net loans ratio to 10 percent in CY04 against 16 percent in CY03 (see **Figure 10.4**). There is still plenty of room for improvement as the ratios continue to remain high. Since majority of the NPLs of DFIs i.e. around 67 percent, are accounted for by a public sector DFI, its restructuring will reduce the overall NPLs portfolio of DFIs in the coming months. Disproportionately large share of equity investments in total investments also causes concern, keeping in view the recent volatility observed in the stock markets.

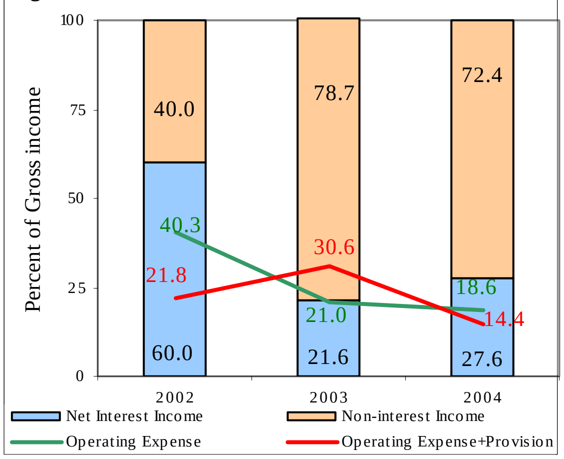
The solvency position of the DFIs improved considerably. The improvement came on the back of healthy profits as well as capital injection. Resultantly, total equity increased to Rs30.1 billion in CY04 as compared to Rs25.0 billion in the last year reflecting a growth of 20.5 percent. The overall performance of the DFIs had long been marred by the public sector DFI. The same after undergoing restructuring has now sought the commercial banking license and with its exit, the outlook of the remaining DFIs would improve significantly. The application of MCR and CAR with effect from July I, 2004 was an important development for DFIs as it would help align the

[15] Earlier, DFIs' main source of funds was foreign credit lines, which with the passage of time dried up, and DFIs therefore, resorted to borrowings from financial institutions.

risk to their capital more accurately. The DFIs with the CAR of 33.7 percent far exceed the benchmark of 8 percent. Similarly, the tier 1 capital to risk weighted assets at 31.4 percent is also significantly above the benchmark. This not only shows the strong solvency position of the DFIs but also leaves plenty of room for further expansion of their operations. Keeping in view the healthy trends being seen in NPLs and significant shift witnessed in structural composition of overall income, more in favour of core income, the prospects of further improvement in capital are bright.

DFIs in CY04 maintained a satisfactory liquidity position. Though the level of liquidity has slightly declined as evident from liquid assets to total asset ratio at 61 percent in CY04 compared to 69 percent in CY03, even then the liquidity position of DFIs is quite satisfactory. The loans to deposits plus borrowings ratio[16] standing at 55 percent amply supports the argument. Besides, DFIs hold significant liquid assets, which provide liquidity cushion.

Figure-10.5: P & L Structure of DFIs



Total profits of the DFIs depict decreasing reliance on the non-recurring sources of income. Moreover, after tax profits declined to Rs5.1 billion in CY04 against Rs5.9 billion in CY03 (see **Figure 10.5**). Decline in overall profitability was primarily driven by fall in non-interest income as evident from the ratio of non-interest income to total average assets standing at 5.7 percent in CY04 compared to 10 percent in CY03. After tax ROA, therefore, fell to 5.9 percent against 8.1 percent in CY03. Had it not been significant reversal against provisions following the improving asset quality, the DFIs might have seen sharp decline in their profits, as the core income could not pick up despite significant growth in loans. Net interest income has further dropped to Rs1.9 billion in CY04 against Rs2.0 billion in CY03 and Rs3.0 billion in CY02. Though fee based income of DFIs has slightly improved to Rs0.21 billion in CY04 against Rs0.19 billion in CY03, but due to the volatility witnessed in fee based income and the minute share which it carries in overall profits, it may not work as a stable and reliable source of income.

To conclude, non-conventional asset and funding mix, over reliance on market activities for profitability, high equity exposure and borrowing at floating rates are the problems which persist with DFIs and need to be addressed vigorously.

The future outlook suggests innovation on the part of DFIs. They need to join hands with one another and with commercial banks in consortium lending. Well equipped with project appraisal and monitoring techniques, the DFIs can better take advantage of the current suitable economic environment, where certain sectors are on the roll out for capacity expansion. This can improve their asset mix with lesser exposure to market risk on one hand and on the other hand their profitability with much less cost of funds.

[16] In case of DFIs, Loans to deposits ratio is not true reflective of liquidity, because, they usually rely more on their equity and borrowings. Therefore, for achieving the ratio borrowings are inculcated into the measurement.

11 Performance of Micro Finance Banks

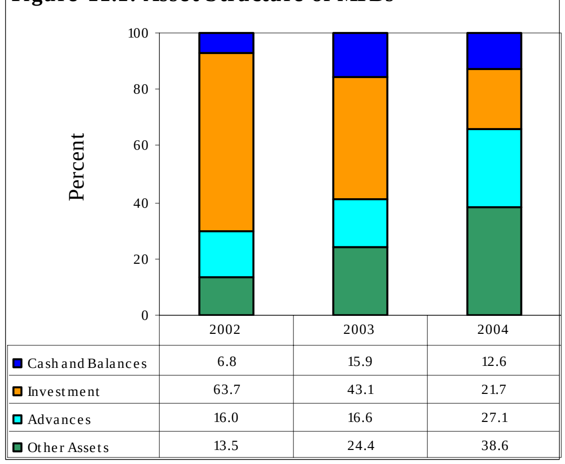
Even though micro finance has already proved its value in many countries of the world, its importance has grown manifold with the recognition awarded to it by the UNO in declaring 2005 as the International Year for Micro Credit. In Pakistan, micro finance has witnessed a steady growth in financial services being provided to the poor. However, until recently it was the informal sources that were catering to the financial services needs of the low income segments. Recognizing the need for diversity of institutions to tap the huge un-served market, a comprehensive policy regime has been devised to allow both regulated and un-regulated players to extend microfinance services to the poor and their micro enterprises while remaining in their respective domains.

Table-11.1: Micro Finance Outreach

	2002	2003	2004
Institution Age (Yrs)	2	3	4
No. of Branches	39	56	75
Total No. of Borrowers	56,939	95,090	177,648
No. of New Borrowers	56,939	38,151	82,558
Total No. of Depositors	2,773	10,150	18,589
No. of New Depositors	2,773	7,377	8,439
Average Loan Size (Rs)	6,232	7,969	7,340
Average Deposit Size (Rs)	23,231	38,625	25,229

Currently two Micro Finance Banks (MFBs)[17] are providing financial services to this sector in Pakistan. During the year under review, the outreach of these micro finance banks experienced significant expansion. Their branch-network grew extensively from 56 in CY-03 to 75 in CY-04 (see **Table 11.1**). This indicates increasing financial intermediation by these institutions, as manifested by 87 percent growth in the number of borrowers and 83 percent in depositors. This growth in outreach of MFBs is quite encouraging. However, there remains much potential which is yet to be tapped. With the launching of two new district-wide MFBs viz. Network Micro Finance Bank and Rozgar Micro Finance Bank in early 2005[18] and the likely establishment of a few more microfinance banks in the near future, the sector is expected to get further boost.

Figure-11.1: Asset Structure of MFBs



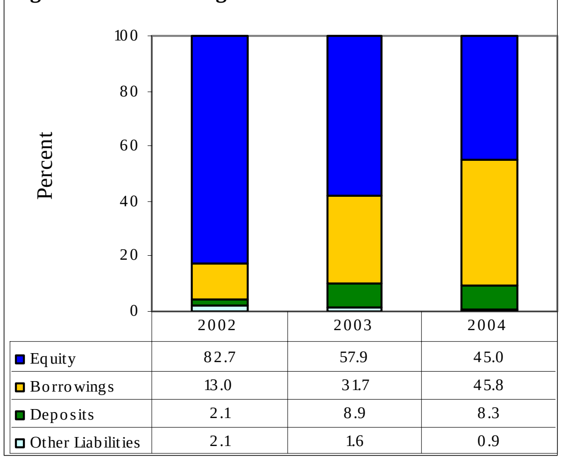
The balance sheet footing of the MFBs shows an expansion of 28 percent to Rs5,673 million from Rs4,423 million in 2003 (see **Figure 11.1**). The asset mix of these institutions was atypical till 2003 characterized by low proportion of loans i.e. 17 percent in the total assets owing to the early years of these MFBs. Moreover, investments held the major share in total assets. However in 2004, the extension in branch network has started to pay off as the share of advances has increased to 27 percent of the total assets. Investments have experienced a corresponding decline in their share to 22 percent from 43 percent in 2003. Other assets for the year grew substantially on account of receivables from the donor agencies and the increase in operating fixed assets, the reasons for which can be traced back in overall expansion in the MFBs.

In line with the improvement of the asset mix that has now turned a bit conventional, the composition of sources of funds has also changed (see **Figure 11.2**). The deposits have grown by 20 percent compared to last year; still their share remains modest at 8 percent. This is because one of the MFBs has not yet started deposit taking on account of the absence of effective MIS

[17] Khushhali Bank and First Microfinance Bank
[18] The latter is yet to start its operations.

which is a prerequisite to the 'small ticket large volume' deposit structure in MFBs. There is a need for the MFBs to enhance their deposit base through strong deposit mobilization. Till last year the shareholders' funds provided main support to the assets i.e. 58 percent; however this year the share of borrowings has gone up. Borrowings and equity provided almost equal support to the asset base, with the former exceeding the latter by slight margin. A major chunk of these borrowings[19] represent the loan from Asian Development Bank under Microfinance Sector Development Program.

Figure-11.2: Funding Structure of MFBs



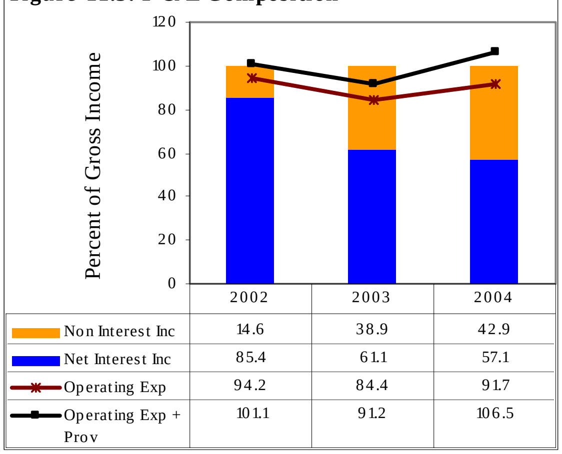
The key performance indicators for CY04 largely exhibit improving trends (see **Table 11.2**); the assets quality despite substantial growth in the loan portfolio during the year, reflect improvement when compared with the previous year, which is reflective of maturity and prudence in lending operations of the MFBs. Introduction of Credit Scoring System by one of the MFBs in September 2003, better cash recovery along-with increased provisions mainly accounted for this amelioration. Having said this, it must be emphasized here that the MFBs need to be cautious given the high international standards of recovery for MFBs, based on the premise of close contact with the borrower which is at the core of micro financing. Hence, a true test for the quality of credit portfolio will come with time.

Table-11.2: Key Performance Indicators

Percent	2002	2003	2004
NPLs to Advances	1.59	7.57	7.20
Net NPLs to Net Advances	(2.94)	2.72	1.33
Provisions to NPLs	356.76	65.02	78.27
Net NPLs to Capital	(0.58)	0.81	0.84
Growth in Advances	346.84	49.26	108.79
Net Interest Margin	8.39	6.94	6.75
Non Interest Income to Avg Assets	1.19	3.46	3.81
Non Interest Exp to Avg Assets	7.68	7.50	8.13
Operating Exp to Gross Income	94.16	84.36	91.66
ROA	0.02	0.63	(0.49)
Operating Sufficiency	91.40	75.83	71.90
Financial Sustainability	45.35	39.33	38.70

On the profitability side, the return on investments was the main source of earnings for the MFBs till 2003 due to the meager share of advances in the earning assets (see **Figure 11.3**). Hence the decline in the net interest margin from its 2002 level came as a natural consequence of the then prevailing low interest rates. In 2004, the net interest margin declined further. Even though the advances lent greater income support, given their increased share in total assets, still it remained modest in terms of growth in earning assets. It is noticeable that a major chunk of assets has been locked up in non-earning assets. This has further hampered the growth in interest income. As regards interest expense, the sources of funds have been dominated by shareholders' equity till 2003. However, during the year under review the share of interest bearing funds viz. borrowings has risen. Hence, the increase in interest expense was quite obvious. A look at the

Figure-11.3: P & L Composition



[19] These borrowings pertain to Khushhali Bank.

non core activities reveals that the share of non interest income continued to increase as percentage of both average assets and gross income mainly because of the gain on sale of investments. The MFBs need to strengthen their core income activities since such gains are essentially non-recurring in nature. The operating expenses of MFBs remained extremely high given the branch extension and the resultant fresh recruitments during the year. Consequently, the operating expense to gross income ratio remained quite high at 92 percent. In addition, the higher provision expenses for 2004 caused the expenses to exceed income. All these factors combined, put a drag on the profitability of the MFBs, which is reflected in the negative ROA for the year (see **Table-11.2**). Despite the argument of higher operational costs associated with the micro financing structure, the MFBs may bring the operational cost down by developing cost effective delivery mechanisms and achieving operational scales. This will improve their profitability and augment their operational self sufficiency[20] and financial sustainability[21] which are currently at a much lower level (see **Table-11.2**).

The future outlook of micro finance sector in Pakistan, with strong government commitment to help develop the sector and rising confidence of the national and international stakeholders in the policy and regulatory environment, is positive and the sector is likely to grow substantially over the medium to long term. It will however require substantial investment by MFBs in building institutional capacity to extend affordable financial services to the low income segments of the society.

[20] Operating Sufficiency= (Total Income less Income from Donations etc.) / (Total Operating Expense plus Actual Cost of Funds)
[21] Financial Self-Sustainability (Total Income less income from donations etc.) / (Total Operating Expenses plus Actual Cost of Funds plus implicit cost of subsidized funds plus Implicit Cost of Equity; computed at SBP discount rate)

Box - 11.1

SBP Initiatives towards the Development of Microfinance in Pakistan

State Bank, recognizing microfinance as an effective poverty alleviation tool has taken a number of initiatives to facilitate growth and activity in the sector. It played a leading role in enactment of separate legal framework for MFBs in 2001 and developed a separate regulatory framework for microfinance banks in consultation with stakeholders to ensure sound risk management systems in microfinance banks and require them to remain focused on their core market viz. the poor and their micro enterprises. The simplicity and flexibility to allow innovations in this emerging component of financial system while ensuring effective regulatory and supervisory oversight of MFBs are the major features of the PRs for MFBs. The framework is being reviewed continuously to ensure its compatibility with the changing MF dynamics; during 2004 SBP issued guidelines for reviewing credit portfolio of NGO-MFBs interested in transformation into formal MFBs and by the close of first quarter of 2005, comprehensive NGO Transformation Guidelines and ***Fit and Proper Criteria'*** for Board members and President/ Chief Executive of Micro Finance Banks have been issued. The bank has created a ***Microfinance Consultative Group*** comprising practitioners, NGO-MFBs Network, Central Bank, relevant government ministries and donor agencies to work as an advisory body for SBP for all MF policy formulation. The group meets on quarterly basis to discuss MF policy issues and has been instrumental in developing trust between the policy makers/regulators and practitioners enabling the central bank to develop and come-up with the sector friendly policies and regulations.

SBP, appreciating the importance of capacity of the central bank/regulatory body for effective regulation and supervision, has adopted a focused approach to develop its MF related capacity. It had established a separate division to focus on all MF related issues as well as develop linkages and partnerships with stakeholders. It entered into a partnership with Swiss Agency for Development Cooperation (SDC) to build and enhance its MF related capacity. Under the partnership, a Microfinance Resource Pool comprising 25 officers from banking supervisory departments have been created to impart extensive trainings in microfinance. Besides developing the pool of expertise and skills, onsite examination manual and off-site surveillance system for MFBs are also being developed under the SDC technical assistance. The initiative is likely to translate into substantial improvement in SBP MF capacity enabling it to ensure effective regulatory oversight of MFBs and play its role in development and growth of the sector. The bank has recently decided to establish a ***Small and Medium Enterprise Department*** (SMED) within its banking cluster. The department likely to be operational during second half of 2005, will focus on the key issues concerning the Micro & SME financing in the country through personnel having rich experience in the relevant areas and in depth knowledge and understanding of the sector dynamics.

SBP, considering the evolving stage of the sector, has also assumed promotional role for the sector to facilitate growth and activity in the sector. It frequently interacts with the stakeholders to create greater awareness and understanding of MF policy environment and encourage private sector investment in the sector. In this respect a very important event, the two-day International Microfinance Conference, '***Microfinance in Pakistan-Innovating and Mainstreaming'*** was organized in December 2004 at Islamabad in collaboration with the Pakistan Poverty Alleviation Fund (PPAF), Pakistan Microfinance Network (PMN) and Khushhali Bank. The conference attended by about 400 MF practitioners, donor representatives, bankers and academia including more than 30 renowned international MF dignitaries proved extremely useful in creating national and international awareness about our MF policy, regulatory and business environment, which is considered as one of the most progressive in the world. It also enabled Pakistan to have visible presence on the world MF map, which will be instrumental in attracting greater international interest and investment in the sector.

12 Performance of Exchange Companies

Since the early 1990's, Authorized Money Changers have provided an avenue to individuals and businesses to exchange currencies for meeting their personal and business requirements. However, due to lack of proper documentation and limited scope of operations the system could not organize itself on sound institutional footing. Following the lifting of exchange controls and financial sector liberalization, the flow of funds increased substantially. There was a need for a system which could respond to the need for timely transfers of funds. This void was filled by the Hundi System through which massive amounts of funds were transferred since it offered efficient service due to its extensive network both abroad and at home and competitive price differential as compared to the banks. The absence of documentary requirement and lack of customers' identification provided an easy escape from the official scrutiny, leading to detrimental impact on the economy.

This called for the establishment of institutions which could offer comparable efficiency, price advantage, and an extensive network to its customers. To fulfill this objective Exchange Companies were allowed to be formed by replacing the existing set up of Authorized Money Changers (AMCs). To inculcate transparency and accountability, these companies have to be incorporated with the Securities and Exchange Commission of Pakistan under Companies Ordinance, 1984 and licensed and regulated by SBP. In order to bring the small AMCs within the regulatory fold, Category 'B' Exchange Companies were allowed with relatively lesser capital requirement and restricted scope of operations (see **Box – 12.1**).

Table-12.1: No. of Operational Exchange Companies

Exchange Companies	25
Branches of Exchange Companies	79
Franchise Arrangement with Ex. Cos	218
Exchange Companies – B	33
Branches of Exchange Companies - B	249

As the money changer setup was to discontinue after 30th June, 2004; out of 375 AMCs, 333 money changers have either formed Exchange Company A or Exchange Company B or entered into franchise arrangement or are conducting business from hotel premises. At the end of CY 2003, there were 11 exchange companies in operation. In 2004, 11 new exchange companies commenced business taking the total to 22. As of April 2005 twenty five exchange companies are operating with 79 branches and 218 franchises. 33 exchange companies (B Category) are operating with 249 branches in the country (see **Table 12.1**).

Table-12.2: Financial Highlights of Exchange Companies 'A'

(Million Rs)

Year ended June	2003	2004
Total Assets	1,775.6	2,395.8
Total Liabilities	438.7	248.4
Capital	1,336.9	2,147.4
Profit Before Tax	17.1	70.0
Profit After Tax	7.8	39.6

In their initial phase of operation, exchange companies have their prime focus on the expansion of branch network. Consequently, the balance sheet footing of the exchange companies has expanded to Rs2396 million recording a 35 percent growth in CY04 (see **Table 12.2**). The asset composition reflects the predominance of the current assets owing to the peculiar nature of the exchange business. In CY04, their share has augmented to 70 percent against 65 percent in the CY03. Shareholders' funds that grew at 61 percent continue to provide main support to the asset growth. As there are regulatory capital requirements for these exchange companies, therefore, the enhancement in the equity came as a natural consequence of increase in number of participants.

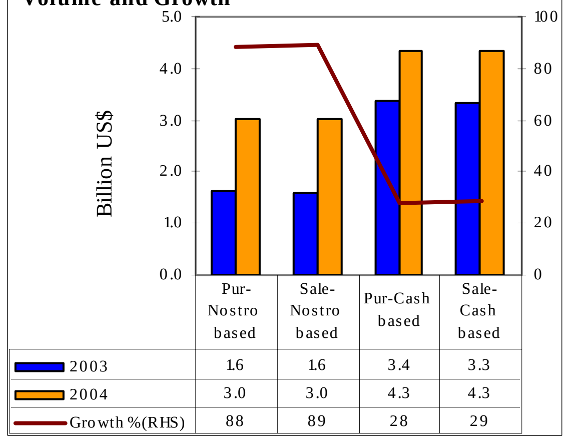
The profitability indicators of the exchange companies show a parallel increase in income and expenses. This is mainly because of the growth in the number of operational exchange companies leading to the increase in the volume of exchange business hence increasing the income on one side and overall expenses relating to branch extension, human resources and physical set up on the other. However, the expenses remained on the higher side which is amply reflected in the operating expenses standing high at 79 percent of the total income. Thus, the income to expense ratio has marginally declined to 1.2 times from 1.3 times in CY03. Despite higher expenses, net profits for the year stand at 5 times their previous year level. This improvement in the profitability is reflected in the returns on assets and equity, which have ameliorated (see **Table 12.3**). As the exchange companies achieve economies of scale in the coming years, the high operating expenses may get rationalized leading to further improvement in the profitability. With more participants, the transaction volume of the exchange companies has witnessed growth of 48 percent over the year **(**see **Figure 12.1)**. Total transactions increased from around US$9.9 billion to US$14.7 billion. Nostro based transactions increased by 88 from US$3.2 billion in CY 03[22] to US$6 billion in CY 04. Cash based transactions grew at 29 percent from US$6.7 billion in 2003 to US$8.6 billion in 2004.

Table-12.3: Key Performance Indicators- Exchange Companies 'A'

(Percent)

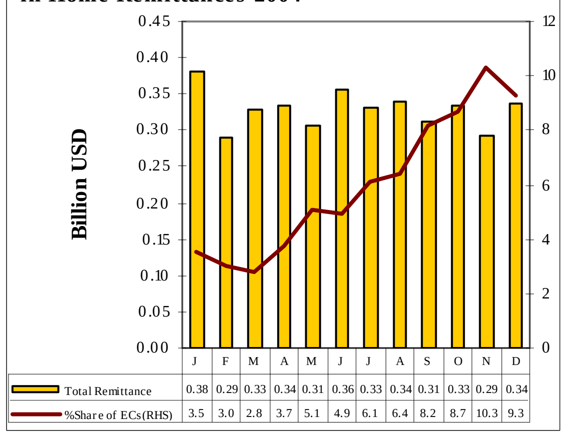
Year ended June	2003	2004
Capital to Total Assets	75.0	90.0
Growth in Assets	-	34.9
Growth in Equity	-	60.6
Income to Expense Ratio (times)	1.3	1.2
Operating Expenses to Income	77.8	79.3
Return on Assets	0.4	1.7
Return on Equity	0.6	1.8
No. of Exchange Cos.	8	13

Figure-12.1: Exchange Companies-Transaction Volume and Growth



The share of exchange companies in the total home remittances is rising. During the year, the home remittances through the exchange companies have increased from US$155 million in CY03 to US$235 million in CY 04 which depicts a growth of 51.6 percent **(**see **Figure 12.2)**. Considering the fact that total home remittances during CY04 fell from US$3,963 million to US$3,944 million posting a decline of 0.48 percent during the same period, the increase in share of exchange companies is impressive. Home remittances sent through exchange companies constitute 6 percent of total home remittances sent through official sources, against merely 4 percent in CY03[23].

Figure-12.2: Share of Exchange Companies(ECs) in Home Remittances-2004



The institutionalization of a documented system, in the shape of exchange companies offering comparable efficiency to transact business, has provided a legal alternative to expatriate Pakistanis as well as corporate entities to transfer funds through this system. With the passage of time, these companies are expected to expand their branch network, hire qualified human

[22] Transactions data for CY 03 pertain to 11 months period i.e., from Feb to Dec 2003.
[23] Home remittance for CY 03 pertain to 11 month period i.e., from Feb to Dec 2003.

resource and put in place systems and controls that are prerequisite to institution building. This would result in curtailment of illegal transfer of funds through Hundi.

Box – 12.1
Regulatory Framework for Exchange Companies

Exchange Companies can be established with a minimum Paid up Capital of Rs100 million which is to be raised to Rs200 million after three years of incorporation of business. These companies have been allowed to enter into arrangement with exchange companies abroad in order to facilitate overseas Pakistanis in respect of their remittance to Pakistan. As a measure for providing liquidity comfort to these companies against contingencies, 25 percent of the paid up capital has to be maintained with SBP as Statutory Liquidity Reserve. The exchange companies shall limit their exposure at the close of business each day at a level not higher than 50 percent of their capital base. They are allowed to buy and sell foreign exchange from individuals in “Ready” value only. They may sell foreign exchange to incorporated companies for remittance on account of royalty, franchise, technical fee, repair and maintenance etc. Exchange Companies can buy and sell foreign currency in “Ready”, “Tom”, and “Spot” value dates with other exchange companies and “sell” foreign exchange in the “Ready”, “Tom” and “Spot” value dates, with banks as counterparty (Interbank Market). They are required to credit the proceeds of export of currency other than US Dollar to their Nostro Accounts.

Exchange companies can enter into franchise arrangements with an existing entity carrying out Money Changing business or an entity formed to carryout Money Changing business for consideration of Franchise Deposit which would be treated as “Second Tier Capital” in the books of the Franchiser. This “Second Tier Capital” would be added to the paid up capital of the Franchiser for the purpose of calculation of 25 percent SLR requirement and 50 percent of the exposure limit. The combined exposure of franchiser and franchisee should not exceed 50 percent of the sum of paid up capital and Second Tier Capital of the exchange company.

Exchange companies may enter into exclusive agreement with other entities for setting up of Payment Booths at their business premises for the purpose of payments in Pak Rupee currency to the beneficiaries against Home Remittances only. These Payment Booths / Outlets shall have a separate and identifiable set up which may consist of a glass or wooden cabin.

Exchange Company (B): A minimum of five Authorized Money Changers could join to establish the company with an initial Paid up Capital of Rs20 million which has to be raised to Rs25 million by 30th June, 2005. 10 percent of the Capital shall be maintained as Reserve with SBP in the form of cash or unencumbered approved government securities. The Exchange Company (B) can sell and purchase foreign currency notes and coins only. They are allowed to buy and sell foreign exchange to and from individuals and exchange companies of either description in ‘Ready’ value only. The exchange company (B) can ‘‘sell’’ foreign exchange in only `Ready` to the banks as counter party (Inter-bank Market). The exchange companies are disallowed to carry overnight exposure; for this purpose they are required to sell their foreign currency holdings at the end of the day either to other exchange companies or to the banks.

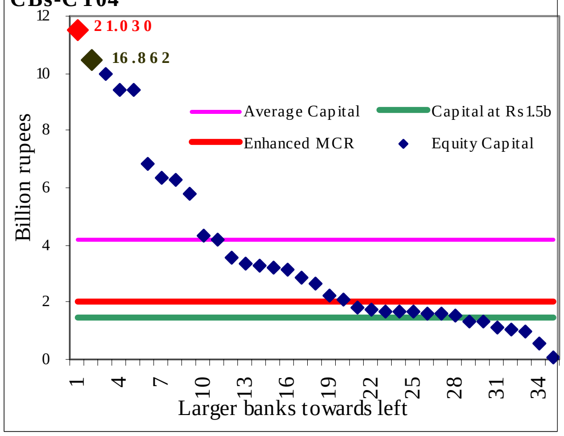
13 Initiatives towards Financial System Stability

13.1 Minimum Capital Requirement Enhancement and Capital Charge for Market Risk

Financial soundness and stability stems from strong capital. A strong capital base of a banking company not only provides a sense of protection to its depositors but also enables it to withstand any unexpected economic and business shocks. Besides, a high capital stake mitigates the moral hazard problem, which is a striking downside characteristic of banking business. Realizing the importance of strong capital base, SBP adopted a two-pronged strategy to address the issue of capital strengthening of the banking system. On the one hand, the deterioration in the capital of public sector banks, due to the chronic inefficiencies, was dealt with by the privatization policy that allowed large public sector commercial banks to get rid of their operating inefficiencies and strengthen their capital base. On the other hand, SBP has been gradually enhancing the minimum capital requirements of the banking companies to strengthen the competitive ability of the banks by weeding out the weak banks and to encourage economies of scale. Each banking company was required to raise its paid-up capital net of losses progressively to the minimum of Rs1 billion upto 1st January 2003. This naturally attracted mergers, acquisitions and consolidation of financial institutions. Though 19 of the banks have undergone the process of mergers and acquisition since CY00, the reduction in the number of banks was not that significant as in most of the mergers/acquisition cases the surviving entities were the banking companies. Now there are 38 banks operating in the country as compared to 46 in CY97. The average capital of the commercial banks has been increased to Rs4.1 billion in Dec-04 from Rs1.9 billion as of end of the year CY00.

In view of weeding out the weak banks that may pose a systemic risk, the MCR has now been raised to Rs2 billion effective from 31 December, 2005. Twenty out of the 34 commercial banks are already compliant with the enhanced MCR. Of the remaining, eight banks have had their capital at Rs1.5 billion by the end of CY-04 (see **Figure 13.1.1**). Keeping in view the trends in the global banking industry, the amount of enhanced MCR of almost US$35 million would need to be revisited. Any policy move in this direction would expedite the process of mergers and consolidation, which in turn would lead to fewer but stronger banks in the market.

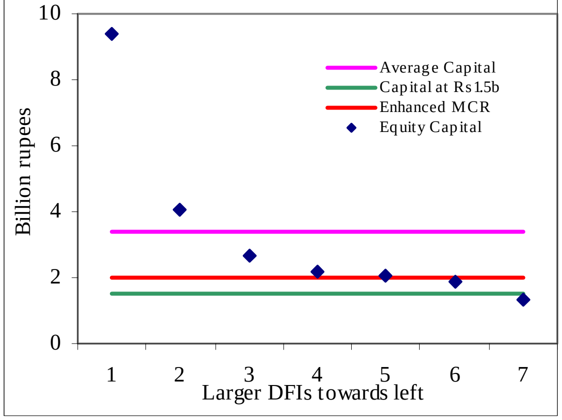
Figure-13.1.1: Equity Capital Vs Enhanced MCR of CBs-CY04



Besides, DFIs have also been subject to the minimum capital requirements. Of the total 7 DFIs, 5 are already compliant with the enhanced MCR of Rs2 billion. Of the remaining two, one DFI had its capital of more than Rs1.5 billion by the end of Dec-04 whereas the other is expected to meet the requirement shortly (see **Figure 13.1.2**).

Moreover, in order to align the regulatory capital requirement in line with the internationally accepted standards and institute a true risk based capital adequacy framework, a step towards the implementation of Basel II, capital charge for market risk has been introduced vide BSD Circular No. 12 dated August 25, 2004. This additional capital charge serves as a cushion against the risks associated with volatilities in the market risk factors namely; interest rates, exchange rates and equity prices. The significant movements in the interest rates during the last couple of years and the increasing complexity in the products in the form of derivatives if employed to take positions only supports the need of an adequate cushion in the form of capital. This additional capital charge for market risk will lend further strength to the stability of the banking system.

Figure-13.1.2: Equity Capital Vs Enhanced MCR of DFIs-CY04



13.2 Resolution of Problem Banks

A few but systemically important weak banks may significantly undermine financial stability of a country. To minimize the episodes of financial distress and also to safeguard depositors' interests, supervisory authorities pay close attention to such banks. SBP is fully cognizant of the fact and it has been a part of its overall financial reforms agenda to revive the health of problem banks and DFIs falling under its domain. It has, so far, been very successful in this endeavor. The privatization of HBL and UBL, the large public sector banks, in previous years was the landmark achievement which helped the private sector emerge as the dominant sector on the financial scene of the country. These banks owing to their large size were a source of permanent systemic risk as they had contracted many afflictions. Their transfer into the hands of professional managements has already started to produce positive results.

SBP remained steadfast in its efforts to reform the problem banks and succeeded in reducing the number of problem banks to one in the year 2004; there were three problem banks in the year 2003. During the period under review, SBP conducted a successful reconstruction of one of the large banks, which was a lingering problem. Its performance was marred by poor asset quality because of the chronic drag of NPLs. Persistent losses had turned its capital to negative. SBP, realizing the gravity of the situation, took upon itself to restore the financial health of the bank. Through a transparent process of bidding, the management of the bank was transferred to a renowned private sector group. To assume the control of the bank, the group injected Rs14.2 billion into the capital for acquiring 325 million additional shares. The assumption of the control by a strategic investor is expected to prove beneficial not only for the bank but also for the banking industry as a whole. The success of the bank's reconstruction is evident by substantial improvement in its key financial indicators. The bank's operations, which had come to a grinding halt, show appreciable activity. The bank has witnessed considerable growth in its deposits and loans. The recapitalisation has not only made the bank fully compliant with the MCR but has also provided substantial cushion. The CAR of the bank comfortably exceeds the internationally accepted benchmark. Consequent upon the reconstruction of this large bank, the consolidated indicators of its peer group have also improved. To summarize, the bank now is fundamentally strong to withstand any adverse shock and contribute effectively toward the goal of financial stability.

Two specialized banks in the public sector were also among the problem banks. The recapitalisation of one of them has helped in the improvement of its solvency position. Resultantly, its status has been upgraded leaving only one bank in the problem bank arena. The efforts to rehabilitate/reconstruct this public sector specialized bank are also underway.

Compared with the past, SBP is better equipped to tackle the problem banks. A spate of policy measures over the last few years has significantly strengthened the supervisory capacity of SBP to establish sufficient safeguards to minimize the emergence of problem banks. SBP has set minimum standards for banks in various areas of their operations. SBP, through its relentless vigilance, ensures enforcement of such standards and any deviation is taken up immediately. Greater interaction with the Board of Directors and senior management, more frequently with weak banks and DFIs, provides an effective mechanism to arrest budding problems. All these paint a healthy picture for more vibrant and healthy banks which will be able to contribute robustly to the financial health and soundness of the system.

13.3 Payment Systems

Stable financial infrastructure plays a vital role in containing systemic risk, and robust payment and settlement system is at the core of it. Until recently, SBP has been following the traditional end-of-the-day settlement system which is characterized by a number of risks including credit risk and liquidity risk. These risks arise from the very nature of the traditional settlement system where the balances of the settlement accounts are worked out at the day end; hence the participants cannot have real time information on the processed payments which result in credit risk. This happens if two functions of interbank fund transfer system viz. the transmission of the information about the payment and actual settlement of the payment do not occur concurrently. As long as the payment is not settled, any payment activity undertaken on the basis of unsettled payment messages remains conditional and results in risk. Besides credit risk, the previous system at SBP also exposed the banking system to the liquidity risk due to inherent settlement lags. In such case it was not possible for the banks to be sure whether or not their liquidity is adequate before the actual settlement; hence overestimations of liquidity could result. As these exposures last for longer and become larger, there was a strong likelihood that a participant's inability to meet its obligations was more likely to affect the financial condition of others in a more serious manner. In extreme cases, such risk could trigger broader financial difficulties threatening the stability of payment system and even the real economy.

As overseer of financial stability of the country, the stable and reliable financial sector has remained the prime mandate of SBP. With increasing international focus on the payment system restructuring, SBP has also initiated the process of setting up a robust payment system that would strengthen the stability of the system as a whole. Of the various steps taken to address this issue, the initiation of a Real Time Gross Settlement (RTGS) System is the one. RTGS is the system that can effect final settlement on a continuing basis during the processing day. Currently, the RTGS is in the process of implementation and is expected to replace the existing system shortly. The implementation of RTGS will change the payment system scenario as all the transactions will be settled on real-time gross basis, the position of settlement will be known instantly and participants will be aware of various risks more precisely resulting into better management of the financial risks. Consequently, it shall provide stability in the financial system of the country. This will not only reduce the systemic and operational risks, but also lower the transaction costs and help in the efficient use of financial resources.

On the enforcement side, the State Bank of Pakistan Act 1956 empowers SBP to oversee the payment system activities in the country. Although the existing statutes provide quite an adequate coverage to the payment and settlement functions, the recent drive of automation exposes the payment system to a separate set of risks; hence a distinct Act well-suited to cater to these was required. Until recently there was no separate statute on payment systems, therefore, in consideration of the need for a distinct legal framework, Payment Systems and Electronic Funds Transfer Act 2005[24] is being formulated. The proposed Act covers the operation of payment systems, including the clearing and settlement obligations of the parties involved, supervisory role of SBP in this regard, documentation requirements by the participants, liabilities of parties in Payment Systems and any legal proceedings in case of any conflict. The prime objective of the Act would be to supervise and regulate payment systems and electronic fund transfers in Pakistan and provide minimum standards for protection of the customers. Once enacted, the Act shall place the payment system and the electronic fund transfers of the country on sound legal footing.

13.4 Margin Financing

Carry Over Transactions (COT) generally known as Badla financing is essentially the lending of funds by the banks to the stock brokers for the purchase of shares. Until recently, the COT constituted a major portion of some of the banks' indirect exposure in the stock market. In case of badla financing, the lender is actually exposed to the market value of the underlying security for which the funds are extended. In case of any sudden movement in the stock market, the lender has no other option available to make good its losses, but the shares. The fact that the motivation for such borrowing is inherently speculative causes discomfort. This makes the COT highly risky and calls for some secured mode of stock trading, so that the actual risk of the banks could be minimized. Introduction of margin financing is in line with these issues relating to the COT and is another step taken by the financial system regulators towards effective risk management.

In order to facilitate the transition from COT to margin financing, encourage active participation of banks/DFIs in this area and to ensure that the relevant activities are undertaken by banks/DFIs in a prudent manner, State Bank of Pakistan has issued the regulations for financing to brokers by banks/DFIs. These regulations address the issues relating to the investment in stock market and set the minimum standards for stock trading. The regulations encompass four broad categories.

Conditions for extending Margin Financing to Brokers: The banks/ DFIs are advised to encourage the brokers availing the margin financing facility from them, to obtain credit rating from the credit rating agencies on the approved panel of SBP. This regulation, however is not mandatory and rather aims to encourage the brokers to provide relevant information to the banks in order to support their decision making. In this connection, the banks/ DFIs are advised to provide margin financing only against the approved shares kept with the Central Depository

[24] *The Draft Act has been placed on SBP Website for comments from the stakeholders.*

Company and through the designated branches of the banks/DFIs. Furthermore, the brokers have been prohibited to extend their funds to the connected parties.

Risk Management and Internal Controls: The banks are required to prepare comprehensive policies for the purpose of margin financing duly approved by their Board of Directors. The banks are also required to obtain legal opinions to ensure that all the legal requirements concerning the acceptance of documents and shares as collateral etc. are being met appropriately. In this regard, uniformity of the legal documents across the banking sector shall be encouraged. Also, the banks/DFIs are required to put in place an effective system so as to monitor their exposure in the stock market on a continuous basis.

Margin Requirements: The banks/ DFIs are required to maintain minimum margins as prescribed by SBP from time to time. In this respect, the banks shall monitor their margins on daily basis at least. Furthermore, the financing against the receivables of the brokers are subject to more stringent margin requirements.

Per Party Limit: The purpose of introducing per party limit is to avoid the concentration of the margin financing by the banks to a few brokers. Moreover, as per this regulation, the total margin financing of a single bank cannot exceed its equity. In order to provide adequate coverage to the concerned areas, most of the per-party limits given in the PRs on corporate and commercial banking have been made applicable to the margin financing as well.

As the date for the phase-out of COT draws near[25], concerted efforts of all stakeholders and seamless coordination is needed to achieve the desired results before the deadline. In this regard, a Committee comprising the representatives of banks, financial institutions and members of the three stock exchanges has been constituted to ensure the smooth implementation of the phase-out of COT in a timely manner. The Committee is responsible for disseminating the information and creating awareness amongst all the stakeholders, particularly the small investors. The introduction of margin financing is a promising step and is largely expected to streamline the investment activities of the banks/DFIs in the stock market.

13.5 Corporate Governance

The subject of corporate governance is increasingly gaining importance not only in Pakistan but also the world over because the very survival of an entity has become strongly dependent on efficient and self-regulated governance system. In the Pakistani banking scene, a lot of changes have taken place like greater emphasis on financial liberalization, globalization, increase in the pace of privatization, emergence of new private banks and technological advancements offering wide array of products and services, thereby increasing the likelihood of banks being exposed to various types of risks like operational, credit, financial and market risks. Therefore, the banks as custodians of public money are required to be governed properly; a clear line of demarcation as to responsibilities of the board of directors (BOD), management, shareholders and external stakeholders was necessary.

Therefore, SBP being cognizant of the real issues has taken very important decisions to inculcate the culture of corporate governance in order to promote safe and sound banking practices, which include;

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[25] Aug-05.

- In order to ensure that the BOD is no longer a rubber-stamping body influenced by senior management, the BOD has been made responsible to formulate objectives, strategies and business plans, and to monitor that the affairs of the institution are carried out within set parameters as laid down by regulators and other agencies.
- In order to reduce the family concentration on BOD, the maximum cap has been reduced to 25 percent from 50 percent.
- The line of authority and responsibility between BOD and senior management has been emphasized.
- The frequency of board meeting (preferably on monthly basis, but in any event, not less than once every quarter) and the minimum number of meetings that a director should attend (at least half of the meetings) have been stipulated. The board is required to prepare a formal summary of the proceedings of the meetings, which is also required to be submitted to SBP
- Being the key players in a bank, BOD and senior management are supposed to understand the risk exposure of bank. Therefore, the composition of BOD and senior management in a bank should include individuals who are highly skilled and experienced in determining the risk appetite given the size and nature of bank's activities. Accordingly, SBP has laid down "Fit and Proper Test" criteria for BOD and senior management/professionals, requiring them to possess certain qualifications and experience.
- Regulators and supervisors have an important responsibility to determine the adequacy of internal controls including the responsibilities of BOD in dealing with organizational structure, financial disclosure, checks and balances and safety of investment. In this context, SBP has issued guidelines on internal controls. Board of Directors is responsible for ensuring existence of an efficient internal control system, management is responsible for appropriate design and functioning of the system, internal audit for continuous monitoring and internal evaluation of that system and for making timely and practical suggestions for improvement. The external auditor is responsible for evaluating the system with respect to its design, performance and management's understanding regarding its adequacy.
- Steps have been taken to make the external audit transparent and impartial. The management letter received from them is required to be acted upon and appropriate measure taken in consultation with audit committee without delay.
- Regular, timely, comprehensive, meaningful and reliable financial disclosure of financial affairs has been made compulsory. In this context, in addition to existing disclosure requirements, SBP has recently made compulsory to include a "Statement on Internal Controls" and comprehensive paragraph under the heading "Risk Management Framework" in the Directors' Report in their Annual Accounts. Besides annual accounts, the Banks and DFIs have also been mandated to publish their Quarterly Accounts and credit rating assigned to them by independent credit rating agency. To further enhance the disclosure requirements in line with best international practices, the format of annual accounts of banks is being reviewed.

SBP has already issued 'Handbook on Corporate Governance' for guidance of banks. Presently, they are also required to follow the " code of corporate governance" issued by Securities & Exchange Commission of Pakistan (SECP) so long as any provision thereof does not conflict with any provision of the Banking Companies Ordinance, 1962, PRs and the instructions/guidelines issued by SBP. The concerted efforts being made by SBP to improve Corporate Governance in banks/DFIs have already started to translate into the improved bottom lines, financial condition of these institutions and the process will be further strengthened over time.

13.6 Regulatory Measures to Reduce NPLs

The problem of NPLs which started to assume serious proportions in the late 1980s, continued to hamper the financial health of banks/DFIs throughout 90s as they had to settle with rising losses and stunted growth. Moreover, the presence of huge classified loan portfolio in the books of Public Sector Commercial Banks and DFIs created hurdles in their privatization or restructuring process.

To address the problem, SBP/Government, in addition to a number of measures e.g. emphasizing upon banks/ DFIs to expedite recovery of big loans through establishing in-house capacity, filing the cases in the courts of law, assigning recovery targets to the banks/DFIs; strengthening of Recovery Ordinance and establishment of Banking Courts, improving the policy and regulatory environment etc, undertook the following steps:

- **CRSIU:** Federal Government issued notification for setting up a Committee for Revival of Sick Industrial Units (CRSIU) in May 2000. SBP monitors the implementation of CRSIU's decision. The Committee restructured loans worth Rs46.2 billion and helped revive 179 sick units till 31st March, 2005 by allowing waivers and write-offs.
- **CIRC:** Federal Government established Corporate & Industrial Restructuring Corporation (CIRC) in September 2000. The CIRC acquires and subsequently auctions the non-performing assets (NPAs) referred by the public sector financial institutions. SBP has also constituted Verification Committee under CIRC Ordinance to determine the correct liabilities in case of dispute. Banks/DFIs have transferred their NPAs worth Rs49.72 billion to the CIRC at the discounted price of Rs5.99 billion. The CIRC has auctioned 136 units recovering cash amount of Rs2.95 billion till 31st March, 2005.
- **NAB Cell:** SBP established a NAB Cell to expeditiously process the cases of willful defaulters referred by the financial institutions to SBP under provisions of NAB Ordinance, 2000. By the end of August, 2004, 73 cases of willful defaulters involving reference/ outstanding amount of Rs13.35 billion were referred to NAB. NAB has settled 25 cases involving reference amount of Rs7 billion which has resulted in cash recovery of Rs1.07 billion.

In spite of these measures, a large quantum of NPLs kept appearing in the books of banks/DFIs in the "Loss" category. The probability of recovery of these loans had almost diminished due to their being in default for a long time. In order to facilitate the banks/ DFIs to deal with these classified loans, State Bank of Pakistan devised a liberal and flexible incentive scheme titled "New Guidelines on Write-Off of Irrecoverable Loans and Advances" in October 2002. Under this scheme, settlement amount was required to be determined on the basis of forced sale value (FSV) of underlying securities of loan vis-à-vis outstanding amount, whichever was lower. The borrowers desirous of settling their liabilities were required to pay at least 10 percent down payment at the time of signing of the agreement and the remaining amount within 3 years on quarterly basis. The scheme was a one-time opportunity initially for a period of six months, however, on representation of trade bodies and as well as banks/ DFIs, the Scheme was extended up to 30 June 2003 except for one bank for which, final expiry date was 31 December 2003. In order to resolve the disputes between the borrowers and banks/ DFIs under the Scheme, SBP constituted an independent committee under the chairmanship of a retired senior banker, and two members each from FPCCI and PBA. The decisions of the Committee were binding on the borrowers as well as on banks/DFIs. After completing the task, Committee has dissolved on 31 January 2005.

As of 31st March 2005, banks/DFIs received 51,434 applications involving an outstanding amount of Rs102.62 billion, out of which 49,863 cases involving outstanding amount of Rs63.64 billion have been settled under the Scheme. Banks/DFIs recovered total cash amounting to Rs9.06 billion in terms of down payments/quarterly installments. The Scheme has helped about 328 sick industrial units in their revival thereby generating or protecting the livelihood of over 17,000 employees. As a result of this scheme, NPLs have reduced by an amount of Rs19.94 billion. Since majority of the classified assets had already been provided for by the bank/DFIs as per the requirements of Prudential Regulations, this scheme did not have any adverse financial impact on their books.

Category wise bifurcation of settled cases in terms of numbers shows that about 96 percent of total settled cases pertain to small borrowers having outstanding loan amount up to Rs0.5 million. These small cases constitute only 4 percent of total outstanding amount settled under the Scheme. The cases involving outstanding amount more than Rs2.5 million are only 2 percent of total number of cases settled under the scheme, however, they constitute 94 percent of total amount settled (see **Table 13.6.1**).

Table-13.6.1: Status of cases settled under SBP Incentive Scheme 2002

Category	Amount Outstanding	Cases Settled (%)	Amount Settled (%)
A	Upto 0.5 million	96	4
B	0.5 – 2.5 million	2	2
C	Above 2.5 million	2	94
		100	100

14 Issues and Developments in the Banking System

14.1 Electronic Banking & Technological Developments

The e-banking and allied services in the banking sector continued to thrive. With strong growth in physical infrastructure in terms of installation of new ATMs by different banks, widespread installation of Point of Sale (POS) electronic terminals and most of all substantial investments by the financial institutions to enhance their hardware and software to facilitate e-business, e-banking is all set for a take-off. Now more and more customers are seeing plastic modes of settling their transactions as a preferred choice due to ease, security and increased reliability.

The number of Automated Teller Machines (ATMs) and On-line branches kept a steady growth pace this year as well. The number of ATMs and online branches grew by 42 percent and 57 percent respectively keeping four years average rates of 40 percent and 67 percent respectively (see **Figure 14.1.1**). The expansion rate of 42 percent in ATM network during 2004 is more than the three years (2000 to 2003) average of 39 percent. Now, since the two different ATM switches (*MNet & 1-Link*) are inter-connected, the customers have greater convenience of using any of the ATMs for making withdrawals and getting a host of other services. Beside ATM cards, debit cards are also gaining popularity which can be used not only on the ATMs but also on the POS terminals to make online debit transactions. Most of the banks are now issuing smart cards which can be used both as an ATM and a debit card. There were about 1.87 million ATM cards (including debit cards) issued by the banks to their customers as at year-end.

Figure-14.1.1: E-banking Infrastructure

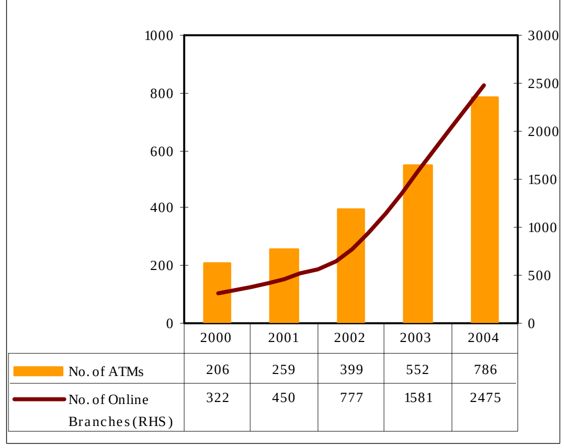
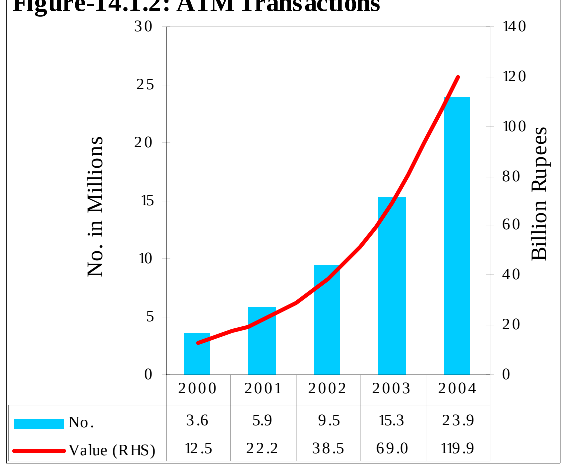


Figure-14.1.2: ATM Transactions



Similarly, the transactions done through ATMs again displayed a significant growth both in terms of numbers and volume. The number of transactions done through ATMs showed growth of 56 percent whereas their value grew by 74 percent during the year 2004 over the previous year (see **Figure 14.1.2**).

The usage of credit and debit cards for the purchase of consumer items is also growing. Therefore, average number of monthly transactions on point of sale through both credit cards and debit cards is rising sharply signifying a paradigm shift from using cash to plastic money (see **Figure 14.1.3**).

The growing trend in plastic money can also be seen from the exponential growth in the number of cardholders. Collectively, number of cards (ATM, Debit and Credit cards) has recorded a growth rate of 58 percent during the year 2004 over the year 2003. Total number of all cardholders which was 1.70 million in 2003 has now reached 2.68 million (see **Figure 14.1.4**). As most of the banks have converted ATM cards into debit cards, therefore, now it can be used on both ATMs and POS.

Another important channel for funds movement is online banking. Using the online banking facility, customers can easily transfer funds from one account to another within the same bank. During the last one year, online banking has shown phenomenal growth (see **Figure 14.1.5**). It is expected that online banking, after standardization, besides customer facilitation will also save intra-bank clearing cost of the banks.

In order to provide an enabling framework to the banking system for promotion of e-banking in the country, SBP is actively enhancing its own capacity in terms of IT infrastructure and encouraging the banks to invest in Information Technology. It is also expediting legislation regarding e-banking. *"Draft Payment Systems & Electronic Funds Transfer Act, 2005*[26]*"* is a step towards this direction. Also, in order to help banks adopt proper risk management practices in their IT infrastructure and processes, SBP has recently issued *"Guidelines on IT Security"*. These guidelines are aimed at helping banks formulate an institution-wide IT Security framework to mitigate the risks involved. These guidelines are however, not all-encompassing and the fuller mitigation of risks related to e-banking will largely depend upon the organizational commitment to formulate and implement risk management policies.

Figure-14.1.3: Monthly average of POS transactions

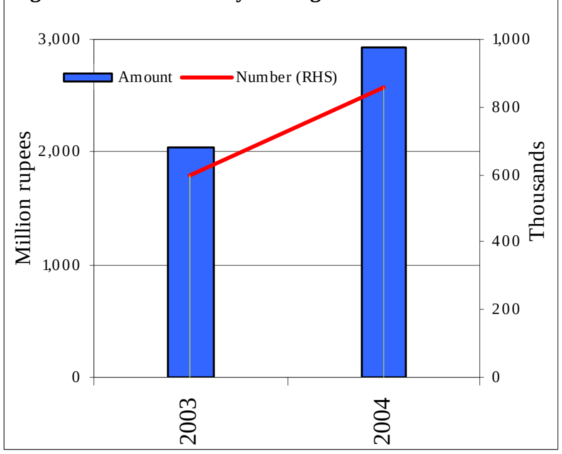


Figure-14.1.4: Cardholders in the Banking System

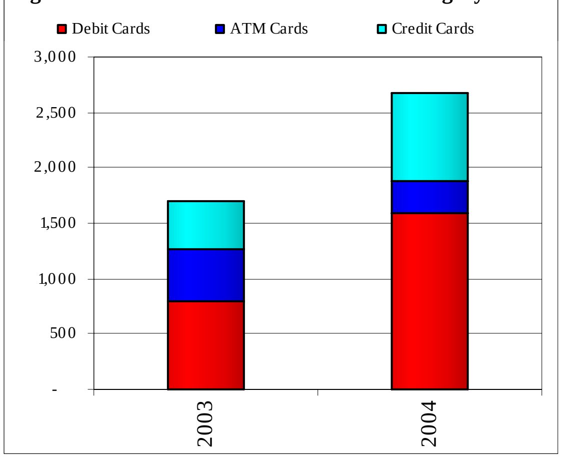
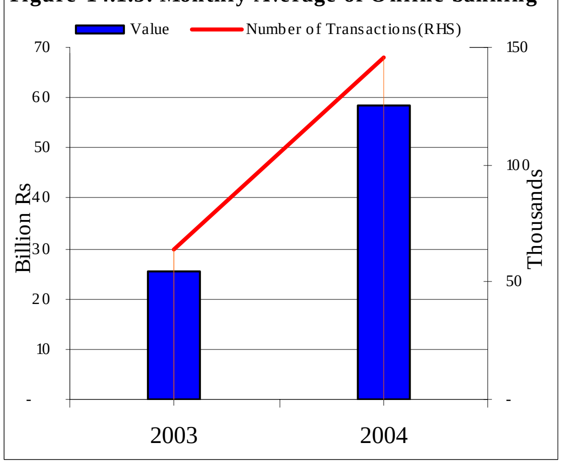


Figure-14.1.5: Monthly Average of Online banking



[26] The Act has been placed at SBP website for comments.

Box – 14.1
Steps taken by SBP to streamline the e-banking services- Retail Side

E-banking started with the installation of ATMs by the commercial banks. However, these were not interconnected and hence the customers could execute transactions at ATMs of their own bank only. In order to promote e-banking, State Bank of Pakistan facilitated establishment of ATMs switch networks. Two consortiums of banks established switch networks. 1Link started its operations in October 1999 and MNet switch started in June 2000. This was a major milestone which enabled the banks to install ATMs at offsite locations. SBP mandated all the banks to connect their systems with either of the switch. This was the beginning of a new era in banking industry where customers were able to withdraw cash from ATMs, carry out balance inquiry, and produce mini statement round the clock using ATMs connected with switches. As a result of successful operations of two separate ATM switching networks, SBP took another initiative to boost e-banking services and facilitated both the switch operators to inter-connect their switches. Responding positively, switch operators, MNet and 1Link, joined hands with SBP to develop a plan to achieve this goal. After comprehensive testing, the interconnectivity was finally achieved on 16th March, 2004. The integration of the switches, on the one hand, helped commercial banks to invest rationally on installation of ATMs and, on the other hand, facilitated the customers to use ATMs of any bank.

These measures provided impetus for high growth and now number of e-banking transactions has reached 19 percent of total (Paper based and Electronic Transactions) retail transactions within a short span of four year.

State Bank and the switch operators carried out surveys to evaluate the services standards of ATMs. Based on survey findings, remedial measures were taken to remove the teething problems of interconnectivity to further improve the services.

To cater to the needs of the public and economize the investment of the banks SBP has allowed banks to operate mobile ATMs. Mobile ATMs will be providing all normal services as offered by a fixed ATM. Beside mobile ATMs; banks were allowed to install ATMs with the help of third party service providers. The banks will, however, carry out due diligence of the third party. While availing the services of third party banks will ensure security, cash management, settlement and customers complaint resolution. This initiative on one hand will increase ATM population in the country and on the other hand will also save bank funds which would otherwise be invested in the installation of their own ATMs.

These policy reforms are an important step in making the e-banking in Pakistan a more efficient, competitive, transparent and market-based component of banking system that plays its due role in the economic development of the country.

14.2 Anti Money Laundering

The thrust of SBP’s efforts in checking money laundering and terrorist financing may be seen in the context of the overall strategic approach with regard to Anti Money Laundering (AML) / Combating the Financing of Terrorism (CFT) in Pakistan.

The strategy consists of a multi-pronged approach that (a) increases the incentives for documenting the economy and reducing cash transactions (b) makes greater use of the banking system for payments and settlement (c) brings the informal money changing business into the formal sector supervised by regulators (d) introduces a comprehensive legislation that facilitates detection, reporting, investigation, prosecutions and penalization of those indulging in these activities (e) develops the enforcement capacity within the banks, exchange companies, National Accountability Bureau (NAB), regulatory agencies through technology, training and interactions with international agencies (f) learns from the international best practices and keeps actively engaged with foreign agencies and institutions actively involved in this field.

The simplification of tax administration and procedures and lowering of tax rate, introduction of Islamic banking to attract customers who have so far shunned the formal banking system, conversion of money changers into properly regulated exchange companies, promotion of credit cards, ATMs and e-banking in the country, consolidating the investigation functions under strong and competent organizations such as NAB and Anti Narcotics Force (ANF), training of bankers and regulators, increased formal coordination between SECP and SBP on one hand and the regulators and NAB on the other, keeping in liaison with other foreign agencies and groups, freezing of accounts of terrorism related persons and entities, issuing and enforcing relevant PRs, switch over to RTGS are some of the specific actions that have already been taken by the Pakistani authorities.

The drive against money laundering continues with SBP focusing more on the Regulatory measures, while upgrading the personnel capacity in the area of AML and simultaneously strengthening the enforcement aspect of the policy framework devised earlier. In continuation of measures against money laundering, certain additional steps have been taken to ensure adherence to the recommendations of Financial Action Task Force (FATF) on anti-money laundering so as to safeguard the interest of depositors from risks arising out of money laundering and to reinforce the measures being taken by the banks / DFIs for proper management of their institutions.

While various regulations on the AML are already in place, SBP has extended its regulatory net concerning AML to ensure the integrity and transparency of the banking system. The regulation on *Know Your Customer* (KYC) has now been made applicable to the walk-in customers also conducting transactions over and above a specified limit to be set by the banks. Moreover, keeping in view the importance of the records of transactions and identification data with regard to legal proceedings, the banks have been advised to retain all the relevant data for at least five years so as to avoid any set back on legal and reputational front. Besides, the banks and DFIs are required to keep an eye on all complex and unusual transactions both in terms of size and pattern, with apparently no legal or economic back up and report such transactions to SBP after due investigation. Additionally, in order to ensure compliance from the overseas branches or subsidiaries of Pakistani banks in foreign countries with the regulations concerning AML and KYC, the banks have been directed to follow the regulations set by SBP or the relevant regulations of the host country, whichever are exhaustive. The banks/DFIs have also been advised to gather sufficient information about their correspondent banks in order to be fully aware of their nature of business and AML and KYC practices and are prohibited to establish correspondent banking relationship where there are deficiencies in KYC policies or where correspondent has no physical presence. Attention has to be paid in continuing relationships with banks located in jurisdiction that have poor KYC standards or have been identified by FATF as "non-cooperative" in the fight against money laundering.

Banks/ DFIs are encouraged to develop and implement screening procedures well suited to ensuring high standards and integrity at the time of hiring their employees. In addition, adequate training is being arranged for the concerned supervisory staff, while the banks are also being encouraged to impart suitable training to their staff in the context of money laundering and terrorist financing. SBP has maintained liaison with Institute of Bankers, Pakistan (IBP) to provide maximum opportunities of training to staff of banks. In this regard, IBP has organized a number of seminars on AML during the year 2004 throughout the country. Also, the officials of SBP have participated in conferences and seminars arranged by Asia-Pacific Group on Money Laundering (APGML) so as to interact with the regional partners with regard to AML/CFT areas, keep abreast with the global developments and coordinate with other stakeholders.

In March CY05, a two-day International Seminar on AML was also arranged at Islamabad by SBP. The prime objective of the seminar was to discuss the core issues involving financial sector in the fight against money laundering while at the same time focusing on the practical implications of tackling money laundering and terrorist financing. The seminar will go a long way in developing a practical insight concerning high-risk sectors, various issues associated with money laundering and their impact on the economy as a whole. As the process of financial deepening persists, the objective of documentation of transactions is being achieved; however, low literacy rate and lack of financial services in remote areas of the country are the prime challenges. In this regard, the overall approach has been to follow the necessary measures in phased manner keeping well suited to the specific needs and environment of the country.

14.3 Basel Capital Accord II

Basel Committee on Banking Supervision (BCBS) finalized the New Capital Adequacy framework commonly known as Basel II in June 2004. The new capital framework envisages safety and soundness of the financial system through its three pillars. Firstly, more risk sensitive calculation of capital charge for individual banks based on their risk management policies and practices. Secondly, Supervisory Review Process to ensure sufficient supervisory oversight for adequacy of banks' capital. Thirdly, enforcement of Market Discipline by requiring banks to make extensive disclosures. Though implementation of Basel II is not mandatory even for member countries, yet its implementation has a host of inherent benefits justifying its implementation in Pakistan. Foremost is the fact that the new framework will pave way for more robust and stronger banks. Besides, it will also enable the domestic banking sector to prepare for stiff competition in the rapidly changing sophistications and boundaries of the financial world. Nevertheless, implementation of Basel II is, by no means, an easy task especially in countries like Pakistan where risk management is still in its infancy stage. Based on in-house discussions, review of implementation of Basel II in other economies and consultations with all the stakeholders, SBP has issued a road map for Basel II implementation on 31st March 2005. The transition to Basel II would be as follows;

- Banks would be required to adopt Basel II as follows:
  1) Standardized Approach for credit risk and Basic Indicator /Standardized Approach for operational risk from 1st January 2008.
  2) Internal Ratings Based (IRB) Approaches from 1st January 2010.

  (Banks interested in adopting IRB Approaches for capital requirement against credit risk before 1st January 2010 may approach SBP for the purpose. Their request will be considered on case-to-case basis)
- To ensure smooth transition to Basel II, there would be a parallel run of one and half year for Standardized Approach and two years for IRB Approaches starting from 1st July 2006 and 1st January 2008 respectively.
- Banks' internal plans for Basel II implementation shall be reviewed and continuously monitored by SBP during the pre- implementation period as well as during parallel run.

The road map also outlines a time-bound action plan whereby various actions to be taken by SBP and the banking industry are enumerated. These actions include formation of capacity enhancement strategies both at the banks and regulator levels, recognition of External Credit Assessment Institutions and mapping of the ratings with the appropriate risk weight, preparation of detailed instructions/guidelines for implementation, parallel run of Basel II, review of banks risk management practices and/or internal rating based models and identifying gaps between the existing and required disclosure under Pillar III.

At present SBP is working on a number of practical issues summarized below;

a) Under Standardized Approach the capital requirement will be based on external risk assessment carried out by rating agencies. It is extremely important that this risk assessment must be reasonably accurate. Consequently, criteria for the eligibility of rating agency for Basel II purposes has been drafted and will be finalized after consultation with the stakeholders. It is expected that this criteria will force our rating agencies to improve their standards.

b) It is expected that many large local banks would want to move to advanced approaches as early as possible due to capital incentives. However, the adoption of advanced approaches requires more financial and technical resources, good risk management capabilities and long history of data. If these banks are to adopt advance approaches in next four to five years, they must establish internal rating framework now.

c) The risk management guidelines issued in 2003 encompass best practices for the management of Credit, Market, Liquidity and Operational risks. Since its issuance, SBP is monitoring the adoption of these guidelines by banks. Most of the requirements of the Pillar II will be fulfilled, if banks follow these guidelines according to their size, nature and complexity of business.

d) Basel II prescribes extensive disclosure requirements under Market discipline. SBP is reviewing the existing disclosure requirements in this context and appropriate changes will be made by the end of this year.

e) Trainings and workshops not only relating to the new capital rules but also on risk management will continue to be conducted both for SBP officers as well as for bankers.

14.4 Financial Derivatives Business Regulations

Financial innovations and increased complications in the financial market, increased competitive environment and technology improvements resulted in continuous development of financial products. Financial Derivatives have been widely used throughout the international financial markets primarily for hedging the market and other risks. In order to provide risk hedging mechanism to the market participants and to look for new avenues for revenue generation, financial institutions in Pakistan took initiative to develop market for structured products. In Pakistan, use of financial derivatives as a formal means of managing the risk profile of the corporate clients and Financial Institutions, is a relatively recent concept as first recognized derivatives transaction was rolled out only in the second half of year 2003. Although derivatives can generate large revenues for institutions and provide value-added solutions to customers, they can also result in large-scale losses. Initially approvals were granted by SBP to the financial institutions who wanted to enter into derivatives transactions with their clients on case to case basis. In order to curtail any speculative motive, these approvals have been granted strictly for hedging purposes only.

As the market moved on, SBP issued Financial Derivatives Business Regulations (FDBR) on 26th November 2004 vide BSD circular No. 17 of 2004 to develop a formal Over the Counter (OTC) derivatives market in Pakistan. These regulations provide guidelines for transacting OTC derivatives in the country and permit three types of derivatives transactions: Foreign Currency Options (FX Options), Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRSs). Under these regulations, State Bank may grant the status of either Authorized Derivatives Dealer (ADD) or Non Market Maker Financial Institution (NMI) to the eligible financial institutions, who meet the minimum criteria set out by SBP and are willing to deal in derivatives business. After acquiring the desired status, these institutions would no longer require case to case approval for their derivative transactions as per the current practice. The eligibility criteria takes into account, the applicant's capability/ capacity to transact derivatives business after detailed on-site and off-site assessments. Currently State Bank has granted the status of Authorized Derivatives dealer to two banks. It is expected that, for the time being, derivative transactions not falling within the scope of FDBR will be few and far between and specific approval for those transactions will be separately given.

Up till now foreign banks have been very active in FX options. These options serve two purposes; on the one hand they provide revenue generating activity for the banks and on the other hand these options hedge foreign exchange exposures of the corporate sector entities. Until recently no intra-financial institution FX Option has been transacted. Furthermore, financial institutions entering FX Options are required to back to back hedge their positions with offshore counterparties, so that they are not exposed to any foreign exchange risk.

Interest rate derivatives provide an opportunity to corporate sector and financial sector entities to hedge their interest rate exposures. On interest rate derivatives side, private banks are shouldering the part of their foreign counterparts in developing the markets.

Till now, keeping in view the infancy stage of derivatives market in Pakistan, substantial transactions have been transacted. **Table 14.4.1** shows the amounts outstanding for each of the allowed derivative transactions as on 31st March

Table-14.4.1: Derivative Transactions

Derivative	Amount Outstanding (Eq. in million PKR)
FX Options	5,971
IRSs	8,521
FRAs	-

2005. The FX Options which have been booked by major foreign banks only amount to around Rs6 billion, while the major currency covered is the Euro against the USD. IRSs have been undertaken mostly by the private banks with their corporate and financial sector clients. FRAs being very short-term in nature are not presently outstanding; however, FRAs involving notional principal of Rs3.090 billion have been transacted till 31-03-2005.

14.5 Banking Ombudsman

The concept of an ombudsman is evolving the world over not only in public but also in private sector, because the phenomenal growth in service and other industries and rapidly expanding consumer base has necessitated its establishment in different industries. Therefore, in order to provide a proper forum for redressal of public complaints against banks, the office of the Banking Ombudsman has been established in Pakistan under the provisions of a banking law (Part IV A of the Banking Companies Ordinance, 1962) as a statutory body. The increase in the pace of privatization and de-regulation, encouraging banks to offer wide array of products and services, and at the same time, increasing volume of associated complaints received at SBP complaint cell on daily basis, necessitated the establishment of a separate statutory body for speedy redressal of public complaints. The Ombudsman's role in the financial industry is to resolve disputes arising out of disagreements and differences between banks and customers through a process which is largely conciliatory, and where mediation is unsuccessful, to recommend a basis for the settlement of a dispute. However, the scope of its operation is limited to handling complaints relating to banking malpractices, inordinate delays, corruption, maladministration etc. In relation to all banks operating in Pakistan, the Banking Mohtasib has been empowered to entertain complaints of the following nature:

- Failure to act in accordance with banking laws and regulations including policy directives or guidelines issued by SBP from time to time.
- Delays or fraud in relation to the payment or collection of cheques, drafts or other banking instruments or transfer of funds.
- Fraudulent or unauthorized withdrawals or debit entries in accounts.
- Complaints from exporters or importers, relating to banking services and obligations including letters of credit.
- Complaints from holders of foreign currency accounts whether maintained by residents or non-residents.
- Complaints relating to remittances to or from abroad.
- Complaints relating to mark-up or interest rates based on the ground of a violation of an agreement or of State Bank of Pakistan directive.
- Complaints relating to payment of utility bills.

In respect of public sector banks, the Banking Mohtasib would in addition to the foregoing, entertain complaints pertaining to

- Corruption or mala fide practices by bank officers.
- Gross dereliction of duties in dealing with customers and
- Inordinate delays in taking decisions.

However, the Banking Mohtasib does not have power to direct a bank to extend loans or advances to a complainant; intervene in the policy matters like mark-up rates, schedule of charges, product pricing, etc. Any matter that has already been decided in a court or complaints by bank's employee in respect of their terms and conditions of service are also out of the jurisdiction of Mohtasib.

Once the complaint is lodged, Banking Ombudsman will institute a process of mediation to achieve an amicable resolution between both parties. If the matter cannot be resolved amicably, he will pass a suitable **'Award'** asking the bank to rectify the situation or make good the complainant's loss. Additionally, where warranted, he will direct the bank to pay to the complainant a reasonable compensation for hardship, if any, suffered by the complainant as a result of the bank's conduct. The Award passed is not binding on both parties, either party can appeal against the order within time frame allowed for the purpose. The complainant has two tier recourse, he can appeal to the Governor State Bank of Pakistan and if he is still not satisfied with his decision then he has the right to go to a court of law. Whereas, a bank has single tier recourse, by appealing to the Governor State Bank of Pakistan against the decision of the Banking Mohtasib. Any order of the Banking Mohtasib not appealed against within 30 days or any order passed by SBP in appeal shall become binding on bank.

The likely impact of Ombudsman Office in Pakistan would be far reaching, not only in the context of dispute resolution but also on the expected improvement in the service and efficiency levels. The courts adjudicate and announce the decision based on facts only, whereas the office of Banking Ombudsman will, in addition to dispute resolution free of cost, identify systemic weaknesses and recommend improvements.

14.6 Update on Deposit Insurance Scheme

The Banking System Review for the year 2003 gave a brief of the deposits insurance system (DIS), its pros and cons with special reference to Pakistan. The foremost advantage of a DIS is the stability of the banking sector through enhanced trust of the depositors, especially the small depositors, in banking system without burdening the taxpayers. Since the early 1990's the financial sector has continuously been liberalized; consequently a large chunk of the banking system deposits now lies with private banks. This coupled with the fact that the number of small depositors is on the rise provides a strong rationale of having explicit deposit insurance scheme instead of implicit government guarantee.

The year under review saw some major developments on this front. The banking system has made some significant improvements that allay some of the concerns on the efficient working of DIS. The system's solvency has significantly improved over the year, and now with the exception of one there is no financially fragile bank, in terms of capital adequacy ratio, that could pose adverse selection problem, thus signifying the reaching of a most appropriate timing for introduction of a DIS.

SBP's internal working group's study has culminated into a draft proposal on the establishment of the system. The study has taken into account the international best practices and analyzed the various modules of DIS operations in nine developing as well as developed countries, considering the socioeconomic and geopolitical conditions prevailing in the country as well as globally. The draft proposal is in the final stages of approval.

The introduction of DIS in Pakistan may accompany certain downside effects also. The most prominent among them is the problem of Moral Hazard. Moral Hazard is the tendency on the part of banks to take excessive risk given the fact that they are protected against losses. In the design of proposed DIS, the working group has tried to keep this potential problem to minimum by incorporating curbing features such as limited coverage, excluding inter bank deposits, and risk based premium. Moreover, implementation of DIS will not lessen the supervisory responsibilities of SBP. In fact if DIS is introduced, it will be accompanied by even more rigorous supervisory regime.

14.7 Branch Expansion

The Pakistani banking system has remained dominated by the five large banks. This domination has come down significantly over the last five years, as the medium sized banks started to register strong growths – both in terms of asset base and outreach. They have shown marked maneuverability to branch out into under-served and un-served areas to reap the economies of scale. This phenomenon is in line with SBP's policy thrust to enhance capabilities and efficiencies of the system and to provide the level playing field for the market participants. Bank's recently announced Branch Licensing Policy also mirrors this strategy. The policy effectively reconciles the divergent issues of stability, efficiency, and service to the society. It is flexible and liberal enough to allow the banks to independently make their branch location decisions within a broad parameter of conditions.

Banks are required to draft their Annual Branch Expansion Plan (ABEP) before the start of every calendar year; the plan will envisage the proposed number of new branches to be opened in urban and rural areas and the number of branches the bank wishes to close down. The approval of the plan is linked to the bank's financial standings, and the factors like opening of branches in rural and under-banked areas, electronic connection of branches, providing for utility bill payments and facilitating delivery of home remittances are also taken into account. Banks are free to install ATMs within branch premises as well as off-site places. They are also allowed to close down any of their existing branches at banked and un-banked places provided that the area is not left without an alternative arrangement for provision of banking services to the local community. Further, banks are free to shift or relocate their banked area branches within the same city/town/villages and on countrywide basis except shifting of branches to five metropolitan cites which requires prior State Bank approval. The policy also specifies detailed criteria for opening, shifting and closure of permanent and temporary banking booths.

Table-14.7.1: Branches of All Banks (Domestic operations)

	Branches opened	Branches closed	Total Branches
Dec-03	104	116	6,904
Jun-04	30	56	6,882
Dec-04	194	27	7,049

Source: Statistics Department

The liberal branch opening policy is witnessed from the figures given in the **Table 14.7.1**. The banking institutions are aggressively expanding their branch network. As is evident from the statistics, as on December 2004, there were total 7,049 branches as compared to 6,882 branches as on June 30, 2004. Out of total number of branches, 194 branches were opened during July-04 to Dec-04 as against only 30 branches in preceding six months. Only 27 loss-making branches were closed down as per criteria laid out in the Branch Licensing Policy. Though five large banks are still representing major share of branch network, i.e. around 80 percent, the last few years' expansion in the network has come from medium sized banks. Under the branch rationalization policy these five banks have actually curtailed their branch network. The figures portray quite healthy branch expansion tendencies among banks, which show that the banks in Pakistan are pursuing targeted market business strategies to enhance their scope and scale of activities.

14.8 Employment Patterns in Banks/DFIs/MFBs

Table-14.8.1: Staff Strength of Banks, DFIs & MFBs

Category	2002	2003	2004
Permanent	83,085	85,073	87,676
Temporary/Contractual	3,480	4,973	4,952
Daily Wagers	2,385	947	458
Outsourced	12,312	14,568	20,817
Others (Deputationists)	52	70	476
Total	101,314	105,631	114,379

While the banking system has played an important role in fueling the economic activities in recent years, it has at the same time contributed significantly in reducing the incidence of unemployment in the country. After going through a torrid time in 1990s during which head count in public sector banks was reduced because of golden handshake/voluntary separation schemes, 2004 presents an altogether changed picture. The banking system has not only recovered strongly in terms of its operational performance but is also opening up growing opportunities of employment (see **Table 14.8.1**). Total number of employees increased by 8,748 in CY04 as compared with 4,317 in CY03. This significant increase in the rate of employment corresponds directly to the diversified services as well as expanding outreach of the institutions falling under the regulatory domain of SBP.

A noticeable development is the change in the patterns of employment. While the jobs in permanent category have increased steadily, the jobs outsourced have grown at a remarkable pace. This significant shift in the employment trend is linked strongly with the change in nature of banking business. Liberalization and technological revolution, by demolishing barriers, have substantially increased competition in the marketplace. Banks in this era strive to keep their bottom line intact by adopting cost effective approaches. Efficiency and ability to deliver are the essential qualities, which banks seek in their workforce and functions. This inclination of banks has not only rendered a number of traditional jobs redundant but has, at the same time, created demand for many new task-oriented and skilled jobs. Keeping in view the growing network of the banking system and efforts to improve their services, the opportunities of new jobs are expected to grow over time.

14.9 Initiatives for Development of SMEs

In view of the important role of SMEs in the economic development of Pakistan, State Bank has been striving to ensure proper flow of credit to the SMEs. In CY 2004, SBP has taken various initiatives to create enabling regulatory environment for financing to SME sector on the parameters other than those relating to commercial and corporate banking. In this regard, SBP has introduced separate PRs to encourage banks/DFIs develop new financing techniques and innovative products meeting the distinct financial requirements of SMEs and providing a viable and growing lending outlet for banks/DFIs.

As the information on credit worthiness of the borrower plays an important role in the decision making of a financial institution for extending financial assistance, the scope of Credit Information Bureau is being enhanced by eliminating its limit. This will facilitate the banks in evaluating the credit requests of small and medium enterprises, leading to provision of credit to this sector. In pursuance of the drive towards enhancing the role of SMEs, the Government had established SME Bank as a specialized institution to cater to the financing needs of the SMEs. The bank is currently undergoing an extensive restructuring phase under the Asian Development Bank's 'SME Sector Development Project'. As part of this restructuring exercise, SBP has also issued commercial banking license to SME Bank, which has enabled the bank to undertake the whole range of banking business.

For the promotion of SME sector, SBP has adopted a focused approach. In this regard, it has recently decided to establish a full fledged **Small and Medium Enterprises Department** (SMED). The department will focus on the key issues concerning SME sector development in the country through personnel having rich experience in regulating the banking industry and in depth knowledge of all aspects of SME financing, including conceptual as well as business. Further, the department will also have a closed liaison with all stakeholders of SME Sector and provide guidance to banks and DFIs in resolving issues impeding the growth of SME.

In order to guide the human resource of banks/DFIs in preparing their business plans and participating in credit extension process under SME financing, SBP has signed a technical assistance agreement under recently negotiated SME Sector Development Program Loan from Asian Development Bank. Under the technical assistance program, SBP shall outsource the services of foreign consultants to provide capacity building support to a few banks on cost sharing basis. Besides, the consulting firm will help SME Bank in preparing its business plan and improve credit delivery system. Extensive trainings for the concerned officials of the banks /DFIs will also be organized as part of this arrangement. This process of information acquisition and dissemination will go a long way in establishing the distinct status of SME sector financing, enhancing intellectual capital development and resolving the perplexity of the issues at the grass root level.

14.10 Financing for the Export Oriented Projects and LMM

To provide medium to longer term financing to the export oriented projects, SBP launched a new scheme called **"Scheme for Long Term Financing for the Export Oriented Projects (LTF-EOP)"** in 2004. The scheme allowed the eligible financial institutions to provide funding facilities to the export oriented units, who meet the financing criteria, on attractive terms and conditions for import of machinery, plant, equipments and accessories etc. (not manufactured locally). The basic objective of the scheme is to support the capacity building of non-SME as well as SME sectors while ensuring synchronization of incentives announced under Trade Policy 2003-04. One of the distinct features of the scheme is multiple pricing option on the basis of period of financing. Besides, the scheme is a window of financing for intangible products like brand name acquisition. The rates of mark up, under the scheme are linked with the weighted average yield on 12 months MTBs as well as PIB of 3 years and of 5 years maturity.

Banks/DFIs while working as an interface will undertake the credit risk and thus can earn a spread upto 3 percent. The sanctioning of limit to banks/DFIs depends upon their credit rating, CAMELS-S and their past experience in the project financing. The financing should be of those projects/units, which export at least 50 percent of their annual production directly or indirectly. The other conditionality of the scheme is that the borrowers having export overdue bills of more than 365 days shall not be entitled for financing under the scheme.
The scheme is expected to give a major boost to the development of exporting entities in the manufacturing sector.

Locally Manufactured Machinery

The reengineering of Locally Manufactured Machinery (LMM) scheme has been done in order to make it more user-friendly. The rate structure has been linked with the weighted average yield of relevant tenure of MTBs and PIB. The facility has been also made available to manufacturers besides purchasers. To increase the coverage of the scheme and to make it available for SMEs; DFIs and Leasing Companies, besides banks, also work as an interface for providing the facility to the end users now.

15 Developments in Banking Supervision

15.1 Guidelines Issued during the Year

15.1.1 Country Risk

An efficient and well-functioning system of banking supervision requires sound and sustainable macro economic policies, a well-established public infrastructure, effective market discipline and mechanisms for absorption of systemic vulnerabilities. Increasing integration of economies around the world, particularly through trade and financial flows is providing access to more capital flows, technology and larger markets. Financial Sector Reforms have laid the foundation of an efficient, effective and resilient banking system in Pakistan. Under Financial Sector Reforms, financial institutions are well positioned to operate in deregulated and liberalized environment. The strengthened regulatory and supervisory functions, prudential enforcement and enhanced risk management capabilities have placed the domestic banking institutions in stronger position to compete more effectively with the rest of the world. Further, the enhanced capital requirement allowed the weaker banks either to exit from the financial system or merge with other commercial banks to capitalize on synergies and economies of scales to enhance cost-efficiency level. The banks are now better equipped to be more innovative in developing business strategies and to price their products and services more competitively. Consequently, a number of Pakistani banks have started looking for expanding their business horizons beyond national boundaries. Although, Pakistani banks have relatively low level of cross border exposure but the need was felt to put in place mechanism of hedging risks arising from cross-national transactions. In order to put in place adequate country risk management procedures, State Bank issued broad guidelines on country risk in May 2004. The objective of these broad guidelines is to assist banks and DFIs in setting up internal structures, policies and procedures for the management of country risk. The guidelines set the minimum requirement on types of country risk, risk assessment, risk rating, risk limits, MIS and internal control & audit. The guidelines place the responsibility on Board to define the level of country risk the institution can undertake and the senior management shall ensure that the staff entrusted with the responsibility is capable of dealing with it and the managerial structure are commensurate with the level of institution’s overseas exposure. In line with these broad guidelines, the banks and DFIs are required to formulate appropriate, well-documented and clearly defined 'Country Risk Management' (CRM) policies, with the approval of the respective Board of Directors. The CRM policy shall address the issues of identifying, measuring, monitoring and controlling country exposure risks. The Policy shall specify the responsibility and accountability of the various levels for the country risk management decisions. The implementation of the requirements would enable the banks and DFIs to minimize cross-country risk and to adopt best practices in this regard. This will also result in achieving compliance of the Basel Core Principle dealing with the country risk management.

15.1.2 Infrastructure Financing

Prior to the year 1999, Pakistan’s economy was confronting declining economic growth, large fiscal deficits, rising debt burden, depleted international reserves and poor credibility among international financial institutions. Pakistan’s economy has taken remarkable turnaround during last five years despite feeble domestic and regional environment (post-9/11 developments). Since

1999, the economic team led by a group of professionals put up concerted efforts for economic revival of the country. As a result, Pakistan's economic growth has remained remarkable in recent years. The restoration of macroeconomic stability, structural reforms, improved economic & corporate governance and coordinated efforts for poverty alleviation are success factors for impressive recovery. In order to sustain the momentum of high growth rate, the government has identified four major sectors viz. agriculture, SMEs, oil & gas and information technology as drivers of growth. The development of infrastructure provides vital support to the productive sector and is a key driver for growth. The government desires that private sector may come up and share the burden of infrastructure development to keep pace with the growth momentum. The basic objectives of public-private infrastructure financing partnership is to assist in designing appropriate mechanisms for accelerating infrastructure development through increased private sector participation in infrastructure development in Pakistan. Financial sector development and economic development are inter-related. The banks in Pakistan account for 95 percent of the financial sector and are thus considered the main source for channeling funds from surplus sector (savers) to deficit sector (investors). Infrastructure projects, by their nature and design, require relatively large investment, besides needing longer gestation period for development, construction, start-up and operation. Therefore, Infrastructure Project Finances are characterized with high cost of capital equipment along with large transaction costs for structuring that inevitably needs long term financing. Hence, financial sector participation can play a pivotal role in financing infrastructure projects.

In order to encourage the banks to finance the infrastructure projects and also to lend a hand in robust economic development process, State Bank has formulated draft guidelines on Infrastructure Project Financing in consultation with its stakeholders. The guidelines will enable the private sector participation and funding of infrastructure projects, especially those under long-term government concession agreements. Further, these guidelines will provide the banks with insight into process of credit appraisal, collateral arrangements and security package, regulatory compliance and checklist for minimum information requirement. It is hoped that these guidelines will help banks/DFIs to develop expertise for financing of infrastructure projects, essentially by evaluating the intrinsic cash flow generating ability of these projects on the basis of sectoral and sub-sectoral studies and other data regarding volume of expected use and future cash projections of infrastructure projects. These guidelines are now in the process of discussion at various levels/committees and will be circulated to banks & DFIs in due course.

15.1.3 IT Security

In the age of globalization, economic & financial integration and technological advancement, the use of information technology (IT) for banks and financial institutions is a must in order to stay competitive in domestic and global markets. Banks and financial institutions are rapidly coming up to take advantage of evolving IT innovations and fast incorporating IT in their business processes to achieve efficiency, customer satisfaction and expanding & modernizing their product offerings. The powerful personal computers, converging technologies and the widespread use of the Internet have replaced stand-alone systems in predominantly closed networks. The market participants are increasingly interconnected with networks eliminating cross border barriers of communication. The nature and type of technologies that constitute the communications and information infrastructure also have changed significantly. As a result of increasing interconnectivity, information systems and networks are now exposed to a variety of threats and vulnerabilities, which could result in total disruption of service and its consequential financial implications. This has necessitated new issues for security and there is need to promote a culture of IT security among the market players.

The banks and DFIs in Pakistan are fast coming up to adopt the modern means of innovative banking. SBP recognizes that financial industry is built around the sanctity of the financial transactions. Owing to the critical role of financial institutions for a country and the extreme sensitivity of their information assets, the concern of IT security and the ever-increasing threats cannot be overstated. As more and more banking operations and products & services are becoming technology driven our reliance on these assets are increasing and so does the need to protect and safeguard these resources to ensure smooth functioning of the financial industry.

Keeping the above mentioned IT security concerns in view and to strengthen and enhance the level of information technology management, State Bank has issued guidelines for IT security in September 2004. The major objectives of these broad guidelines are to encourage the banks and DFIs to design and review their IT systems as a means of protecting valuable financial and technical assets and creating awareness about the risk to information systems networks; the policies, practices, measures and procedures to address these risks. The guidelines specify minimum requirements for design and review of IT system; awareness, training and commitment among participants for security of information systems; policy development; risk management; information system audit and certification; and contingency and disaster recovery planning for adequate level of IT Security. The guidelines place the responsibility on the Board and senior management in implementing IT governance, risk management practices and developing in-house expertise. The implementation of guidelines would enable the banks and DFIs to minimize risks associated with service interruptions.

15.1.4 Business Continuity Planning

The importance of Business Continuity Planning (BCP) in today's business environment of rapid change cannot be overstated. In order to withstand expected and unexpected business disruptions, the institutions need to institute physical security measures so that their sustainability as well as that of the industry as a whole is ensured. Business continuity planning is at the core of it. BCP is essentially a risk-based framework which requires development of such policies and strategies as may be necessary for proactively processing and dealing with the operational risk. With its focus on strengthening resilience of the banking system towards threats posed by internal and external factors, SBP has issued guidelines on the Business Continuity Planning (BCP). The guidelines make following recommendations to banks/DFIs:

- Board of Directors and the senior management is responsible for devising policies and procedures governing BCP and putting in place adequate systems to ensure that the ability of the institution to withstand operational disruptions remains intact.
- BCP should be formulated depending on the size, scale and complexity of the business and include clear-cut policy and budget, detailed description of the responsibilities of the key persons and the succession plans thereon, training programs for enhancing the awareness of the staff, emergency plans and the arrangements for the movement of staff to primary/ backup sites and coordination with the external parties etc.

- Banks/DFIs should highlight their critical business functions and the arrangements for their resumption on priority basis. In case of technology based products/services, manual delivery of the same should be preplanned.
- As the centralization of key business functions might expose the institution to concentration risk and hamper the ability of the institution to replace critical information or staff in time of emergency, the geographic diversity for critical operations should be ensured.
- Time targets should be set by the banks/DFIs for the resumption of core business functions as well as full fledged functioning of their business.
- The institutions should validate the reliability of BCP by means of regular testing and updation of the same.

The issuance of guidelines on BCP is another promising step towards a resilient and stable financial system. Development of robust and practical contingency plans shall go a long way in inculcating awareness amongst the stakeholders and enhancing the overall capacity of the banking system to deal with the threats posed by the environment in which it operates.

15.1.5 Internal Controls

Adequate risk management and good corporate governance are crucial to the success of banking system and effective internal control system is an integral part of an ideal risk management framework. Keeping this in view, and in order to encourage banks/DFIs to adopt robust risk management practices, SBP has issued guidelines on internal controls. With the objective of ensuring efficiency and effectiveness of operations, reliability, completeness and timeliness of financial management information and ensuring compliance with the policies, procedures, laws and regulations; these guidelines require the banks/DFIs to put in place an effective internal controls system. The guidelines encompass five broad areas:

- Suitability of the control environment in which the system operates.
- Risk assessment and management system including risk identification and evaluation of the factors that cause them.
- Control activities and segregation of duties.
- Accounting, information and communication systems to ensure that the policies and procedures are clearly communicated and understood while at the same time the risk-taking activities are within prescribed limits.
- Self assessment and correcting deficiencies.

The guidelines clearly specify the respective responsibilities of all the stake-holders viz. BOD, senior management, employees, internal and external auditors and the regulator. The idea is that all concerned should participate in ensuring effectiveness of the existing internal controls, their institution wide understanding and implementation, and suggest practical and timely suggestions for improvement. The main objective of these guidelines is to ensure that the internal systems and procedures of the banks/DFIs are sound and strictly enforced, so that their profitability and assets are protected from operational losses; frauds and forgeries are checked; and the overall stability of the system is strengthened, thereby creating value for the stakeholders.

15.2 Uniform Reporting Chart of Accounts

The accurate and transparent data reporting by financial institutions is an essential prerequisite for effective supervision. Anomalous data create distortions and make analyses of the financial health of financial institutions vague and unreliable. The financial institutions under the regulatory ambit of SBP also submit a vast range of data pertaining to numerous areas of their activities. At present, the data is being submitted to various departments in returns, designed in line with the departments' requirements, with varying periodicity. In spite of SBP's efforts for streamlining the data and reducing the reporting burden on banks, the problems involving definition and duplication keep arising every now and then.

To eliminate the irritants, to introduce harmony and to facilitate easy access to the data, SBP started work on the development of a Uniform Reporting Chart of Accounts (RCOA). For this purpose, SBP hired the services of a reputed chartered accountancy firm. The consultant has since submitted the draft chart of accounts which has been shared and extensively discussed with the internal and external stakeholders. Once finalized, the RCOA will replace the existing returns being submitted to different departments of SBP. The RCOA will not only be comprehensive enough to meet the existing data needs but will also be flexible enough to cater to the future requirements.

The RCOA combines in a single report all the information presently being submitted to SBP through various returns. This will not entail any change in the accounting systems of the reporting institutions and would require them to generate information in the single report, thus saving considerable time and resources, which they presently need to produce different reports of varying frequencies. SBP on its part will also benefit a lot, as various users will be able to generate reports in line with their requirements. The problem of different definitions for the same variable will also be removed because of the advantage of the single report. This, in turn, will help produce uniformity in all the reports generated by the different departments of SBP. More importantly, the impact of policies framed on the basis of accurate and consistent data will be more effective and pronounced which will greatly facilitate the achievement of desired goals.

15.3 Supervisory Developments

15.3.1 On-Site Examination

With the privatization of the state owned banks and the emergence of the private banks as the dominant force, the competitive spirit seems to have taken firm hold of the banking system of Pakistan. While the competition leads to higher level of efficiency among banks and also accrues benefits both for banks and their customers, it also generates concerns relating to excessive risk-taking. Consequently, the responsibilities of the regulators have also increased manifold to act as a vigilant watchdog and to put in place effective regulatory framework to cope with the challenges of the increasingly complex financial market. The crux of supervisory activities is thus based on rigorous risk based on-site supervisory framework, which emphasizes proactive monitoring of financial institutions. During 2004, SBP continued to direct supervisory resources at high-risk areas to monitor financial health and stability of financial system and enforcement of prudential regulatory measures.

A more focused and structured approach adopted in the on-site examination, inter alia, has contributed significantly towards the overall improvement in the performance of the financial institutions over the last couple of years. This is evident by marked improvement in the CAMELS-S rating of majority of banks; both in terms of number of banks as well as in terms of their market share in total assets (see **Figures 15.3.1 to 15.3.4**). The banks are tending to converge towards three rating which is indicative of fair performance. The overwhelming share of these banks in total assets of the system also holds special significance for the financial stability. With effective supervision and increasing compliance with the regulatory standards, their rating is expected to improve even further in the days ahead. An important factor contributing to this development has been the significant turn around in the performance of the large five banks, which used to be in critical condition, mainly because of their public ownership. The improvement in their performance may be attributed to a number of policy measures aimed at their reformation. Consequently, the share of four and five rated banks declined significantly to 11 percent from 71 percent in 1998. The decline in the number one and two rated banks may be traced to the on-going consolidation process, which led to the merger or acquisition of some of the top performing foreign banks.

Figure-15.3.1: Rating-wise distribution of No. of Banks - 1998

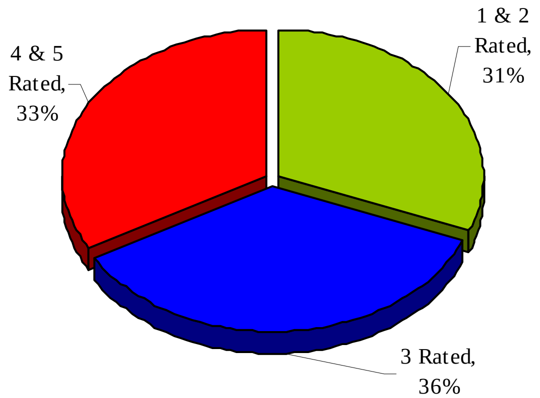
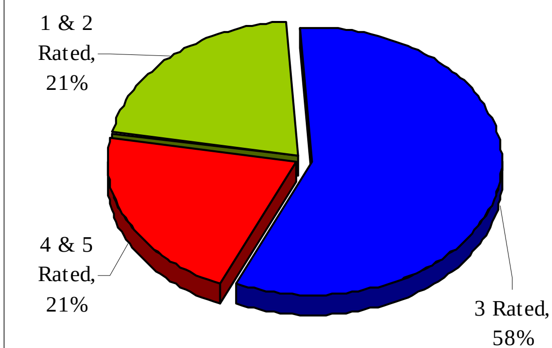


Figure-15.3.2: Rating-wise distribution of No. of Banks - 2004*



** Latest available On-site Inspection ratings*

Figure-15.3.3: Rating-wise market share of Banks in terms of Total Assets - 1998

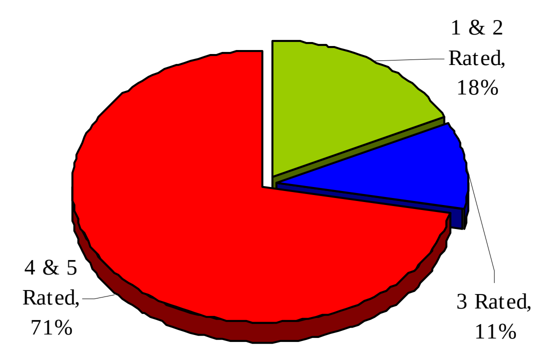
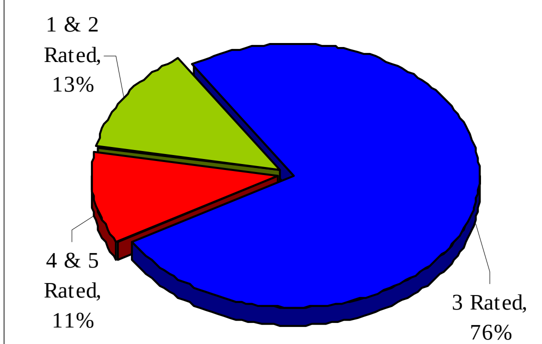


Figure-15.3.4: Rating-wise market share of Banks in terms of Total Assets - 2004*



** Latest available On-site Inspection ratings*

The DFIs, which used to be in extremely poor shape, have also witnessed substantial improvement in their performance. The role of on-site examination was commendable in unearthing the malpractices and mismanagement in the DFIs. This transpired either in the liquidation or reconstruction of such DFIs. The majority of the existing DFIs display improved on-site rating. The persisting low performance of the specialized banks remains the major cause of concern. Their poor performance may be attributed to the peculiar nature of their activities as well as costs involved in their restructuring. Keeping in view the role of these specialized banks in the emerging economic scenario, the policy makers have undertaken a number of initiatives for their rehabilitation and restructuring. It is expected that financial health of these specialized institutions would improve in coming years and they would be able to play a more meaningful role in economic development.

With the more proactive and risk-focused approach backed by skilled manpower, the onsite inspection is expected to continue playing an important role in strengthening the supervisory standards of SBP in the days ahead as well.

15.3.2 Off-Site Surveillance

Over the last many years, the offsite surveillance system at SBP has evolved into a well-developed system. The overarching approach, involving analysis both at individual bank as well as system level, has helped not only in detecting problems confronting individual banks but has also helped in promoting transparency as well as assessing the overall financial health of the system.

The individual bank analysis under the CAELS framework has become more probing with the use of additional indicators, especially those involving measurement of market risks. To proactively monitor the banks' exposure to interest rate risk because of their substantial holding of the fixed income securities, in addition to the regular offsite surveillance reports of banks and DFIs, a separate report assessing the impact of interest rate movement on their fixed income portfolio is also being generated on quarterly basis.

SBP is also well aware of the importance of keeping all the stakeholders abreast of banking systems soundness. In this regard, its quarterly and annual reviews on the performance of the banking system have played an important role in disseminating the vital information about the health of the banking system as well as promoting the culture of transparency.

Considering the growing use of sophisticated techniques and models in various countries to determine the vulnerability of banks to various shocks, SBP has also been working on same lines to develop a stress testing model to make the analysis more quantitative and forward looking. The analysis so far is at an early stage and with the availability of more data and increasing expertise it is expected to mature into a full fledge model in the near future. The stress test exercise being used is based on quarterly data using single factor sensitivity and regression based analysis. Under single factor sensitivity analysis exposure of the five big banks towards five major risks i.e. interest rate risk, credit risk, real estate price risk, equity price risk and exchange rate risk is being assessed after giving unusual but plausible shocks to interest rate, NPLs, forced sale value of collateral, stock market index and exchange rates. The stress testing exercises are helping a lot to assess overall risk exposures as well as structural vulnerabilities in banks that could trigger potential externalities and market failures.

In addition to in-house stress testing exercise, SBP is also preparing guidelines on stress testing for banks so as to impress the importance of this exercise on banks and assess the vulnerabilities of entire banking system. These guidelines contain framework for regular stress testing, technique and scope of stress testing along with methodologies and calibration of shocks. These guidelines will be issued to banks in due course, which will further augment the process of quantifying the adequate level of risk at individual bank level.

To further strengthen the existing supervisory mechanism and to mitigate the variety of risks banks are exposed to, SBP has also developed Institutional Risk Assessment Framework (IRAF)[3]. The framework aims at collaborative and seamless supervisory focus amongst various supervisory departments within SBP to ensure cohesive and proactive monitoring of risks within banks and DFIs. Being extensively technology driven, swift flow of information would enable SBP to institute more efficient and effective banking supervision and continuous monitoring, integrating off-site surveillance, on-site examination and current market information.

15.3.3 Prudential Meetings with Board of Directors and top Management

An active and well-informed Board of Directors plays an important role in the smooth running of a bank. Realizing its significance and to tackle the various challenges facing banks and DFIs, SBP has increased its interaction with their senior managements and Boards of Directors. The regular high-level meetings with Presidents/Chief Executives and the members of the Board of Directors provide an opportunity to the banking institutions to share with the supervisor the different challenges their organizations are facing. It also provides a forum to SBP to discuss various issues relating to the individual banking institutions like group structure, business strategies, strategic plans, market positioning, corporate governance, risk management, performance, capital adequacy, liquidity, asset quality and all the major issues observed during the course of on- site inspection. Where supervisory issues are of significant in nature requiring speedy corrective actions, institutions are required to give specific action plans through formal memorandum of understanding. The frequent interaction with the top hierarchy of banks is expected to contribute significantly towards further strengthening of the financial system as it would help in early resolution of various issues.

The foregoing lines amply demonstrate the success of SBP in erecting a solid superstructure of banking supervision over the last few years which has not only helped in restoring the health of the institutions which were in distress for quite some time but also succeeded in raising the supervisory standards to international best practices.

15.3.4 Risk Management in Banks

Banking, by its very nature, is a risky business. With the financial intermediaries embarking upon a wide and diverse array of products, the nature and complexity of the risks they assume changed. With a variety of risk mitigation tools at hand, and challenges from global, technological, social, economic, political, human resource and environmental facets, the risk managers and regulators are expected to strike the right balance between the risk and return in such a way that the interests of all the stakeholders are maximized. State Bank, being cognizant of this fact, introduced guidelines on risk management in CY03. The guidelines precisely required the banks to take measures for risk management in their institutions keeping in view the nature, size and complexity of their business. In this regard, the responsibilities of the Board of Directors and the senior management were clearly specified; whereby the overall responsibility of policy formulation governing risk management in the banks/DFIs, and putting in place such systems and procedures as may be required for the implementation of the same, rests with the BOD.

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[3] The Framework is in implementation process.

The implementation of the above mentioned guidelines would translate into substantial improvement in risk management of the banks/ DFIs, enabling them to ensure and strengthen their role in development and growth of the overall financial system. Whilst most of the foreign banks and some of the local private banks were already using systematic risk management tools such as asset liability management, credit scoring and setting standards, putting in place effective MIS, Value at Risk (VaR) models, simulation models, contingency planning etc, the remaining banks are also in the process of designing different risk management models and techniques in response to the guidelines. Moreover, banks have taken steps to enhance their pool of expertise and skills. Appreciating the importance of their in-house capacity for effective risk management, banks have adopted a focused approach to enhance their human resource base. Accordingly, separate risk management departments have been established by some of the banks. These efforts on part of the banks in enhancing their risk management capacity will facilitate them in their preparation for the implementation of New Basel Capital Accord once it is effective, and other initiatives which are likely to be introduced in future.

15.4 Prudential Regulations for Agricultural Financing

As the agriculture sector continues to make significant contributions towards major economic indicators, its importance for the economy of Pakistan cannot be overemphasized. Realizing the significance of the agriculture sector towards the economy of Pakistan, SBP has been endeavoring in collaboration with commercial banks to provide due sustenance in order to ensure a vibrant and sustainable agriculture sector. While these efforts have provided an enabling environment for the growth of agriculture sector, there was still room for further development. Until recently, there was no separate set of regulations governing the agricultural financing. This necessitated the promulgation of separate Prudential Regulations well suited to the peculiar nature of agricultural financing. Accordingly, SBP has prepared the Draft Prudential Regulations for Agriculture Financing. These regulations will provide a broader regulatory framework to the banks/DFIs, within which banks/DFIs would be able to develop comprehensive agriculture financing and introduce new and innovative financial products for financing the agriculture sector covering such areas as farm credit for inputs, farm development finance, finance for purchase of agriculture machinery and equipment, financing for livestock farming and corporate farming etc. The proposed regulations require the banks/DFIs to prepare comprehensive agricultural financing policy covering broader areas of strategic importance such as loan administration, disbursement and appropriate monitoring mechanism. Besides, the regulations lay down per party limits, emphasize on the banks to take a meticulous and expeditious approach towards loan disbursement and recovery, and require the standardization of loan documentation across the banking system. Once effective, these regulations shall place the agricultural financing on sound regulatory footing and would create a win-win situation for the agriculture sector as well as the banks.

16 Evaluation of Financial Sector of Pakistan under FSAP

Following the severe financial crisis of the late 1990s and its consequent jolts across different countries, the IMF and World Bank introduced the Financial Sector Assessment Program (FSAP) as a policy measure to identify the weaknesses and strengths of the member countries' financial systems to prevent or minimize the likelihood of such a crisis in future. The Program aims to strengthen surveillance of member countries, facilitating early detection of financial sector vulnerabilities and identification of financial sector development needs. The ultimate objective of the FSAP is "to help countries enhance their resilience to crises and foster growth by promoting financial stability and financial sector diversity". Participation in the Program is entirely voluntary and ever since its inception, the number of countries showing willingness to undergo the FSAP has grown rapidly.

The FSAP mission, comprising representative from both the IMF and World Bank, made two visits to Pakistan in February and April 2004 in connection with its Financial System Stability Assessment (FSSA). To compile their observations, they held meetings with SBP, SECP, the Ministry of Finance, banks, stock exchanges, professional bodies, other financial institutions and independent associations. Additionally, their assessment also involved analysis of the country's laws and regulations governing financial sector activities. The mission also evaluated the internal feedback based on FSAP questionnaires as well as self-assessment done by the concerned authorities. The questionnaires mainly covered compliance with:

- The Basel Core Principles for Effective Banking Supervision (BCP);
- The International Organization of Securities Commission's (IOSCO) Objectives of Securities Regulations; and
- The IMF's Code of Good Practices on Transparency in Monetary and Financial Policies.

Apart from the detailed assessments of compliance with these standards, the FSAP also carried out a comprehensive review of the macroeconomic environment and financial structure, issues involving stability, soundness and development of the financial system, systemic liquidity and public debt management practices & policy responses to crisis management & existence of safety nets and finally the prevailing financial infrastructure.

The overall condition of the financial sector of Pakistan was assessed as sound and satisfactory. The FSAP mission found compliance with the international codes and standards very high. Particularly, it was appreciative of SBP in making considerable progress in recent years to achieving and maintaining high regulatory standards. In its assessment of compliance with the Basel Core Principles for Effective Banking Supervision, it commended SBP in its efforts toward establishing a bank supervision system at the level of international best practices and achieving a degree of compliance with most of the Core Principles. The Principles are traditionally grouped into seven major categories: (i) preconditions for effective banking supervision; (ii) licensing and structure; (iii) PRs and requirements; (iv) methods of ongoing supervision; (v) information requirements; (vi) formal powers of supervisors; and (vii) cross-border banking.

The assessment shows that SBP has achieved Full Compliance with 22 of the 30 Core Principles and sub-principles. It is 'Largely Compliant' with four Principles and 'Materially Non-Compliant' with only four Principles. However, since the release of this assessment SBP has become fully compliant with a few more principles. SBP has notified all banks and DFIs to apply capital charge for their market risk related activities with effect from December 31, 2004. Moreover, comprehensive guidelines on country risk have also been issued. Keeping in view the substantive progress made in other areas, SBP is expected to become fully compliant with the remaining principles soon.

SBP also observes most of the good practices on transparency in monetary and financial policies recommended by the IMF. In this respect, the mission carried out separate assessment for monetary policy and banking supervision. The broad areas under these practices included (i) assessment of clarity of roles, responsibilities and objectives, (ii) process for formulation and reporting monetary and financial policies decisions, (iii) public availability of information on monetary and financial policies, and (iv) accountability and assurances of integrity by the central bank/financial agencies. SBP is found to be fully observing 43 of 45 good practices on monetary policy. Of the remaining two, one each was classified as 'broadly observed' and 'partly observed'.

The summary assessment of observance of good practices on banking supervision indicates that SBP is fully observing 30 out of 36 practices whereas one is found 'broadly observed' and two are 'partly observed'. The remaining three are not applicable.

The FSAP report accredits the significant progress made in the consolidation and strengthening of the financial sector to persistent reforms agenda pursued vigorously in recent years. In its technical note on condition of the banking system, the FSAP observes noticeable improvement in the structure and performance of commercial banks in Pakistan. The report regards as great achievement the transformation of the banking system from state-owned and weak banking system into a healthier, primarily privately owned system. Gradually changing structure of the banking system has given rise to significant improvement in its performance. All this is reflected in robust financial soundness indicators, greater resilience to credit, market and liquidity risks and observance of international supervisory standards. Moreover, the rapid expansion of credit in previously underserved sectors-SMEs, consumer finance, and agriculture-provides much needed diversification in the banking system's loans portfolio. Given the significantly fast growth in loans, the report cautions against higher credit risk. The report emphasizes upon the need to continue the reform process in order to consolidate the gains. It calls for divestiture of the government's share in the remaining banks and continuation of legal reforms. It also recommends developing a strategy for consolidated supervision and ensuring legal authority of SBP in this respect.

The mission observes that the reform process is not equally advanced across all segments of the financial sector. It, therefore, recommends further strengthening of SECP in terms of its capacity and resources so as to promote sectors which seem to be falling behind the overall reform process. Capital markets have grown substantially over the last decade but still remain relatively narrow and shallow relative to the large regional markets. The FSAP feels that COT or Badla system in the market should be replaced immediately by margin financing rules in order to reduce systemic risks. It appreciates SECP in demonstrating high regulatory standards, as reflected in the assessment of compliance with the IOSCO principles. To make its regulatory functions more effective, the FSAP calls upon SECP to commence a regular program of on-site inspection. In their assessment of the capital market, they feel that there is an immense potential for growth and further development would help support more rapid economic growth. The FSAP report highlights certain bottlenecks in areas relating to insurance and pension funds and suggests measures for their removal.

17 Resilience of Pakistan's Banking System to Stress Tests

The significance of the assessment of potential vulnerabilities in the financial system and the measures to reduce these vulnerabilities for both the regulators and the managers can not be stressed enough especially due to rising volatilities in the financial markets. The IMF's FSAP conducted an assessment on the stability of the Pakistani banking system and its capacity to withstand a set of macroeconomic and financial shocks in early CY04 on the data of September 2003. The assessment employed a macro prudential approach, which looks for quantifying the impact of stress test shocks to the banking system. These tests encompass severe but plausible shocks. The shocks were based on both historical and hypothetical scenarios. The stress test gauged the vulnerabilities of the 12 largest commercial banks as well as the three groups of commercial banks namely PSCBs, LPBs and FBs towards deterioration in the quality of credit portfolio, exchange rate, interest rate, equity price movements and liquidity withdrawals.

Drawing on the FSAP methodology, SBP has also carried out stress testing for the year ended on December 31, 2004. In this study, some additional risk scenarios have been taken into account in addition to the risk scenarios used by the FSAP.

This chapter discusses in detail the principal characteristics of these "stress tests" and presents the findings of both the stress testing exercises, the one carried out by the FSAP on the September 2003 data and the other carried out by SBP on the same grounds on December 2004 data.

Testing Approach

The strategy adopted by the FSAP mission to carry out stress testing in Pakistan was single and multifactor sensitivity analysis. This static sensitivity analysis takes into account the instantaneous impact of shocks to monetary, foreign exchange and financial markets. These are mainly univariate shocks, however multivariate shocks are also included where the impact of two or more shocks is combined. These shocks are generally large in magnitude and their price impact is instantaneously calibrated in the bank's portfolio.

The stress scenarios have been classified into three types of shocks i.e. credit quality shocks, market shocks, and liquidity shocks (see **Box - 17.1)**.

Calibration of Shocks

For each type of stress scenario, the impact has been measured in terms of two different indicators: the one that deals with the operating performance of the banks and the other with overall solvency ratio. These indicators are the gross profit and the capital adequacy ratio respectively. On the earnings perspective the expected cumulative change in the earnings has been quantified under each of the scenarios and compared with the earnings of the respective period. Hence, the impact is expressed in relative terms in comparison with the level observed in the respective periods. The impact of changes in the earning is calibrated into the capital of the banks. The effect of the same is also accounted for in calculation of the risk weighted assets to arrive at the capital adequacy ratio after the shock.

Box – 17.1
Reference Scenarios

Credit Risk

Scenario 1 assumes deterioration in quality of 20 percent of loans provided to the agriculture and textile sectors (with a provisioning rate of 50 percent for these loans).
Scenario 2 assumes a shift in categories of classified loans (all loans classified as OAEM become substandard, all substandard loans become doubtful, and all doubtful loans become loss).
Scenario 3 assumes a 50 percent decline in the value of non-liquid collateral held by banks.
Scenario 4 assumes a cumulative impact of all shocks used in Scenarios 1, 2, and 3.
Scenario 5 is based on the assumption of an increase in the ratio of NPLs to total loans, which would wipe out capital (with a provisioning rate of 50 percent for marginal NPLs).

Market Risk; Interest Rate Risk

Scenario 6 assumes an increase in interest rates by 300 basis points.
Scenario 7 assumes an increase in interest rates of outlying maturities (by 100, 300, and 500 basis points)
Scenario 8 assumes a shift coupled with flattening of the yield curve by increasing 150,100 and 50 basis points in the outlying maturities respectively.
Scenario 9 assumes a shift coupled with steepening of the yield curve by increasing 50,100 and 150 basis points in the outlying maturities respectively

Market Risk; Exchange Rate Risk

Scenario 10 assumes a depreciation of ER by 25 percent (around double of the maximum change in the monthly average PKR/US$ exchange rate (12.83) over the period from Jan 1994 to Dec 2003).
Scenario 11 is based on the hypothetical assumption of appreciation of rupee by 20 percent.
Scenario 12 assumes a 10 percent depreciation of the rupee and deterioration in the quality of 20 percent of unhedged foreign currency loans with 50 percent provisioning requirement.
Scenario 13 assumes a 10 percent depreciation of the rupee and deterioration in the quality of 50 percent of unhedged foreign currency loans with 100 percent provisioning requirement.

Market Risk; Equity Price Risk

Scenario 14 assumes a 20 percent fall in the index, based on largest percent change in the monthly Karachi Stock Exchange Index (KSE100 Index) over the period from Jan 2000 to Dec 2003, in May 2000 (19.2 percent).
Scenario 15 assumes a decline in the value of non-government securities held by banks by 30 percent.

Combined Credit and Market Risk

Scenario 16 assumes depreciation by 25 percent, deterioration in the quality of 50 percent of unhedged FX loans (100 percent provisions), and an increase in rates of outlying maturities by 100, 300 and 500 basis points.
Scenario 17 assumes depreciation by 25 percent, deterioration in the quality of 50 percent of unhedged FX loans (100 percent provisions), and an increase in rates of outlying maturities (by 100, 300 and 500 basis points) and a stock market crash by 40 percent.

Liquidity Risk

Scenario 18 assumes a 10 percent decline in the liquid liabilities.
Scenario 19 assumes a 20 percent decline in the liquid liabilities.

Results of the Shocks

The assessment concludes that the commercial banks are generally resilient towards the historical and hypothetical shocks of both the univariate and multivariate types. However, the banks are vulnerable towards the simultaneous occurrence of the credit and market shocks. The other scenarios, like large shifts in the yield curve, big movements in the yield curves and large exchange rate and equity price shocks would have a smaller effect on the capital adequacy. The results of the stress test for the two periods have been summarized in the **Box-17.2** and briefly discussed as follows:

Credit Shocks

For the credit risk factors, three different scenarios have been constituted that give shocks to the respective factor and the fourth scenario assumes the cumulative impact of these three stressed scenarios. And lastly, a critical level of infection ratio is identified i.e. increase in the level of infection ratio that would completely erode the capital base of banks.

Figure-17.1: Impact of Credit Shocks on CAR, Sep-03

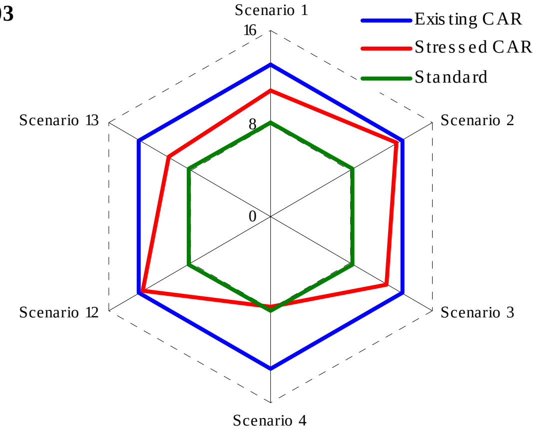
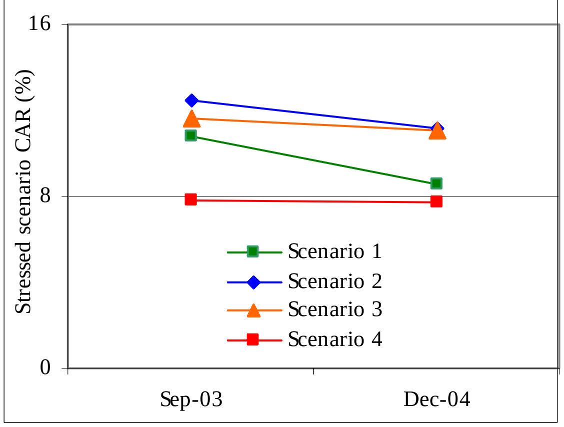


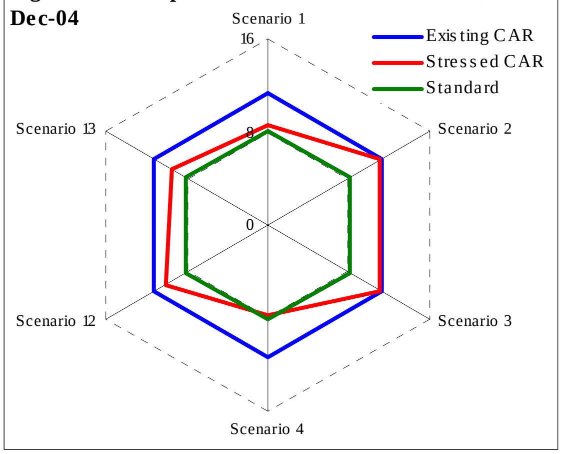
Figure-17.2: Sensitivity to Credit Shocks Sep-03 to Dec-04



As per the FSAP exercise in September 2003, the Pakistani banking system is generally resilient towards the credit shocks. The Scenario 1 puts the highest pressure on financial condition eroding 2.3 percentage points of system's CAR (see **Figure 17.1**) and 20.6 percent of gross income respectively. Nonetheless, the revised CAR of the banks remains well above the benchmark. The system's sensitivity to the Scenario 2 is lowest of the two that indicates lower share of NPLs in less risky categories probably due to stemming of the flow of NPLs, which are quite long outstanding in Loss category. Due to dependence on forced value of mortgaged assets against NPLs for meeting provisioning requirements, the Scenario 3 erodes 13.7 percent of gross income and pushes down CAR by 1.5 percentage points to 11.6 percent. However, the cumulative impact of these three scenarios (Scenario 4) will push the CAR below 8 percent standard by 20 basis points. The critical infection ratio i.e. the ratio that will completely erode the capital base of the system will reach if the existing infection ratio increases by 24.4 percentage point (Scenario 5).

The assessment of the results for December 2004 shows that due to strong growth of lending portfolio since September 2003, banks' overall sensitivity to the credit risk factors has increased (see **Figure 17.2**). However, the system is showing almost the same level of resilience against individual stress scenarios, and even the combined effect of the three shocks push down the CAR below 8 percent standard by only 21 basis points (see **Figure 17.3**). The critical infection ratio stands at 23.4 percentage points away from the existing level, slightly lower than September 2003 level, indicating an increased sensitivity. A detailed analysis shows that increase in sensitivity emanates from the increase in the banking system's exposure to the sectors identified in scenario 1, while the flow of NPLs has stemmed and their existing stock carries higher provisions, as reflected by a lower sensitivity to deterioration in the NPLs categories. Moreover, dependence on the value of mortgaged assets for meeting provisioning requirement shows signs of decline.

Figure-17.3: Impact of Credit Shocks on CAR, Dec-04



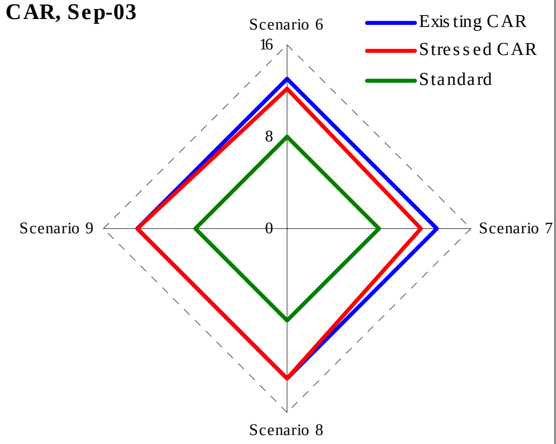
The foreign banks, largely on account of selected exposure and high CARs, have the strongest resilience against credit shocks. The local private banks have the highest sensitivity to these shocks which shows their higher exposure in lending portfolio and relatively lower CARs as compared with other two groups.

Market shocks

Of the market risk factors the shocks have been given to the interest rate, exchange rate and the equity prices. The instantaneous shocks have been given to the ***interest rate*** assuming the movements in the yield curve namely parallel shift in the yield curve and the steepening of the yield curve by increase in the interest rates in the outlying maturities. However, for December 2004 two additional shocks have also been calibrated including the flattening of the yield curve and the steepening of the yield curve (Scenario 8 & 9).

The results of the "Stress Test conducted by FSAP" for the September 2003 indicates that the interest rate exposure of the Pakistani banks, with the exception of public sector commercial banks, was limited due to relatively small gaps between the rate sensitive assets and liabilities. Taking the immediate price effect on all the commercial banks' portfolio, the impact of the parallel shift in the yield curve by 300 basis points (a relatively larger shock calibrated under Scenario 6) the amount of loss was expected to be around 9 percent of the gross profits or could cause 1 percentage point fall in CAR (see **Figure 17.4**). However, the public sector commercial banks

Figure-17.4: Impact of Interest Rate Shocks on CAR, Sep-03



were more prone to this risk where the same shock would cause 2 percentage points fall in the CAR (under scenario 7 the CAR of the public sector banks would fall by 5.1 percentage points to 9 percent).

Box 17.2

Results of "stress tests" of Pakistani Banking System

			%age Change in Gross Profit		*%age Point Change in CAR*		*Revised CAR*	
		Single and multifactor sensitivity tests	**Sep-03**	**Dec-04**	**Sep-03**	**Dec-04**	**Sep-03**	**Dec-04**
Credit Shocks								
Scenario	1	Deterioration in the qualityof loan to agriculture and textile sectors	-20.58	-39.74	-2.30	-2.70	10.80	8.69
Scenario	2	Shift in categories of classified loans	-5.44	-1.94	-0.60	-0.10	12.50	11.29
Scenario	3	Decline in the value of real estate collateral	-13.69	-3.63	-1.50	-0.20	11.60	11.19
Scenario	4	Cumulative impact of all shocks in 1,2 and 3	-45.07	-52.17	-5.30	-3.60	7.80	7.79
Scenario	5	Level of NPLs to advance ratio where capital wipes out (ratio in percent)	24.40	23.40	na	na	na	na
Market Shocks; Interest Rate Shocks								
Scenario	6	Shift in the yield curve	-8.84	-19.14	-1.00	-1.30	12.10	10.09
Scenario	7	Shift and steepening of the yield curve (large shock)	-12.25	-29.88	-1.40	-2.00	11.70	9.39
Scenario	8	Shift & flattenining of the yield curve	-	-3.68	-	-0.20	-	11.19
Scenario	9	Shift and steepening of the yield curve	-	-9.06	-	-0.60	-	10.79
Market Shocks; Exchange Rate Shocks								
Scenario	10	Depreciation of Rs/US$ exchnage rate (double of the historical high)	7.06	6.38	0.80	0.40	13.90	11.79
Scenario	11	Appreciation of Rs/US$ exchnage rate (hypothetical)	-5.61	-5.09	-0.60	-0.30	12.50	11.09
Scenario	12	Depreciation in ER along with deterioration of quality of FX Loans (50 % Provisioning)	-3.66	-2.99	-0.40	-0.20	12.70	11.19
Scenario	13	Depreciation in ER alongwith deterioration of quality of FX Loans (100 percet provisioning)	-25.26	-25.22	-2.90	-1.70	10.20	9.69
Market Shocks; Equity Price Shocks*								
Scenario	14	Fall in the KSE index (historical high)	-6.11	-4.68	-0.70	-0.30	12.40	11.09
Scenario	15	Fall in the value of non-govt. securities	-15.27	-11.62	-1.70	-0.80	11.40	10.59
Combined Credit and Market Shocks								
Scenario	16	Combines credit and market risk (1)	-37.42	-121.64	-4.30	-8.80	8.80	2.59
Scenario	17	Combines credit and market risk (2)	-82.58	-214.60	-10.20	-9.50	2.90	1.89

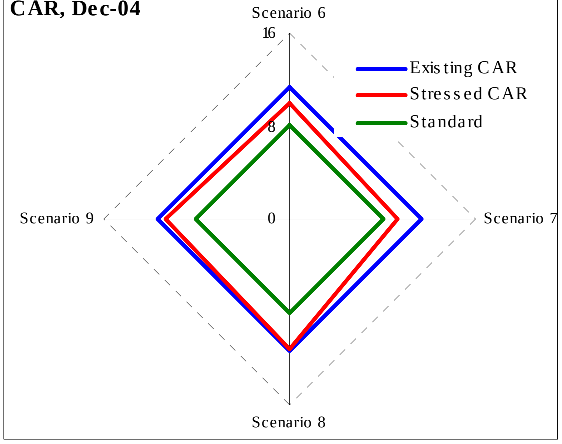
Liquidity Shocks			**Sep-03**		**Dec-04**	
Liquidity Coverage Ratio			*Actual*	*After Shock*	*Actual*	*After Shock*
Scenario	18	Fall in the Liquid Liabilities (1)	50.50	44.90	40.10	33.50
Scenario	19	Fall in the Liquid Liabilities (2)	50.50	38.10	40.10	25.20

Note: For September-03 the results are based on the stress test conducted on Pakistani Banking sytem by the FSAP mission whereas for December-04 the results are based on the assessment of the SBP as per the methodology used by the FSAP mission.

* The results of the FSAP exercise for the Sep-03 have been revised using the investment in ordinary shares, since the total of non-government securities used in then analysis includes other securities too which are not traded in the stock market.

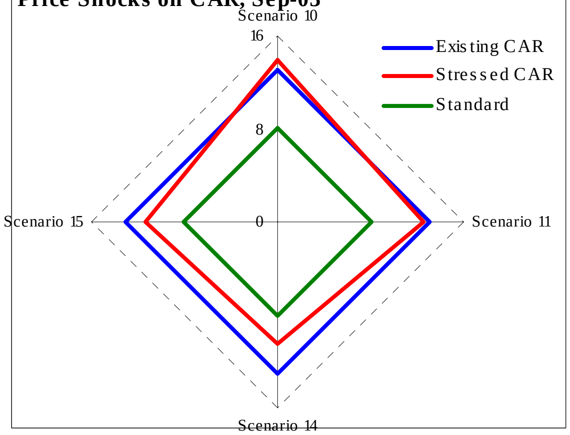
For December 2004 this parallel shift of 300 basis points to the yield curve would lead to a fall of around 20 percent in the gross profits or 1.3 percentage points in CAR (see **Figure 17.5**). Nevertheless, the level of CAR after this shock would remain comfortable at 10 percent. Though the comparatively larger mismatches have led to greater reduction in the profits as well as CAR of the banking system in December 2004, yet for all of the scenarios of interest rate shocks the impact seems not seriously threatening for meeting the capital adequacy requirement.

Figure-17.5: Impact of Interest Rate Shocks on CAR, Dec-04



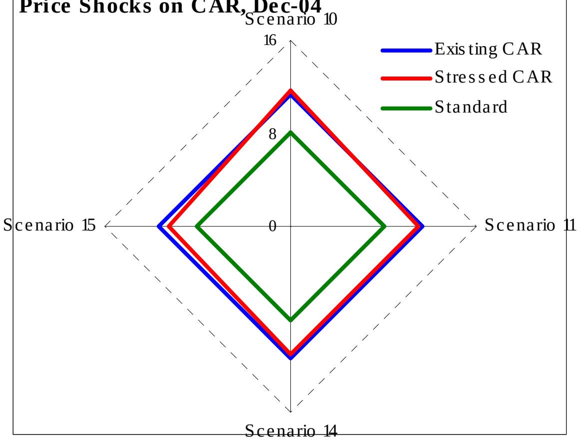
The shock given to the Rs/$ ***exchange rate*** only (Scenario11) seems relatively benign (see **Figure 17.6**). In fact the banks have long position in foreign currency and they would gain from the depreciation and lose from appreciation of rupee. The data suggests that the direct impact of exchange rate has immaterial impact on both the profitability and capital adequacy. However, when the indirect impact of the exchange rate is taken in terms of deterioration of the quality of FX loan, the combined impact of exchange rate as well as large credit shocks (Scenario 13) suggests a 2.9 percentage points fall in the CAR as per the FSAP assessment. However, the number has reduced to 1.7 percentage points in December 2004 due to reduced exposure in foreign currency loans.

Figure-17.6: Impact of Exchange Rate & Equity Price Shocks on CAR, Sep-03



As for the ***equity price*** shocks, the results of this exercise reveals that the banks are easily capable of withstanding the shocks of fall in the equity price by 20 percent. This level of shock broadly corresponds to the largest monthly decline in the Karachi Stock Index (KSE 100 index) over the three years period starting from January 2000. The plausibility of the second assumption (Scenario 15; the hypothetical assumption of stock market crash by 50 percent) does not seem unlikely given the higher stock market volatility reflected in the sharp appreciation of the stock market index since CY2001. Its impact on CAR indicates that the banks are generally resilient to this level of shock too (see **Figure 17.7**).

Figure-17.7: Impact of Exchange Rate & Equity Price Shocks on CAR, Dec-04



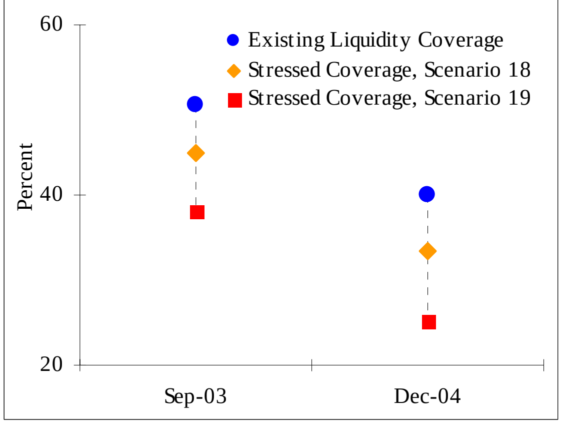
Liquidity Risk

The two scenarios (Scenarios 18 and 19) have been identified to gauge the system's resilience to liquidity shocks. These scenarios assume 10 and 20 percent squeeze in the liquid liabilities. And the impact has been calibrated in terms of residual liquidity coverage ratio after these shocks.

As of September 2003, the system is showing a strong resilience against the liquidity crunches, as at that time the system was experiencing abundant liquidity. The coverage ratios after the liquidity shocks stay well within safe limits.

The situation by the end of December 2004 has changed significantly. The lending portfolio saw a phenomenal growth significantly squeezing the excess liquidity cushion available with the banks. But this increased lending has not put the banks to any significant liquidity threat. For both the shock scenarios, the system is having a reasonable liquidity coverage ratio to operate within safe limits (see **Figure 17.8**). As regards the 12 leading banks, only one bank will face marginally negative liquidity coverage after the extreme shock scenario, and the individual sectors are quite immune to these liquidity shocks.

Figure-17.8: Impact of Liquidity Shocks on Liquidity Coverage Ratios



Major Findings and Future Strategy

The exercise results reveal that since, by and large, the banks have sufficient margin of solvency, the banking system is generally resilient towards the single factor and multifactor shocks of both the historical and hypothetical nature. Of all the single factor shocks, the credit shocks of 20 percent deterioration in the quality of loan to textile and agriculture sectors with accompanying provisioning of 50 percent puts the highest pressure on both the earnings and capital adequacy of the banks. Nonetheless, even at this level the CAR of the banks is well above the required level. However, the banks are vulnerable towards the simultaneous occurrence of the credit and market shocks.

With regard to the methodology used in the stress test exercise, the simple single and multifactor sensitivity tests have been employed. However, in the absence of any statistical models to link the macroeconomic variables with that of banking and financial variables the need for carrying out the comprehensive stress tests remains there. SBP in its capacity has been in process of devising such comprehensive statistical models that can well capture the relationships of the internal and external variables and deploy the same to assess the resilience of the banking system towards such shocks.

Annex-A

Financial Soundness Indicators

Indicators	1997	1998	1999	2000	2001	2002	2003	2004p
CAPITAL ADEQUACY								
Risk Weighted CAR								
Public Sector Commercial Banks	(1.3)	11.6	10.6	10.4	9.6	12.3	11.0	13.4
Local Private Banks	11.9	11.4	10.7	9.2	9.5	9.7	9.0	10.1
Foreign Banks	14.6	15.6	18.6	18.0	18.6	23.2	23.0	17.4
Commercial Banks	**6.0**	**12.5**	**12.2**	**11.4**	**11.3**	**12.6**	**11.1**	**11.4**
Specialized Banks	(6.2)	(1.4)	0.3	(3.3)	(13.9)	(31.7)	(28.2)	(9.0)
All Banks	**4.5**	**10.9**	**10.9**	**9.7**	**8.8**	**8.8**	**8.5**	**10.5**
Tier 1 Capital to RWA								
Public Sector Commercial Banks	(2.0)	8.3	7.7	7.7	7.1	8.6	8.2	8.6
Local Private Banks	11.4	10.2	9.3	8.1	8.4	6.6	7.1	7.5
Foreign Banks	14.4	15.4	18.4	17.9	18.6	23.0	23.0	17.1
Commercial Banks	**5.5**	**10.5**	**10.3**	**9.8**	**9.7**	**9.7**	**9.1**	**8.6**
Specialized Banks	(6.3)	(1.6)	0.3	(3.4)	(13.9)	(31.7)	(28.7)	(15.0)
All Banks	**4.1**	**9.1**	**9.2**	**8.3**	**7.3**	**6.2**	**6.5**	**7.6**
Capital to Total Assets								
Public Sector Commercial Banks	0.3	4.9	3.8	4.6	3.7	5.6	6.1	8.2
Local Private Banks	4.9	4.9	4.9	3.5	3.8	5.2	5.1	6.5
Foreign Banks	7.9	8.8	9.7	8.8	8.5	10.6	10.0	9.0
Commercial Banks	**3.1**	**5.6**	**5.0**	**4.9**	**4.6**	**6.1**	**6.0**	**7.1**
Specialized Banks	8.8	0.2	1.7	(1.1)	(10.3)	(23.0)	(9.5)	(11.3)
All Banks	**3.5**	**5.3**	**4.8**	**4.5**	**3.8**	**4.8**	**5.4**	**6.5**
ASSET QUALITY								
NPLs to Total Loans								
Public Sector Commercial Banks	30.8	29.0	30.7	26.3	25.9	25.5	20.4	13.3
Local Private Banks	10.2	11.1	15.5	15.4	16.3	15.4	11.3	9.0
Foreign Banks	5.0	5.3	5.1	4.7	4.3	3.8	3.1	1.6
Commercial Banks	**20.1**	**19.5**	**22.0**	**19.5**	**19.6**	**17.7**	**13.7**	**9.0**
Specialized Banks	50.6	47.2	51.6	52.4	53.0	54.7	55.6	54.1
All Banks	**23.5**	**23.1**	**25.9**	**23.5**	**23.4**	**21.8**	**17.0**	**11.6**
Provision to NPLs								
Public Sector Commercial Banks	52.9	55.6	48.8	59.2	56.6	57.1	65.8	77.0
Local Private Banks	57.8	53.3	35.0	36.9	40.5	58.6	62.7	70.2
Foreign Banks	65.9	75.0	63.4	65.9	74.1	73.3	77.4	101.9
Commercial Banks	**54.2**	**56.2**	**46.6**	**53.9**	**53.2**	**58.2**	**64.7**	**72.7**
Specialized Banks	22.8	65.3	54.2	58.1	59.2	66.9	60.8	68.6
All Banks	**46.6**	**58.6**	**48.6**	**55.0**	**54.7**	**60.6**	**63.7**	**71.6**
Net NPLs to Net Loans								
Public Sector Commercial Banks	17.0	15.0	18.5	12.7	13.1	12.8	8.1	3.4
Local Private Banks	4.6	5.5	10.7	10.3	10.4	7.0	4.5	2.8
Foreign Banks	1.8	1.4	1.9	1.7	1.1	1.1	0.7	(0.0)
Commercial Banks	**10.3**	**9.6**	**13.1**	**10.1**	**10.3**	**8.3**	**5.3**	**2.6**
Specialized Banks	44.1	23.6	32.8	31.6	31.5	28.5	33.0	27.0
All Banks	**14.1**	**11.1**	**15.3**	**12.2**	**12.1**	**9.9**	**6.9**	**3.6**
Net NPLs to Capital								
Public Sector Commercial Banks	2,081.0	119.9	212.0	124.5	160.2	83.4	50.0	17.2
Local Private Banks	43.3	51.4	103.5	153.5	125.2	54.8	40.5	24.1
Foreign Banks	10.0	7.1	9.9	9.0	5.8	4.7	3.3	(0.2)
Commercial Banks	**143.6**	**72.1**	**117.4**	**96.7**	**100.7**	**54.2**	**37.5**	**19.2**
Specialized Banks	380.0	11,139.0	1,502.3	-	-	-	-	-
All Banks	**183.8**	**92.6**	**149.8**	**131.3**	**150.5**	**85.5**	**55.4**	**28.8**
EARNINGS								
Return on Assets (Before Tax)								
Public Sector Commercial Banks	(3.4)	(0.4)	(0.4)	0.5	-	1.3	1.8	2.4
Local Private Banks	1.4	0.9	0.9	(0.1)	0.9	1.4	2.2	1.7
Foreign Banks	3.0	1.7	1.8	1.4	1.7	2.3	2.6	2.5
Commercial Banks	**(0.8)**	**0.4**	**0.3**	**0.4**	**0.6**	**1.5**	**2.1**	**1.9**
Specialized Banks	(0.2)	(9.4)	1.8	(2.3)	(8.4)	(10.2)	(2.5)	(2.5)
All Banks	**(0.8)**	**(0.3)**	**0.4**	**0.3**	**0.1**	**0.9**	**1.9**	**1.8**

Indicators	1997	1998	1999	2000	2001	2002	2003	2004[P]
Return on Assets (After Tax)								
Public Sector Commercial Banks	(3.1)	0.7	(1.0)	0.2	(0.5)	0.6	1.0	1.3
Local Private Banks	0.5	0.4	0.4	(0.7)	0.4	0.7	1.4	1.2
Foreign Banks	1.4	0.4	0.7	0.6	0.8	1.5	1.5	2.0
Commercial Banks	**(1.3)**	**0.5**	**(0.3)**	**(0.0)**	**(0.0)**	**0.8**	**1.2**	**1.3**
Specialized Banks	(0.2)	(9.4)	1.7	(2.3)	(8.8)	(12.1)	(3.2)	(2.6)
All Banks	**(1.2)**	**(0.1)**	**(0.2)**	**(0.2)**	**(0.5)**	**0.1**	**1.1**	**1.2**
ROE (Avg. Equity& Surplus) (Before Tax)								
Public Sector Commercial Banks	(272.7)	(14.6)	(9.6)	10.9	0.5	26.3	29.9	32.1
Local Private Banks	29.0	17.5	18.5	(3.2)	25.4	32.3	42.2	28.5
Foreign Banks	37.7	20.5	19.3	15.6	19.3	24.2	25.2	26.7
Commercial Banks	**(23.8)**	**8.0**	**6.5**	**8.8**	**12.2**	**27.5**	**34.0**	**29.1**
Specialized Banks	(1.8)	(211.0)	182.8	-	-	-	-	-
All Banks	**(20.2)**	**(6.4)**	**8.7**	**5.7**	**1.4**	**21.1**	**36.4**	**29.4**
ROE (Avg. Equity &Surplus) (After Tax)								
Public Sector Commercial Banks	(255.0)	24.0	(24.0)	4.9	(12.2)	11.5	17.3	18.0
Local Private Banks	10.9	7.3	8.1	(17.4)	10.3	17.3	26.2	20.1
Foreign Banks	17.2	5.1	7.1	6.1	9.1	15.2	14.9	21.5
Commercial Banks	**(36.2)**	**12.0**	**(6.2)**	**(0.3)**	**(0.3)**	**14.3**	**20.5**	**19.8**
Specialized Banks	(2.0)	(211.6)	179.1	-	-	-	-	-
All Banks	**(30.7)**	**(2.7)**	**(3.9)**	**(3.5)**	**(12.6)**	**3.2**	**20.5**	**19.5**
NII/Gross Income								
Public Sector Commercial Banks	36.1	58.6	56.5	61.8	69.9	69.5	64.1	64.1
Local Private Banks	50.2	54.9	53.4	63.2	72.1	65.5	56.8	62.8
Foreign Banks	56.1	50.1	50.0	54.0	59.4	57.5	55.3	57.6
Commercial Banks	**46.5**	**55.6**	54.3	**61.2**	**68.9**	**66.1**	**59.4**	**62.5**
Specialized Banks	88.5	85.1	71.7	78.6	86.7	78.0	75.8	90.9
All Banks	**48.7**	**59.3**	**55.6**	**62.3**	**70.4**	**67.1**	**60.5**	**64.0**
Cost / Income Ratio								
Public Sector Commercial Banks	140.0	92.1	84.7	70.1	62.3	56.9	42.8	39.4
Local Private Banks	60.9	73.8	76.6	80.9	67.3	60.0	53.2	56.3
Foreign Banks	43.6	55.5	57.0	59.4	54.5	45.4	48.3	49.0
Commercial Banks	**85.8**	**78.5**	**76.9**	**71.6**	**62.7**	**56.7**	**48.6**	**51.8**
Specialized Banks	74.6	32.2	62.2	70.5	59.0	84.7	55.6	47.9
All Banks	**85.2**	**72.7**	**75.8**	**71.6**	**62.4**	**59.1**	**49.1**	**51.6**
LIQUIDITY								
Liquid Assets/Total Assets								
Public Sector Commercial Banks	39.4	40.4	38.6	37.1	36.5	49.0	49.0	43.4
Local Private Banks	40.6	40.1	38.0	34.0	39.8	47.1	42.9	34.3
Foreign Banks	47.6	46.0	40.3	45.2	50.3	48.5	49.8	39.9
Commercial Banks	**41.4**	**41.3**	**38.7**	**37.5**	**39.9**	**48.1**	**46.0**	**36.9**
Specialized Banks	14.1	14.6	10.5	12.7	13.6	16.4	22.2	25.7
All Banks	**39.5**	**39.7**	**36.8**	**36.0**	**38.5**	**46.7**	**45.1**	**36.5**
Liquid Assets/Total Deposits								
Public Sector Commercial Banks	46.0	48.4	46.4	45.0	43.4	59.6	59.0	51.7
Local Private Banks	49.9	49.7	48.0	44.3	49.6	60.2	54.5	42.3
Foreign Banks	57.9	56.9	55.6	67.7	78.3	74.2	69.7	53.4
Commercial Banks	**49.4**	**50.3**	**48.2**	**48.0**	**50.3**	**61.5**	**57.9**	**45.5**
Specialized Banks	102.8	134.8	78.8	90.8	79.8	98.5	131.5	153.2
All Banks	**50.0**	**51.0**	**48.6**	**48.5**	**50.7**	**61.8**	**58.5**	**46.3**
Advances/Deposits								
Public Sector Commercial Banks	48.4	46.5	50.8	54.0	53.8	44.3	45.6	49.8
Local Private Banks	56.6	57.0	59.6	67.5	57.9	52.3	58.3	67.6
Foreign Banks	54.3	56.7	68.2	71.5	66.8	72.0	63.9	70.1
Commercial Banks	**51.8**	**51.2**	**55.9**	**60.5**	**56.9**	**51.0**	**53.6**	**63.7**
Specialized Banks	551.7	671.3	586.8	553.0	450.5	453.8	381.5	359.3
All Banks	**57.6**	**56.6**	**62.0**	**66.2**	**61.7**	**54.9**	**56.5**	**65.9**

P ***Provisional***

Annex-B

Group-wise Balance Sheets and Income Statements of Banks as of 31-12-2004

(Figures rounded to nearest Million Rs)

	PSCBs		LPBs		FBs		SBs	
	Amount	**%age**	**Amount**	**%age**	**Amount**	**%age**	**Amount**	**%age**
FINANCIAL POSITION								
ASSETS								
Cash & Balances With Treasury Banks	101,989	15.7%	163,056	8.2%	44,854	14.8%	3,210	3.1%
Balances With Other Banks	53,169	8.2%	81,502	4.1%	25,612	8.4%	16,838	16.3%
Lending To Financial Institutions	18,914	2.9%	89,527	4.5%	32,983	10.9%	76	0.1%
Investments - Net	171,535	26.4%	463,751	23.4%	30,949	10.2%	6,900	6.7%
Advances - Net	271,533	41.8%	1,082,853	54.7%	159,172	52.4%	62,328	60.2%
Other Assets	20,968	3.2%	46,366	2.3%	7,267	2.4%	11,805	11.4%
Operating Fixed Assets	10,102	1.6%	42,423	2.1%	2,055	0.7%	2,356	2.3%
Deferred Tax Assets	1,317	0.2%	10,159	0.5%	740	0.2%	1	0.0%
TOTAL ASSETS	**649,526**	**100.0%**	**1,979,638**	**100.0%**	**303,632**	**100.0%**	**103,514**	**100.0%**
LIABILITIES								
Bills Payable	8,574	1.3%	32,998	1.7%	4,741	1.6%	282	0.3%
Borrowings From Financial Institution	18,310	2.8%	159,469	8.1%	36,624	12.1%	73,441	70.9%
Deposits And Other Accounts	544,820	83.9%	1,602,893	81.0%	226,976	74.8%	17,345	16.8%
Sub-ordinated Loans	-	0.0%	12,125	0.6%	-	0.0%	3,405	3.3%
Liabilities Against Assets Subject To Finance Lease	99	0.0%	410	0.0%	59	0.0%	0	0.0%
Other Liabilities	24,174	3.7%	39,351	2.0%	8,026	2.6%	20,724	20.0%
Deferred Tax Liabilities	9	0.0%	4,489	0.2%	21	0.0%	-	0.0%
TOTAL LIABILITIES	**595,986**	**91.8%**	**1,851,734**	**93.5%**	**276,448**	**91.0%**	**115,197**	**111.3%**
NET ASSETS	53,540	8.2%	127,903	6.5%	27,184	9.0%	(11,683)	-11.3%
REPRESENTED BY:								
Share Capital	7,945	1.2%	58,349	2.9%	20,053	6.6%	9,266	9.0%
Reserves	14,594	2.2%	32,454	1.6%	24	0.0%	4,408	4.3%
Unappropriated Profit	9,529	1.5%	12,960	0.7%	7,079	2.3%	(26,558)	-25.7%
	32,068	**4.9%**	**103,763**	**5.2%**	**27,157**	**8.9%**	**(12,885)**	**-12.4%**
Surplus/Deficit On Revaluation Of Assets	21,473	3.3%	24,141	1.2%	28	0.0%	1,202	1.2%
TOTAL	**53,540**	**8.2%**	**127,903**	**6.5%**	**27,184**	**9.0%**	**(11,683)**	**-11.3%**
OPERATING POSITION *(as % of Gross Income*)*								
Mark-Up/ Return/Interest Earned	25,050	93.2%	74,041	89.2%	11,757	81.4%	10,626	146.4%
Mark-Up/ Return/Interest Expenses	7,808	29.0%	21,945	26.4%	3,432	23.8%	4,027	55.5%
Net Mark-Up / Interest Income	**17,241**	**64.1%**	**52,096**	**62.8%**	**8,325**	**57.6%**	**6,599**	**90.9%**
Provisions & Bad Debts Written Off Directly	2,035	7.6%	6,115	7.4%	155	1.1%	6,364	87.7%
Net Mark-Up / Interest Income After Provision	**15,206**	**56.6%**	**45,981**	**55.4%**	**8,170**	**56.5%**	**235**	**3.2%**
Fees, Commission & Brokerage Income	5,362	19.9%	11,834	14.3%	3,741	25.9%	23	0.3%
Dividend Income	1,891	7.0%	2,255	2.7%	44	0.3%	28	0.4%
Income From Dealing In Foreign Currencies	1,066	4.0%	4,062	4.9%	1,555	10.8%	-	0.0%
Other Income	1,327	4.9%	12,743	15.4%	785	5.4%	610	8.4%
Total Non - Markup / Interest Income	9,646	35.9%	30,893	37.2%	6,125	42.4%	660	9.1%
	24,852	**92.4%**	**76,874**	**92.6%**	**14,294**	**98.9%**	**896**	**12.3%**
Administrative Expenses	10,518	39.1%	46,017	55.4%	7,063	48.9%	3,241	44.6%
Other Expenses	75	0.3%	689	0.8%	14	0.1%	238	3.3%
Total Non-Markup/Interest Expenses	**10,593**	**39.4%**	**46,705**	**56.3%**	**7,077**	**49.0%**	**3,479**	**47.9%**
Profit Before Tax and Extra Ordinary Items	14,258	53.0%	30,169	36.4%	7,217	49.9%	(2,583)	-35.6%
Extra ordinary/unusual Items (to be specified)	-	0.0%	(509)	-0.6%	-	0.0%	-	0.0%
PROFIT/ (LOSS) BEFORE TAXATION	**14,258**	**53.0%**	**30,678**	**37.0%**	**7,217**	**49.9%**	**(2,583)**	**-35.6%**
Taxation - Current	5,308	19.7%	6,795	8.2%	2,471	17.1%	5	0.1%
- Prior Years	820	3.1%	(189)	-0.2%	(1,089)	-7.5%	3	0.0%
- Deferred	135	0.5%	2,404	2.9%	14	0.1%	-	0.0%
PROFIT/ (LOSS) AFTER TAX	**7,994**	**29.7%**	**21,669**	**26.1%**	**5,821**	**40.3%**	**(2,591)**	**-35.7%**

** Gross Income = Net Interest Income + Non Interest Income*

Annex-C

Balance Sheets and Income Statements of CBs & All Banks as of 31-12-2004

(Figures rounded to nearest Million Rs)

	CBs		All Banks	
	Amount	**%age**	**Amount**	**%age**
FINANCIAL POSITION				
ASSETS				
Cash & Balances With Treasury Banks	309,899	10.6%	313,109	10.3%
Balances With Other Banks	160,283	5.5%	177,121	5.8%
Lending To Financial Institutions	141,424	4.8%	141,500	4.7%
Investments - Net	666,234	22.7%	673,134	22.2%
Advances - Net	1,513,559	51.6%	1,575,886	51.9%
Other Assets	74,601	2.5%	86,406	2.8%
Operating Fixed Assets	54,580	1.9%	56,936	1.9%
Deferred Tax Assets	12,216	0.4%	12,217	0.4%
TOTAL ASSETS	**2,932,796**	**100.0%**	**3,036,310**	**100.0%**
LIABILITIES				
Bills Payable	46,313	1.6%	46,595	1.5%
Borrowings From Financial Institution	214,403	7.3%	287,844	9.5%
Deposits And Other Accounts	2,374,689	81.0%	2,392,034	78.8%
Sub-ordinated Loans	12,125	0.4%	15,530	0.5%
Liabilities Against Assets Subject To Finance Lease	567	0.0%	568	0.0%
Other Liabilities	71,552	2.4%	92,276	3.0%
Deferred Tax Liabilities	4,519	0.2%	4,519	0.1%
TOTAL LIABILITIES	**2,724,168**	**92.9%**	**2,839,365**	**93.5%**
NET ASSETS	208,628	7.1%	196,945	6.5%
REPRESENTED BY:				
Share Capital	86,347	2.9%	95,613	3.1%
Reserves	47,073	1.6%	51,480	1.7%
Unappropriated Profit	29,568	1.0%	3,010	0.1%
	162,987	**5.6%**	**150,102**	**4.9%**
Surplus/Deficit On Revaluation Of Assets	45,641	1.6%	46,843	1.5%
TOTAL	**208,628**	**7.1%**	**196,945**	**6.5%**
OPERATING POSITION *(as % of Gross Income*)*				
Mark-Up/ Return/Interest Earned	110,848	89.2%	121,474	92.3%
Mark-Up/ Return/Interest Expenses	33,186	26.7%	37,213	28.3%
Net Mark-Up / Interest Income	**77,662**	**62.5%**	**84,261**	**64.0%**
Provisions & Bad Debts Written Off Directly	8,305	6.7%	14,669	11.1%
Net Mark-Up / Interest Income After Provision	**69,356**	**55.8%**	**69,592**	**52.9%**
Fees, Commission & Brokerage Income	20,936	16.8%	20,959	15.9%
Dividend Income	4,190	3.4%	4,218	3.2%
Income From Dealing In Foreign Currencies	6,683	5.4%	6,683	5.1%
Other Income	14,855	11.9%	15,465	11.8%
Total Non - Markup / Interest Income	46,664	37.5%	47,324	36.0%
	116,020	**93.3%**	**116,916**	**88.9%**
Administrative Expenses	63,597	51.2%	66,839	50.8%
Other Expenses	778	0.6%	1,016	0.8%
Total Non-Markup/Interest Expenses	**64,375**	**51.8%**	**67,854**	**51.6%**
Profit Before Tax and Extra Ordinary Items	51,645	41.5%	49,061	37.3%
Extra ordinary/unusual Items (to be specified)	(509)	-0.4%	(509)	-0.4%
PROFIT/ (LOSS) BEFORE TAXATION	**52,154**	**41.9%**	**49,571**	**37.7%**
Taxation - Current	14,575	11.7%	14,579	11.1%
- Prior Years	(458)	-0.4%	(454)	-0.3%
- Deferred	2,553	2.1%	2,553	1.9%
PROFIT/ (LOSS) AFTER TAX	**35,484**	**28.5%**	**32,893**	**25.0%**

** Gross Income = Net Interest Income + Non Interest Income*

Annex-D

Group-wise Off - Balance Sheets Exposures of Banks as of 31-12-2004

(Figures rounded to nearest Million Rs)

	PSCBs	LPBs	FBs	CBs	SBs	All Banks
Direct credit substitutes						
Financial Guarantees in favor of :						
Banks and financial institution	14,847	55,016	7,519	77,383	127	77,509
Transaction-related Contingent liabilities / Commitments						
Guarantees in favor of :						
Government	8,700	71,144	16,545	96,389	97	96,487
Others	10,919	32,952	14,672	58,543	43	58,585
Suppliers credit / payee guarantee	63,311	1,707	15	65,034	-	65,034
Claims against the bank not acknowledged as debt	14,400	56,426	3,791	74,618	1	74,619
Trade related Contingent liabilities	5,634	305,597	45,604	356,835	1	356,836
Commitments in respect of forward lending						
Forward call lending	10	4,635	52	4,697	-	4,697
Commitments to extend credit	5,435	24,069	57	29,560	-	29,560
Commitments in respect of forward exchange contracts						
Purchase	21,152	139,074	127,157	287,384	-	287,384
Sale	20,599	128,099	129,589	278,287	-	278,287
Commitments in respect of operating leases						
Not later than one year	-	223	10	234	-	234
Later than one year and not later than five years	-	146	239	386	-	386
Commitments for the acquisition of operating fixed assets	165	1,599	62	1,826	-	1,826
Other commitments	490	79,240	44,145	123,875	6	123,882
Total Memorandum Items	**165,663**	**899,930**	**389,458**	**1,455,051**	**275**	**1,455,327**

Annex-E

Bank-wise Major Statistics as of 31-12-2004

(Figures rounded to nearest Million Rs)

S. #	Name of the Bank	Net Advances	Total Assets	Deposits	Capital	Profit/ (Loss) before Tax	Profit/ (Loss) after Tax
1	National Bank of Pakistan	221,444	549,741	465,572	42,936	12,025	6,243
2	First Women Bank Limited	1,649	9,647	8,690	590	211	124
3	Bank of Punjab	39,439	66,320	54,724	7,839	1,736	1,368
4	Bank of Khyber	9,001	23,818	15,834	2,175	287	259
5	Punjab Provincial Cooperative Bank	5,765	10,647	2,004	1,529	(31)	(34)
6	Industrial Development Bank of Pakistan	4,202	11,215	12,230	(24,576)	(1,496)	(1,501)
7	Zari Taraqiati Bank Limited	52,360	81,651	3,111	11,363	(1,056)	(1,056)
8	Allied Bank Limited	58,800	154,208	126,392	10,321	457	168
9	Bank Al-Falah Limited	88,931	154,835	129,715	5,261	1,654	1,092
10	Askari Commercial Bank Limited	69,938	107,168	83,319	6,016	2,843	1,923
11	Bank Al-Habib Limited	47,367	77,436	62,171	3,824	1,039	541
12	Bolan Bank Limited	7,245	13,436	10,923	1,649	87	84
13	Crescent Commercial Bank Limited	4,017	10,593	5,093	2,343	(84)	(87)
14	Dawood Bank Limited	58	3,687	233	1,035	(38)	(25)
15	Faysal Bank Limited	51,373	78,538	56,460	10,214	2,207	1,753
16	Habib Bank Limited	250,612	464,855	386,333	31,188	7,150	5,666
17	KASB Bank Limited	8,295	16,214	11,201	1,732	50	120
18	Muslim Commercial Bank Limited	137,318	259,285	219,966	14,747	4,203	2,540
19	United Bank Limited	146,249	272,613	230,257	17,364	4,890	3,702
20	Prime Commercial Bank Limited	21,264	40,336	30,117	2,947	525	345
21	Metropolitan Bank Limited	40,122	67,891	48,596	4,264	1,378	816
22	Union Bank Limited	51,075	77,711	62,955	3,346	1,410	830
23	PICIC Commercial Bank Limited	25,828	52,008	44,092	3,529	1,130	900
24	Soneri Bank Limited	24,376	49,852	37,384	3,043	1,047	648
25	Saudi Pak Commercial Bank Limited	25,487	42,721	33,271	1,617	478	307
26	NDLC-IFIC Bank Limited	12,158	16,557	10,649	1,364	31	123
27	Meezan Bank	12,340	19,697	13,770	2,098	221	224
28	ABN Amro Bank	32,088	57,506	48,213	2,792	1,147	714
29	Habib Bank A. G. Zurich	25,405	41,203	28,167	2,074	511	380
30	Al Baraka Islamic Bank	6,991	11,940	8,128	1,880	167	127
31	American Express Bank	2,070	8,298	5,070	1,357	15	51
32	Citibank, N.A.	33,008	66,064	47,103	6,172	1,746	1,970
33	Deutsche Bank A.G.	2,020	5,109	2,069	1,328	0	0
34	The Hongkong & Shanghai Banking Corporation	4,761	12,032	8,924	1,630	93	58
35	Oman International Bank S.A.O.G	486	1,845	504	1,035	(6)	(6)
36	Rupali Bank	11	562	178	92	32	8
37	Standard Chartered Bank	51,508	94,602	76,514	6,989	3,461	2,485
38	The Bank of Tokyo – Mitsubishi	823	4,472	2,107	1,835	52	34
	Total	**1,575,886**	**3,036,310**	**2,392,034**	**196,945**	**49,571**	**32,893**

Annex-F

Bank-wise Key Performance Indicators as of 31-12-2004

S. #	Name of the Bank	Capital Adequacy Ratio	NPLs to Advances (gross)	NPLs to Advances (Net)	ROA (after Tax)
1	National Bank of Pakistan	13.5%	14.4%	3.2%	1.2%
2	First Women Bank Limited	20.3%	4.0%	2.0%	1.3%
3	Bank of Punjab	12.1%	2.9%	1.6%	2.5%
4	Bank of Khyber	14.8%	27.2%	16.6%	1.2%
5	Punjab Provincial Cooperative Bank	14.4%	14.7%	4.1%	-0.4%
6	Industrial Development Bank of Pakistan	-385.8%	96.0%	87.7%	-11.9%
7	Zari Taraqiati Bank Limited	23.3%	50.6%	24.7%	-1.3%
8	Allied Bank Limited	16.5%	22.2%	8.4%	0.1%
9	Bank Al-Falah Limited	8.2%	3.3%	1.8%	0.9%
10	Askari Commercial Bank Limited	9.7%	1.5%	-1.0%	2.0%
11	Bank Al-Habib Limited	9.4%	0.4%	0.1%	0.8%
12	Bolan Bank Limited	17.0%	12.7%	9.6%	0.7%
13	Crescent Commercial Bank Limited	26.2%	48.2%	25.2%	-1.0%
14	Dawood Bank Limited	71.0%	14.7%	-1.4%	-1.1%
15	Faysal Bank Limited	12.1%	4.7%	1.8%	2.8%
16	Habib Bank Limited	8.7%	13.8%	4.5%	1.3%
17	KASB Bank Limited	11.3%	7.0%	4.8%	1.0%
18	Muslim Commercial Bank Limited	9.6%	6.1%	1.6%	1.0%
19	United Bank Limited	9.9%	12.4%	2.9%	1.5%
20	Prime Commercial Bank Limited	13.9%	3.6%	1.7%	1.0%
21	Metropolitan Bank Limited	9.2%	0.2%	-1.0%	1.3%
22	Union Bank Limited	8.2%	6.8%	4.5%	1.1%
23	PICIC Commercial Bank Limited	11.1%	1.8%	0.8%	2.0%
24	Soneri Bank Limited	8.4%	1.1%	-0.3%	1.5%
25	Saudi Pak Commercial Bank Limited	8.4%	10.6%	4.5%	0.8%
26	NDLC-IFIC Bank Limited	10.3%	11.4%	6.2%	1.0%
27	Meezan Bank	10.0%	0.5%	-0.2%	1.5%
28	ABN Amro Bank	9.8%	0.1%	-0.3%	1.4%
29	Habib Bank A. G. Zurich	8.3%	1.4%	0.4%	1.0%
30	Al Baraka Islamic Bank	18.8%	2.8%	0.9%	1.2%
31	American Express Bank	127.1%	5.2%	0.0%	0.6%
32	Citibank, N.A.	17.6%	1.6%	-0.5%	3.1%
33	Deutsche Bank A.G.	44.6%	0.0%	-0.2%	0.0%
34	The Hongkong & Shanghai Banking Corporatio	16.5%	1.6%	-0.1%	0.5%
35	Oman International Bank S.A.O.G	148.5%	3.0%	-0.3%	-0.3%
36	Rupali Bank	229.4%	92.6%	-2.3%	1.3%
37	Standard Chartered Bank	17.8%	2.0%	0.1%	2.8%
38	The Bank of Tokyo – Mitsubishi	90.3%	0.0%	0.0%	0.8%

Annex-G

Selected Indicators for Different Categories of Banks in terms of Size

Indicators	Top 5 Banks	Top 10 Banks	Top 20 Banks	Industry
Share of Total Assets	56.0%	73.0%	92.8%	100%
Share of Total Deposits	59.9%	74.3%	93.8%	100%
Share of Gross Income	55.7%	76.3%	95.0%	100%
Share of Risk Weighted Assets	52.5%	70.0%	91.7%	100%
<u>Capital Adequacy</u>				
Capital/RWA	10.3%	11.6%	11.3%	10.5%
Tier 1 Capital / RWA	6.6%	8.1%	8.2%	7.6%
Net Worth / Total Assets	6.6%	7.1%	6.9%	6.5%
<u>Asset Composition</u>				
Sectoral Distribution of Loans (Domestic)				
- Corporate Sector:	49.9%	67.7%	92.8%	100%
- SMEs:	53.9%	68.7%	89.2%	100%
- Agriculture	24.3%	91.6%	94.2%	100%
- Consumer Finance:	53.7%	69.3%	94.5%	100%
- Commodity Financing	72.6%	82.8%	98.3%	100%
- Staff Loans	68.7%	89.1%	95.5%	100%
- Others	54.3%	64.5%	93.7%	100%
- Total	51.3%	71.4%	92.9%	100%
NPLs / Gross Loans	11.5%	13.3%	11.0%	11.6%
Net NPLs / Capital	23.5%	28.3%	24.7%	28.8%
<u>Earning & Profitability</u>				
ROA	1.2%	1.2%	1.3%	1.2%
ROE	19.9%	18.4%	19.6%	19.5%
Net Interest Margin / Gross Income	62.0%	64.5%	64.3%	64.0%
Income from Trading & Foreign Exchange / Gross Income	13.8%	12.4%	12.0%	12.0%
Non-Interest Expense / Gross Income	53.0%	50.1%	49.9%	51.6%
<u>Liquidity</u>				
Liquid Assets / Total Assets	38.2%	36.8%	36.3%	36.5%
Liquid Assets held in Govt. Securities / Total Liquid Assets	49.3%	49.4%	47.3%	45.8%
Liquid Assets / Total Deposits	45.4%	45.9%	45.5%	46.3%

Chronology of Policy Announcements Annex-H

Date of Announcement	Circular #	Policy Decision
2004 7-January	(BSD-01)	**Master Circular on Financial Disclosure – Frequency & Timelines** 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: 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 SBP as prescribed in the BCO,1962. 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 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. 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 be published in the newspaper(s) by all banks / DFIs, including branches of foreign banks, within the aforesaid time. Besides above, other requirements of Code of Corporate Governance regarding financial disclosure shall remain applicable, provided they are not inconsistent with SBP's instructions.
2004 14-January	(BSD-2)	**Strengthening of Interaction between SBP & Banks / DFIs** 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. It will now be mandatory for all banks/DFIs to inform SBP 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

Date of Announcement	Circular #	Policy Decision
		of regular inspections, Banking Inspection Department shall check, on a test basis, whether the banks / DFIs have followed these instructions. Additionally, SBP 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 SBP for these meetings.
2004 21-January	(BPD-01)	**Benchmarking Corporate Lending Products to KIBOR** 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 1st January all the commercial banks are required to link their lending rates with one, three, six month & any other longer period tenors, if available. The rate over & above KIBOR will be decided with mutual consent between borrower & bank. All the floating & fixed rate time loans/TFCs/Commercial Papers with reset dates, overdrafts & running finances obtained after 31-01-2004 are required to be benchmarked against KIBOR. Financing under export refinance scheme of SBP, consumer & SME financing, overdrafts, running finances, term loans, TFCs, CPs approved by SECP &/ or submitted to any stock exchange before 31-01-2004 are exempted from application of KIBOR.
2004 29- January	(BPD-2)	**Section 33-a of BCO-1965 Fidelity & Secrecy** In order to create uniformity in obtaining declaration under Section 33-A of BCO, 1965, it has been decided that President and Chairman & 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 required to be kept in safe custody with the banks/DFIs.
2004 10-February	(BPD-5)	**Undertaking of Brokerage Business by Banks/DFIs** 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
2004 12-February	(FE-01)	**Franchise Arrangements of Exchange Companies** In order to facilitate the Exchange Companies, the following Franchise Arrangement has been decided to be allowed.

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		i) Franchiser and Franchisee would enter into a formal agreement, which should be duly registered as per existing laws of the land. 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. 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. 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. 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 & Franchisee as per requirement of SBP. vi) All the Rules & Regulations specified by SBP for the Franchiser shall be equally applicable to the franchisee in addition to the clauses of the Franchise Agreement. 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. viii) SBP reserves the right to inspect Franchisee's books of accounts and premises as and when it may deem fit and necessary. ix) In case of any violations of related rules, 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.
2004 24-February	(FE-02)	**Local US Dollar Instruments Collection & Settlement System** With the liberalization of the foreign currency regime in the country, and to facilitate operations for maintaining Foreign Currency Accounts under FE-25, SBP 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.
2004 8-March	(BPD-08)	**Establishment of Subsidiaries by Banks/DFIs** 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: ❑ The Banks/DFIs desiring to establish any subsidiary shall obtain prior approval of SBP.

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		❑ The subsidiary shall be a public limited company. ❑ 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. ❑ 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. ❑ Before increasing its investment in the equity of the subsidiary, the Bank/DFI will seek prior approval of SBP. ❑ 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. The Banks/DFIs shall take sufficient measures to ensure that the Bank/ DFI is not exposed to risks, especially reputational and legal risks, on account of its subsidiary. The Non-Bank Finance Companies set-up as subsidiaries will be regulated by SECP.
2004 24-April	(BPD-10)	**Collated Instructions on Margin Restrictions** SBP has withdrawn instructions on margin requirements. Banks are now 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: - (i) Margin restrictions on shares/TFCs as per existing instructions (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 to remain applicable until further instructions. 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 SBP. 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.
2004 26-April	(BPD-12) Circular Letter	**Settlement of willful defaulter cases referred to NAB under Section 31-D of NAB Ordinance** It was observed that some of the financial institutions after forwarding the cases of their willful defaulters to NAB under Section 31-D through SBP, enter into agreements with the borrowers for settlement of outstanding liabilities without obtaining prior consent of the NAB. This practice on the

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		part of financial institutions renders the whole exercise futile. It has been 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 SBP and are still in the process of referring the same to NAB, the financial institutions should first withdraw their requests/cases from SBP before entering into settlement agreements with borrowers.
2004 17-May	(BSD-03)	**Guidelines on Country Risk** 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. 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.
2004 18-May	(BPD-14)	**Scheme for Long Term Financing of Export Oriented Projects (LTF-EOP)** To augment the present efforts of banks, and to help exporters, especially under SME sector, for import of machinery, up-grading existing technology and financing facilities availed at competitive rates, SBP has designed a new scheme styled as the "Scheme for Long Term Financing of Export Oriented Projects (LTF-EOP)" which will allow eligible financial institutions to provide financing facilities to borrowers on attractive terms and conditions for import of machinery, plant, equipment and accessories thereof (not manufactured locally) by export-oriented units.
2004 20-May	(EPD-05) Circular Letter	SBP has directed all Exchange Companies to make arrangement for credit to their Nostro Accounts directly with the equivalent US Dollars against export of currencies other than US Dollars, instead of importing equivalent US Dollars in Cash.
2004 22-May	(BSD-04)	**Statutory Liquidity Requirement (SLR) -DFIs** State Bank of Pakistan decided that all the Development Financial Institutions shall maintain SLR @15 percent of their Total Time & Demand Liabilities in the form of liquid assets (excluding Cash Reserve maintained @1 percent of their TDL) as enumerated under Section 29 of the BCO. Moreover, they will continue to maintain Cash Reserve (CRR) with State Bank of Pakistan @ 1 percent of their Demand & Time Liabilities.
2004 22-May	(BSD-05)	**Minimum Capital Requirement for DFIs** SBP has decided that all Development Financial Institutions (DFIs) shall be required to meet minimum paid-up capital requirement of Rs1 billion free of losses and maintain capital adequacy ratio not less than 8 percent of their risk weighted assets.

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2004 24-May	(BSD-06)	**Investment In Sub-Ordinated/Unsecured TFCs by Banks/ DFIs** SBP has allowed banks/DFIs to invest in subordinated/ unsecured TFCs issued by other banks/DFIs to raise Tier-II Capital subject to the following restrictions: i) The banks/DFIs' investments in such TFCs will be assigned a risk weight of 100 percent and will not be deducted from Tier-I capital for the purpose of calculating the Capital Adequacy Ratio, provided the Banks/DFIs' investment in such TFCs will not exceed 10 percent of their equity (in the case of DFIs not mobilizing deposits/ COIs from general public the investment in such TFCs will not exceed 25 percent of their equity). ii) The investments of the banks/DFIs in such TFCs in excess of the limits will be assigned a risk weight of 0 percent for Capital Adequacy Purpose and will be deducted from Tier-I Capital of the investing bank/DFI. iii) A bank/DFI's investment in a single issue of such TFCs of any other bank/DFI will not at any time exceed 5 percent of its own equity or 15 percent of the total size of the issue, whichever is less. The banks/DFIs' investments in such TFCs will not be counted towards the aggregate limit on unsecured financing facilities prescribed under Prudential Regulation R-4 of Corporate and Commercial Banking.
2004 27-May	(BSD-07)	**Guidelines on Internal Controls** With the advent of increasing emphasis on proper management of various risks facing financial institutions throughout world, the need of an effective internal control system was greatly felt, which is an integral part of an ideal risk management framework. Therefore, State Bank of Pakistan has prepared **Guidelines on Internal Controls**. These guidelines require all banks/DFIs to ensure existence of an effective system of internal controls which is commensurate with the nature, size and complexity of their business; minimizes the risk inherent in their activities; and responds to changes in the business and general economic environment in which the banks/DFIs operate. These guidelines include a brief introduction to the Internal Controls, followed by Objectives of Internal Control System, Control Principles, Components of Internal Control System, Responsibilities of key players, Implementation of Internal Controls, Evaluation of Internal Controls, and finally, Reporting of Internal Controls. All banks/DFIs are also required to submit a half-yearly progress report, within 30 days of the end of each calendar half-year, regarding the status of the development and implementation of the guidelines. In addition, the internal control systems will be tested/checked by our inspectors and will factor in the CAMELS-S rating system under 'S' (Systems & Controls).
2004 07-June	(EPD-06)	**Formation of Exchange Company 'B' Category [E.C.(B)]** In order to bring the existing Authorized Money Changers within the realm of Exchange Companies and to ensure smooth transition of their existing business, it has been decided that the existing authorized Money Changers may be allowed to establish Exchange Companies of 'B' Category. The procedure for establishing the E.C (B) is given below: ❑ The applicants (Minimum 5 Licensed AMCs) shall apply on

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		prescribed form to State Bank for obtaining an NOC ❑ On receipt of the NOC from SBP, the applicant will submit an application to SECP for incorporation under the Companies Ordinance. After the Exchange Company of 'B' Category is registered by SECP, the applicant would apply to SBP for issuance of Licence against surrender of at least 5 MC Licences and for commencement of operations.
2004 22-June	(EPD-07)	**Restricted Authorization to Deal in Foreign Currencies – Hotels** SBP has decided to issue Restricted Authorisation to 3, 4 & 5 Star Hotels to deal in purchase/encashment of foreign currency notes, coins and travelers cheques (TCs) from the hotel customers only.
2004 03-July	(BPD-22)	**Regulations for Financing to Brokers by Banks / DFIs** In order to facilitate the transition from Badla to Margin Financing in Stock Exchanges of Pakistan, encourage active participation of banks / DFIs in this area, unlock investments in equities, enable investors to leverage their stock holdings and to ensure that the relevant activities are undertaken by banks / DFIs in a prudent manner, State Bank of Pakistan has issued regulations for financing to brokers by banks / DFIs.
2004 08-July	(BID-01)	**Questionnaires for Self-Assessment-IRAF** SBP has introduced the concept of IRAF for ensuring proactive monitoring of the risks the banks/DFIs are exposed to and to further strengthen the existing supervisory mechanism. The new framework envisages a collaborative and seamless supervisory focus amongst the various supervisory departments within SBP. The review of banks/DFIs under IRAF shall be based on inputs relating to four areas. These include compliance with standards, codes & guidelines; supervisory & regulatory information; financial performance & condition and market information & intelligence. In this regard, SBP has prepared and circulated the Questionnaires for Self-Assessment of banks/DFIs. These questionnaires have been prepared in light of PRs & guidelines issued from time to time for compliance by the banks/DFIs.
2004 13-July	(BSD-10)	**Revaluation Surplus / Deficit** It has been decided that banks/DFIs will classify their entire investment portfolio into 'Held to Maturity', 'Available for Sale' and 'Held for Trading' securities The banks/DFIs shall decide the category of the investment at the time of acquisition and the decision taken to that effect shall be recorded in writing on the investment proposals. However, banks/DFIs will be free to determine the extent of holding under the above categories taking into consideration various aspects such as trading strategies, intention of acquisition of securities, capital position, expertise available to manage investment portfolio, and the risk management capabilities, etc. The banks/DFIs will not resort to frequent shifting of securities from one category to another to take undue advantage of fluctuation in the market/ interest rates. Under exceptional circumstances, shifting from one category to another , except ' held to Maturity' will be allowed subject to the

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		following conditions: i) Shifting to/from 'Available for Sale' category will be allowed with the approval of the ALCO subject to the condition that the reasons for such shifting will be recorded in writing. ii) Shifting of investment from 'Held for Trading' category to 'Available for Sale' category would generally not be allowed. It would be permitted under exceptional circumstances like not being able to sell the securities within the prescribed period of 90 days due to tight liquidity position in the market or extreme market volatility with the approval of the ALCO. iii) Shifting of securities from one category to another at the lower of the market value or the acquisition cost/book value, iv) The surplus/deficit arising as a result of revaluation of 'Held for Trading' securities shall be taken into Profit & Loss Account. Furthermore, the surplus/deficit on revaluation of 'Available for Sale' securities shall be taken to "Surplus/Deficit on Revaluation of Securities" Account. However, any impairment in the value of 'Available for sale' securities will be provided for by charging it to the Profit & Loss Account. v) The "Held to Maturity" securities shall be carried at amortized cost and shall not be required to be revalued. This will, however, be subject to the condition that once a security is classified as "Held to Maturity" no subsequent reclassification/shifting to "Available for Sale" or "Held for Trading" categories will be permissible.
2004 25-August	(BSD-12)	**Minimum Capital Requirements for Banks / DFIS** In order to align the regulatory capital requirement with the internationally accepted standards and institute a true risk based capital adequacy framework, SBP has decided to impose capital charge for market risk, in addition to presently applicable capital requirement on credit risk Furthermore, in order to strengthen the capital base of institutions, the minimum paid–up capital requirement (net of losses) of Rs1 billion is being increased to Rs2 billion. The capital position should be reported to SBP on consolidated as well as on standalone basis on the revised format as part C of the Quarterly Report of Condition Any bank/DFI that will fail to meet the minimum paid-up capital requirement (net of losses) of Rs1.5 billion by 31st December 2004 and Rs2 billion by 31st December, 2005, shall not be allowed to undertake a full range of financial services.
2004 04-September	(BSD-13)	**Guidelines on Business Continuity Planning** The need for making comprehensive arrangements for instituting physical security measures in order to ensure the operational sustainability of individual institutions and that of the industry necessitated SBP to issue Guidelines on Business Continuity Planning (BCP) meaning the level of readiness in the face of any actual or potential danger, damage, and disaster. BCP, being a risk-based framework, is a proactive process and deals with operational risk by developing policies, strategies, and specific responsibilities for the recovery of critical business functions. Most importantly, it should be commensurate with the institutions' nature, scale and complexity of business activities.

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		It may be noted that the guidelines are issued with a view to help strengthen overall resilience of the financial system. Development of robust and practical contingency and security plans, involving participation from all concerned areas of organization, will ensure that banks / DFIs have the capacity to deal with an unexpected situation that might flow from sudden, internal as well as external events.
2004 29-September	(BSD-15)	**Guidelines on Information Technology Security** Today is the age of information technology (IT) and the banking institutions, in order to stay competitive, are taking maximum advantage of rapidly evolving innovations in IT. They are fast incorporating IT in their business processes to achieve efficiency, to serve their customers satisfactorily and to expand & modernize their product offerings. The use of information technology creates new risks, and the worst case would be the total disruption of service and its consequential financial implications. Keeping the above in view, SBP has prepared the guidelines for IT Security and expects all banks/DFIs to make adequate and reliable arrangements for IT Security. These guidelines will provide a starting point to set practices and procedures in place for enhancing IT Security. The guidelines emphasize on the commitment to IT Security and provides guidance on IT Security concept, Risk management, IT Security policy and plan development, IT Security areas, IT Security team, Awareness and training, Incident management, Contingency and disaster recovery planning, Information system audit and certification, and finally requires the banks/DFIs to have a well functioning and reliable IT Security system, which is working round the clock and is continuously being improved.
2004 30-September	(EPD-09) Circular Letter	**Permission for Establishment of Payment Booths/ Outlets.** In order to facilitate and further promote Home Remittances, all Exchange Companies are hereby authorized to establish Payment Booths at the place of business with whom they have entered into an exclusive agreement, after obtaining prior approval from Exchange Policy Department (EPD), SBP, Karachi, specifically for the purposes of payments in Pak Rupees of Home Remittances to the beneficiaries in Pakistan against funds to be received by the Exchange Companies from abroad. Records of all transactions are required to be maintained, also for the purposes of submission of the same to SBP in such form, as may be required. Other than payments in local currency to the beneficiaries against Home Remittances, Payment Booths shall not be allowed to undertake any other business activity. Appropriate Signboards must be displayed at such booths mentioning the words “Payment Booth” and name of the Exchange Company. Prominent signs both in Urdu and English should be placed clearly indicating that the facility is “Restricted for payment of Home Remittances only”.
2004 11-October	(EPD-11) Circular Letter	**Overnight Exposure** In order to facilitate Exchange Companies of ‘B’ Category, it has been decided to allow such Exchange Companies to carry a foreign currency exposure at the close of business each day at a level not higher than 25 percent of the capital base. The method to determine exposure shall be that

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		the "Pak Rupee equivalent of all the Foreign Currencies held by the Exchange Company including at all of their branches, shall not exceed 25 percent of the capital base at the close of business each day".
2004 26-November	(BSD-17)	**Financial Derivatives Business Regulations (FDBR)** At present banks are allowed to undertake the business of financial derivatives after getting specific transactional approval from SBP for entering into such transactions. In order to develop an Over the Counter (OTC) financial derivatives market in the country, it has been decided to allow Banks/DFIs to undertake derivatives business, provided they meet the eligibility criteria and obtain Authorized Derivatives Dealer (ADD) or Non Market Maker Financial Institution (NMI) status from SBP. Banks/DFIs obtaining the status of ADD or NMI should ensure that the derivative transactions undertaken do not contravene any other applicable laws, regulations, or restrictions, in force. In this context the Financial Derivatives Business Regulations (FDBR) have been issued, which interalia contain the regulatory framework for the OTC financial derivative transactions. FDBR comprises two parts, the main body of regulation and the product annexures. The first part i.e. the main body sets out the eligibility criteria and procedure for the institutions to become an ADD or NMI. It also sets the minimum operational, dealing and risk management standards, reporting and disclosure requirements. The second part contains the specifics related to Foreign Currency Options, Forward Rate Agreements, and Interest Rate Swaps, including permissible currency, tenor, and benchmarks.
2005 07-January	(BSD-02) Circular Letter	**Risk Management Framework –Disclosure in Annual Accounts** In order to enhance disclosure and to meet information needs of the stakeholders, it has been decided that effective from the Accounting Year ended 31st December, 2004, all banks and DFIs will include a comprehensive paragraph under the heading "Risk Management Framework" in the Directors' Report in their Annual Accounts. This paragraph will cover ❑ the overall / broad plan to meet SBP's guidelines on risk management; ❑ the status and details of action / steps taken under the bank's individual plan to implement SBP's guidelines on Risk Management; and ❑ the indicative timeframe to achieve completion of their plan i.e. full compliance of SBP's guidelines.
2005 19-January	(BSD-01) Circular	**Reporting Requirements on Frauds/Forgeries/Dacoities** Operational Risk is gaining importance in the banking industry in the wake of increasing complexity of operations and the risks involved therein. The incidents of internal and external frauds and forgeries are included in list of the operational risk events that have the potential to result in substantial losses. In view of the importance of frauds prevention/mitigation strategy in overall operational risk framework and to improve the mechanism for active supervisory response, SBP has formulated the revised reporting requirement for banks/DFIs on frauds/forgeries/dacoities cases. Submission of complete and timely information on revised formats will

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		enable SBP to remain apprised of developments at banks/DFIs and monitor follow-up action taken by them for all medium and high severity frauds/forgeries including the emergency reported cases. The information so collected will also be used to develop a database of frauds, forgeries, and dacoities events, which will be used for measuring operational risk and determining capital requirements thereagainst. Furthermore, banks/DFIs will separately report all material incidents of frauds/forgeries/dacoities etc. of Rs1 million and above on urgent basis as under:- a) Preliminary report within 2 working days of the occurrence of such incident by mentioning the date of the incident and other information about the case as available at the time of such reporting; and b) Detailed report within 15 days of the occurrence of such incident
2005 26-January	(BSD-03) Circular Letter	**Guidelines on Internal Controls** SBP has decided that banks/DFIs will include a Statement on Internal Controls, as envisaged in "Guidelines on Internal Controls" in their Annual Audited Financial Reports.
2005 28-January	(BPD-01) Circular	**Establishment of Subsidiaries /Brokerage Companies by Banks / DFIs** SBP has issued a consolidated circular containing its earlier instructions with some modification for Banks/DFIs intending to undertake brokerage business and diversification of their activities through subsidiaries The following instructions in consolidated form will supersede the earlier instructions 1. The Banks/DFIs are required to establish separate subsidiaries if they wish to undertake asset management or conduct brokerage business. However they may at their own discretion, establish other subsidiaries as admissible under the law. 2. The Banks/DFIs desiring to establish any subsidiary shall obtain prior approval of State Bank of Pakistan. 3. The subsidiary can either be a public limited company or a private limited company. It should be ensured that the subsidiaries are established only for activities as are admissible under Section 23 of the Banking Companies Ordinance, 1962. It is clarified that the instructions contained in this circular are not applicable on the exchange companies established by the Banks in terms of FE Circular No. 9 of 30th July, 2002.
2005 19-March	(BPD-10) Circular	**Housing Finance: Relaxations in the Regulatory Framework** In order to facilitate origination of housing loans and securitization of mortgage/construction/developer finance, following relaxations in the present regulatory framework are allowed to Banks/DFIs: Keeping in view the active role of banks/DFIs for the provision of housing finance to a cross section of the society, the maximum per party limit of Rs10 million in respect of housing finance, as per Regulation R-15 of the Prudential Regulations for Consumer Financing, is being removed with immediate effect. Accordingly, banks/DFIs are allowed to determine the housing finance limit in accordance with their internal credit policy, credit

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		worthiness and loan repayment capacity of the borrowers. In order to facilitate securitization of mortgage/construction/developer finance through Special Purpose Vehicle (SPV), banks/DFIs are allowed the following relaxations with respect to Listed and Unlisted Mortgage /Construction/Developer Finance Asset Backed Securities (ABS): **a. Listed ABS:** The minimum credit rating for banks/DFIs to make direct investment and for taking exposure (i.e. undertaking lending and reverse repo) against listed ABS for mortgage/construction/developer finance is reduced from "A" to "A- (or equivalent)". **b. Unlisted ABS:** Banks/DFIs are allowed to invest in non-listed mortgage/construction/developer finance ABS having a minimum credit rating of "A- (or equivalent)" as well as to take exposure (i.e. undertaking lending and reverse repo) against the security of such non-listed ABS.
2005 21-March	(BPD-11) Circular Letter	**Opening of Pakistani Banks' Branches Abroad** State Bank of Pakistan has allowed opening of Pakistani Banks' branches abroad. The procedure for opening of branch(es) /office(s) abroad by locally incorporated banks has been notified to them.
2005 28-March	(BSD-02) Circular	**Fit & Proper Criteria for Board Members and President/Chief Executive of Microfinance Banks** State Bank of Pakistan has formulated "Fit & Proper Criteria" for the Board Members and President/Chief Executive of Microfinance banks, which prescribe the minimum qualification, experience and integrity standards etc. for the MFBs' Board Members and President/Chief Executive. The criteria are being introduced as Prudential Regulations for Microfinance Banks, Fit & Proper Criteria for MFBs' Board Members and President/Chief Executive Officer.
2005 31-March	(BSD-03) Circular	**Implementation of Basel II in Pakistan** SBP has decided to adopt the Basel II in Pakistan. For the smooth, realistic and undisrupted transition from present capital adequacy framework towards more risk sensitive new capital adequacy framework – the Basel II, all banks/DFIs are required to designate one senior officer from their institution who will supervise all activities relating to Basel II within the bank and will serve as a point of contact between SBP and that particular bank. For this purpose, banks may also put in place a support functionary to assist the person in charge as considered appropriate. SBP has provided a broad roadmap and outline which is required to start work for the adoption of Basel II. The new framework consists of three mutually reinforcing pillars; the first pillar relates to Minimum Capital Requirement, second pillar describes Supervisory Review Process under the new framework and the third pillar describes the Market Discipline required to be adopted by the banks. Under pillar one, the framework offers three distinct options for assessment of capital requirements for credit risk and three options for operational risk. The approaches available for assessment of capital for credit risk are Standardized Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach. The approaches available for computing capital charge for operational risk are Basic

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		Indicator Approach, Standardized Approach and Advance Measurement Approach. Whereas the capital requirement as to the Market Risks remains unchanged and banks will continue to assess the capital charge against the market risk based on the existing instructions under the Basel-I. The timeframe for adoption of different approaches under Basel II is as under: - i) Standardized Approach for credit risk and Basic indicator / Standardized Approach for operational risk from 1st January 2008. ii) IRB approach from 1st January 2010. Banks interested in adopting IRB Approach for capital requirement against credit risk before 1st January 2010 may approach SBP for the purpose. Their requests will be considered on case-to-case basis. Banks/DFIs will be required to adopt a parallel run of one and a half year for Standardized Approach and two years for IRB Approach starting from 1st July 2006 and 1st January 2008 respectively. The above timeframe has been finalized after consultation with and with the agreement of the Presidents / CEOs of all banks/DFIs. Each bank/DFI is required to formulate their internal plans specifying the approach they are willing to adopt and the plans for moving to the particular approach. The plans should envisage the risk management setup, various risk assessment methodologies being used for assessment of various risk categories and the policy and procedures for the capital allocation. It must highlight what are the gaps for moving to Basel II implementation and what steps are required to overcome those gaps. Banks/DFIs should give a time bound action plan narrating the activities to be done and the time when it will be accomplished within the overall implementation timeframe as mentioned above.
2005 11-April	(BPD-15) Circular	**Financing Facilities by SBP (Enhancement In Repo Rate)** SBP has enhanced the minimum rate of return to be paid by recipients of financing facilities for meeting temporary liquidity shortage i.e. SBP 3-day Repo facility, against Government of Pakistan MTBs and PIBs from 7.5 percent to 9.0 percent.

Glossary **Annex-I**

Available for sale securities are the securities which do not fall within 'held for trading' and 'held to maturity' categories.

Capital adequacy ratio is the amount of risk-based capital as a percent of risk-weighted assets.

Capital gearing is the ratio between long-term borrowings and shareholders' funds.

Consumer Financing means any financing allowed to individuals for meeting their personal, family or household needs. The facilities categorized as Consumer Financing include credit cards, auto loans, housing finance and personal loans.

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

Corporate Governance is 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 arises from the potential that a borrower or counter-party will fail to perform an obligation or repay a loan.

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

Derivatives are 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 is the rate at which SBP provides three-day repo facility to the banks, acting as the lender of last resort.

Duration (Macauley Duration) is 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 rate environments. A bond's price is a function of its coupon, maturity and yield.

Economic Value of Equity (EVE) is the present value of the expected cash flow of assets minus the present value of the expected cash flows on liabilities, plus or minus the present value of the expected cash flows on off-balance sheet instruments, discounted to reflect market rates.

Foreign exchange risk is the risk associated with exposure to fluctuation in spot exchange rates.

Funding liquidity risk is defined as an institution's inability to obtain funds to meet cash flow obligations or the risk that the counterparties who provide the bank with short-term funding will withdraw or not roll over that funding, e.g. there will be a 'run on the banks' as depositors withdraw their funds.

GAP is the 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 is the net interest income (before provisions) plus non-interest income; the income available to cover the operating expenses.

Held to maturity securities are the securities acquired by the banks/DFIs with the intention and ability to hold them upto maturity.

Held for trading securities are **t**he securities acquired by the banks/DFIs with the intention to trade by taking advantage of short-term market/interest rate movements. Such securities are to be sold within 90 days from the date of their classification as 'Held for Trading' under normal circumstances.

Incidence of NPLs is the 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.

Incremental NPLs or Advances is the net increase or decrease in NPLs or advances between two periods.

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

Interest rate risk 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 is 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 is the administrative expenses divided by the average deposits and borrowings.

Liquid assets are 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 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.

M2 includes currency in circulation (CIC), other deposits with SBP, demand deposits, time deposits and resident foreign currency deposits with the scheduled banks.

Market liquidity risk is the risk of a generalized disruption in asset markets that make normally-liquid assets illiquid or the risk that market transactions will become impossible due to market disruptions or inadequate market depth.

Market risk is 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.

Net interest income is the 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) is the net interest income as a percent of average earning assets.

Net loans are loans net of provision held for non-performing loans.

Net non-performing loans (NPLs) is the value of non-performing loans minus provision for loan losses.

Net NPLs to net loans means 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) are 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 stands for non-performing loans as a percent of gross loans.

Off-the-run securities are less liquid securities signifying low trading activity in the secondary market.

Open Market Operations is the buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system. Purchases inject money into the banking system and stimulate growth while sales of securities do the opposite

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

Over the counter (OTC) market is the market where securities transactions are made via telephone and computer rather than on the floor of an exchange.

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

PVBP is a measure used to describe how a basis point change in yield affects the price of a bond. There is an inverse relationship between bond price and yield. As yields decrease, the bond prices increase and vice versa. The degree of change in bond price per a 1 bps change in yield is determined by a number of other factors, such as the bond's coupon rate, time to maturity, and credit rating.

Rate sensitive assets (RSA) are 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.

Repricing risk arises from timing differences in the maturity of fixed rate and the repricing of floating rates as applied to banks' assets, liabilities and off-balance sheet positions.

Return on assets 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 is 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: Total risk weighted assets of a bank would comprise two broad categories: credit risk-weighted assets and market risk-weighted assets. Credit risk weighted assets are calculated from the adjusted value of funded risk assets i.e. on balance sheet assets and non-funded risk exposures i.e. off-balance sheet item. On the other hand for market risk-weighted assets, first the capital charge for market risk is calculated and then on the basis of this charge amount the value of Market Risk Weighted Assets is derived.

Secondary market is 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 and Tier III). Tier 1 capital includes fully paid up capital, balance in share premium account, reserve for issue of bonus shares, general reserves as disclosed on the balance-sheet and un-appropriated /unremitted profit (net of accumulated losses, if any).

Tier II capital: Supplementary Capital (Tier II) is limited to 100 percent of core capital (Tier I). It includes; general provisions or general reserves for loan losses, revaluation reserves, exchange translation reserves, undisclosed reserves and subordinated debt.

Tier III capital: The tier III capital consisting of short-term subordinated debt would be solely for the purpose of meeting a proportion of the capital requirements for market risks.

Yield risk is 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 curve risk materializes when unanticipated shifts have an adverse effect on the bank's income or underlying economic value.

Yield spread 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.

Group-wise Composition of Banks

Annex-J

1997-1998	2003	2004
A. Public Sector Comm. Banks (6) - Habib Bank Ltd. - National Bank of Pakistan - United Bank Ltd. - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **B. Local Private Banks (16)** - 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. **C. Foreign Banks (20)** - 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. - Mashreq Bank PJSC - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Societe Generale - Standard Chartered Bank **D. Specialized Banks (4)** - Agriculture Development Bank of Pakistan - Industrial Development Bank of Pakistan - Federal Bank for Co-operatives - Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks (42)** Include A + B + C **All Banks (46)** Include A + B + C + D	**A. Public Sector Comm. Banks (5)** - Habib Bank Ltd[1] - National Bank of Pakistan - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **B. Local Private Banks (18)** - 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. **C. Foreign Banks (14)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - Bank of Ceylon[2] - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - Credit Agricole Indosuez[3] - Deutsche Bank A.G. - Doha Bank[4] - Habib Bank A. G. Zurich - The Hongkong & Shanghai Banking Corporation Ltd. - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Standard Chartered Bank **D. Specialized Banks (3)** - Zari Taraqiati Bank Ltd. - Industrial Development Bank of Pakistan - Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks (37)** Include A + B + C **All Banks (40)** Include A + B + C + D	**A. Public Sector Comm. Banks (4)** - National Bank of Pakistan - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **B. Local Private Banks (20)** - 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. - Habib Bank Ltd - Dawood Bank **C. Foreign Banks (11)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - 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 **D. Specialized Banks (3)** - Zari Taraqiati Bank Ltd. - Industrial Development Bank of Pakistan - Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks (36)** Include A + B + C **All Banks (38)** Include A + B + C + D

1. *HBL now stands as local private bank after being privatized on 26-02-2004.*
2. *Bank of Ceylon was merged with Dawood Commercial Bank on 25-03-2004.*
3. *Credit Agricole was merged with NDLC-IFIC Bank on 19-04-2004.*
4. *Doha Bank was merged with Trust Commercial Bank which was later merged with Crescent Commercial Bank.*