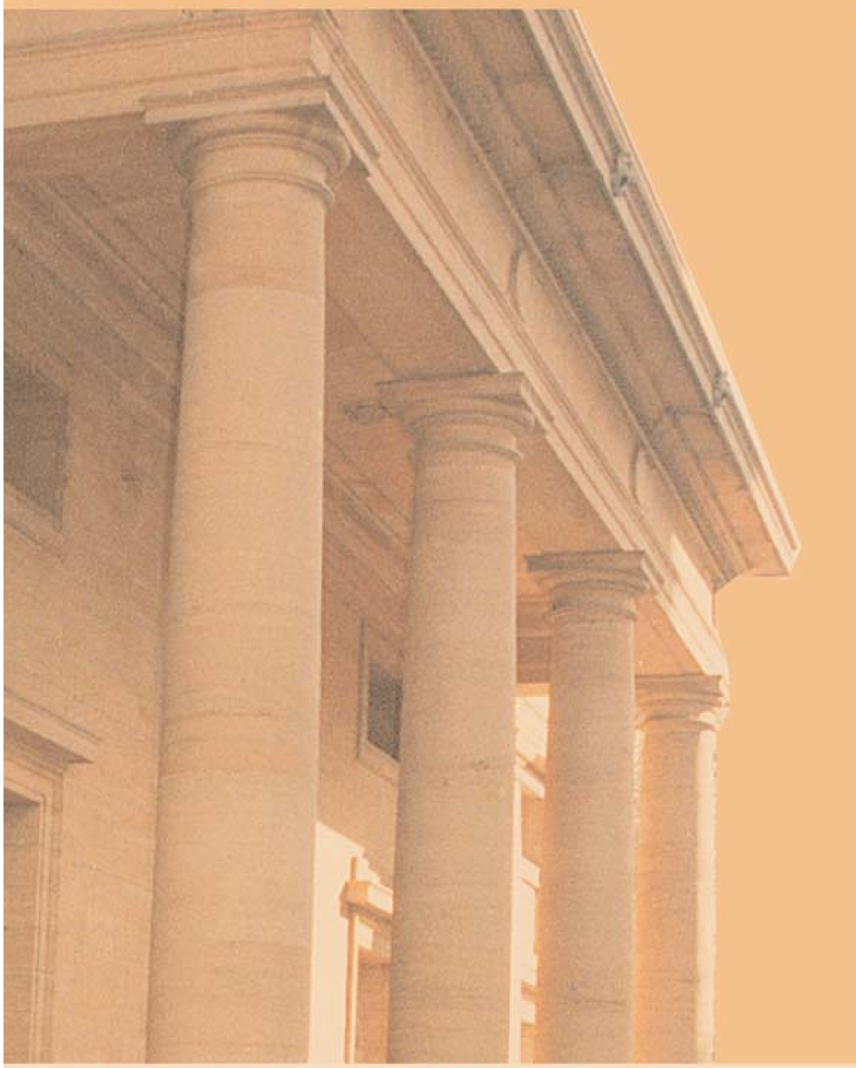
BSR

Banking System Review



2006

State Bank of Pakistan

Banking Surveillance Department

The Team

Team Members

Muhammad Akhtar Javed

Muhammad Rizwan

Aamir Ali

Abdul Samad

Rizwana Rifat

Raza Habib Raja

Team Leader

Lubna Farooq Malik

List of Abbreviations

ABEP	Annual Branch Expansion Plan	**IVR**	Integrated Voice Recording
ADB	Asian Development Bank	**KSE**	Karachi Stock Exchange
ADD	Authorized Derivatives Dealer	**KYC**	Know Your Customer
ADR	Advances to Deposits Ratio	**LPB**	Local Private Bank
AML	Anti Money Laundering	**MCR**	Minimum Capital Requirement
ATM	Auomated Teller Machines	**MFB**	Micro Finance Bank
BCBS	Basel Committee on Banking Supervision	**MINFAL**	Ministry of Food, Agriculture and Livestocks
BCO	Banking Companies Ordinace	**MTB**	Market Treasury Bill
BLP	Branch Licensing Policy	**NBFC**	Non-Banking Finance Companies
BO	Back Office	**NBFIs**	Non-Bank Finanace Institutions
BOD	Board of Directors	**NII**	Net Interest Income
bps	basis ponits	**NIM**	Net Interest Margin
CAELS	Capital, Assets Quality, Earnings, Liquidity and Sensitivity	**NMI**	Non Market Maker Financial Institution
CAR	Capital Adequacy Ratio	**NPA**	Non Performing Assets
CB	Commercial Bank	**NPF**	Non Performing Finance
CCOP	Cabinet Committee on Privatization	**NPL**	Non Performing Loan
CCS	Cross Currency Swaps	**OGDCL**	Oil & Gas Development Company Limited
CEO	Chief Executive Officer	**OMO**	Open Market Operations
CFC	Card Faciliation Center	**ONIR**	Overnight Interest Rates
CFT	Combating the Financing of Terrorism	**OTC**	Over the Counter
CIB	Credit Information Bureau	**PACRA**	Pakistan Credit Rating Agency
CPI	Consumer Price Index	**PBA**	Pakistan Banks Association
CRR	Cash Reserve Requirement	**PIB**	Pakistan Investment Bond
CRSIU	Committee for Revival of Sick Industrial Units	**PIN**	Personal Identification Number
CY	Calendar Year	**POS**	Point of Sale
DFI	Development Finance Institution	**PSCB**	Public Sector Commercial Bank
DR Plan	Disaster Recovery Plan	**PTC**	Participation Term Certificate
ECAI	External Credit Assessment Institutions	**ROA**	Return on Assets
EPZ	Export Processing Zone	**ROE**	Return on Equity
ERF	Export Refinance	**RSA**	Rate Sensitive Asset
EU	European Union	**RSL**	Rate Sensitive Liability
FB	Foreign Bank	**RTGS**	Real Time Gross Settlement
FCY	Foreign Currency	**RWA**	Risk Weighted Assets
FDBR	Financial Derivatives Business Regulations	**SB**	Specialized Bank
FDI	Foreign Ditrect Investment	**SBP**	State Bank of Pakistan
FPT	Fit & Proper Test	**SCRAs**	Special Convertible Rupee Accounts
FRA	Forward Rate Agreement	**SECP**	Securities and Exchange Commission of Pakistan
GDR	Global Depository Receipts	**SLR**	Statutory Liquidity Reserves
HTM	Held-to-Maturity	**SME**	Small and Medium Enterprise
IBIs	Islamic Banking Institutions	**SMEDA**	Small and Medium Enterprise Development Authority
IFS	International Financial Standards	**TFC**	Term Finance Certificate
IMF	International Monetary Fund	**VPN**	Virtual Private Network
IRAF	Institutional Risk Assessment Framework	**VSS**	Voluntary Separation Schemes
IRB	Internal Ratings Based	**WPI**	Weighted Price Index
IRS	Interest Rate Swap	**YoY**	Year on Year
IT	Information Technology		

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Foreword

The banking system of Pakistan has witnessed highly positive financial results during the year under review, adding further strength to its key financial soundness indicators. Though the profitability has maintained its upward trend, factors such as the changing ownership structure, transformation in the banking system composition, emergence of more compatible banking institutions, venturing of banks into relatively newer and riskier areas, growing market competition, technological advancement and implementation of Basel-II etc. demand proactive surveillance, effective risk management and enhanced focus on corporate governance culture, thus making the role of SBP more challenging. The forthcoming pages discuss these challenges in more detail.

State Bank of Pakistan, in its efforts to increase the disclosure and transparency, has been releasing a series of publications. Banking System Review (BSR) is one of the important documents of that series, which critically analyses the performance, risks, resilience and key initiatives and developments in the banking system.

This BSR has been prepared on the basis of information available in annual accounts of the banks and DFIs for year 2006. To ensure consistency, the basic format of the document has been kept unchanged. The primary focus of BSR for 2006 remains on the banking system and all the four groups of banks namely, local private banks (LPBs), public sector commercial banks (PSCBs), foreign banks (FBs) and specialized banks (SBs) have been analyzed separately. While the prime focus remains on the banking system, the performance, issues and development within Development Finance Institutions (DFIs), Micro-finance Banks (MFBs), Islamic Banks, and Exchange Companies have also been discussed in separate chapters.

Though, we have continuously been striving to improve contents of the review and make our assessments and analyses more comprehensive in all respects; feedback and suggestions to bring further improvement in the documents are always welcomed and appreciated.

June 30, 2007

LUBNA FAROOQ MALIK

DIRECTOR

Banking Surveillance Department

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1 Executive Summary

During CY06, the financial performance of the banking system of Pakistan remained outstanding- witnessing an extension of the last couple of years' trends. The robust profitability, strong solvency profile, managed asset quality, better risk management practices and ongoing consolidation of banking system have witnessed further improvement in almost all the key financial performance and soundness indicators. The growth trends in all the key components, to somewhat, continued to maintain the recent years' pace, as a result, total assets surpassed Rs4 trillion level and pre-tax profit set another milestone by crossing Rs100 billion mark. This has placed Pakistan among the top half in a group of 44 emerging economies[1] in terms of capital adequacy and asset quality while, in terms of profits, Pakistani banking System has been ranked among the top ten. The banking system continued to invite the foreign investors' interest in Pakistan and attract significant share of direct foreign investment. On the back of excellent results, banks maintained their dominance in the capital markets as their market capitalization has surged to one third of the total capitalization of Karachi Stock Exchange.

Profitability of the banking system kept its momentum largely on the back of persistent growth in high yield earning assets and expanded business volumes. During the year under review, pre-tax and after-tax profit of the banking system raised to Rs123.6 billion and Rs84.1 billion respectively. Resultantly, all the key profitability indicators kept on healthy trends. ROA of the banking system has further improved to 2.1 percent. ROE, however, slightly dropped to 24.2 percent from 25.6 percent over the year due to proportionately greater increase in the banks' equity base as a result of high retention of profits and fresh capital injections.

Though the non-interest income continued to provide support to the earnings, it was the Net Interest Income (NII) which extended a greater contribution to the higher profitability. The recent upward movement in cost of deposits put some strain on growing NII as interest rate variance on deposits of the commercial banks has increased to Rs39.3 billion as against Rs26.3 billion in CY05. While on the income side, the contribution of interest rate variance on loans decreased to Rs36.2 billion as compared to Rs50.2 billion in CY05. Further, the contribution of volume variance in interest income increased in CY06, thus increasing the NII by Rs36.7 billion.

In addition to the outstanding profits the fresh capital injections have further added strength to the solvency profile of the banking system. Capital adequacy ratio (CAR) of all banks increased to 12.7 percent in CY06 from 11.3 percent in CY05. Cross-sectional analysis showed that capital position of individual banks also strengthened and the number of banks having CAR at more than 10 percent increased to 32 from 30 in CY05.

On credit risk front, the banking system was able to contain the key asset quality indicators. Total NPLs of the banking system declined to Rs175 billion from Rs177 billion in CY05. However, the commercial banks (CBs) witnessed an increase in their NPLs by around Rs2 billion to Rs138 billion during CY06. NPLs to loans and net NPLs to net loans ratio of all banks remained in the vicinity of 7 percent and 2 percent respectively. The banking system continued to broad-base its loans portfolio to diversify their credit risk and increased the financial services access besides generating more productive alternative avenues of earnings.

[1] IMF Staff Report for the 2006 for Pakistan, Article IV Consultation.

As compared to the last year, the loans portfolio of the banking system grew at a relatively lower rate of 18.8 percent (CY05: 24 percent). This slow down was mainly due to deceleration in credit to private sector which can be attributable to subdued demand for fixed investment, as the growth in working capital finance has actually accelerated. Resultantly, the share of fixed investment loans decreased to 21 percent from 23.2 percent in CY05, whereas share of working capital loans increased to 35.3 percent from 33.2 percent in CY05. The sluggish demand for fixed investment credit, in some sectors, may be due to reliance of corporate sector on retained earnings or foreign borrowings. Further, banks may have deliberately reposed to reassess and develop their risk management capacities for taking additional exposures in some of the sectors.

Consumer finance though has been growing significantly in last couple of years its share in total credit (13.5 percent) as well as percentage of GDP (5.86 percent) is still lower, especially when compared in regional and international perspective[2]. Higher growth, which has been hallmark of consumer finance in recent years, marginally decelerated in CY06. As for its asset quality, NPLs of consumer sector though are still lowest among all the borrowing sectors, registered increasing trend and its infection ratio increased to 2.2 percent in CY06. The overall analysis revealed that, so far, the consumer sector exposure remained contained and did not depict significant threat to stability of the banking system. However, the rising interest rate trend along with growing level of indebtness may impact the repayment capacity of the consumer adversely which attracts close attention of banks' risk managers and supervisors.

Higher advances to deposit ratio (ADR) at 74.6 percent (excluding export refinance: 70.3 percent) suggested squeezed liquidity of the banking system in 2006. However, the position has been eased in recent months as during Mar07, ADR has declined to 70.5 percent (Excluding ERF: 66.0 percent) due to slow down in credit off take. The growing capital base besides availability of other funding sources had been providing cushion to the banks to expand their lending capacity despite having already a high ADR. It can be substantiated through advances to total assets ratio, which at the level 55.8 percent does not signify the stressful liquidity situation. Further, interbank exposures were also not that large, hence did not warrant systemic liquidity risk. However, adverse maturity mismatches in some of the banks were source of concern.

The strengthening capital and improved solvency position of the banks have significantly added to the resilience of our banking system towards different credit and market related shocks. As for the credit, the banks were generally resilient towards the shocks envisaged in the stress testing exercise conducted by SBP. However, a significant shock to the consumer loans may put some strain on profits of a few banks. The shift coupled with movements in the yield curve may generally not show a major impact on the values of the banks' portfolio. On currency side, the exchange rate risk was benign. On equities front, though exposures were not that large, may raise a concern if the capital market experiences a significant dip. On liquidity front, shocks of heavy withdrawals of deposits from the system may also affect the liquidity of the banking system.

The interest rate spread determined on the basis of weighted average rates on outstanding loans and deposits had been hovering around 7.3 to 7.5 percent during CY06 however, the spread on gross disbursements and fresh deposits remained lower, in the range of 5.1 to 6.5

[2] Sources: IMF, *World Economic Outlook*; CEIC; and IMF staff estimates based on data from country authorities.

percent. The squeezed spread in the later case was mainly owing to shift in deposit structure with growing share of fixed deposits and relatively increasing pressure on interest rates on all deposits' categories. This may be attributable to the moves of the market forces; whereby the banks demand longer term deposits to address their maturity mismatches and offer higher rates, while the depositors are attracted to lock their money in such longer term deposits to yield better returns. The unique structure of deposits of the banking system which still is dominated by very low-yield deposits especially of larger banks, can be the one of the key factors of wide spread.

During CY06, the asset composition of the banking system witnessed a shift towards loans as incremental loans accounted for about 64 percent of assets growth. Accordingly, the share of advances in total assets increased to 55.8 percent from 54.4 percent in CY05, while the investment portfolio of the banking system further lost its share to19.2 percent from 21.9 percent in CY05. As a result of this shift in asset composition, risk-weighted assets of the banking system also increased to 67.3 percent of total assets from 64.3 percent in CY05. Such compositional shift indicates the banks' attempt assumingly to improve the yield on earning assets on the back of leverage provided by higher CAR.

Looking at another perspective, the transformation in assets distribution pattern of the banking system also continued in CY06. Though more than half of the total assets of the banking system still rested with five largest banks, the concentration has been gradually declining over the period. It can be substantiated by a decline in share of top-five banks in total assets to 52 percent from 54 percent in CY05 with a corresponding increase in the share of next large five banks, which increased to 23 percent from 18 percent of last year. The shift was attributed to substantial slowdown in deposits growth of top-five banks which is evident from their pace of growth at 9.4 percent as compared to 39.5 percent for the next-five banks. This skewness in assets distribution among top-five and next-five banks is expected to improve further on the back of growing competition from the latter, improvement in efficiency, synergies and economies of scales induced by the consolidation process.

Sustained deposit growth has continued to remain one of the most significant factors behind robust banking activities and accomplishment of strong and sustained bottom line. Apart from pace of growth, the most liked feature of deposits during CY06 was continuance of structural transformation on the pattern of last year as a result of which share of fixed deposits, increased significantly. The increased share of fixed deposit of 31 percent from 26 percent in last year against decline in saving deposits to 36 percent from 41 percent may address the issue of maturity mismatches of the banking system.

Besides conventional banking, growth in Islamic banking also remained encouraging. Growing at the higher pace, the number of branches increased to 150 from 70 in C05. With the entry of 3 more conventional banks, the total number of conventional banks offering Islamic banking increased to 13 whereas the full-fledged Islamic banks have increased to 6 from 2 in CY05. Besides expansion, key performance indicators also witnessed healthy trends during the year, auguring well for the future growth prospects. Total assets of this segment grew by almost 67 percent to Rs119 billion thus increasing its share in the overall banking system to 2.9 percent from 2 percent in CY05. Infection ratio (gross) stayed at 1.3 percent while ROA remained at 0.9 percent. Building a specialized human resource would help Islamic banking system foster as a successful parallel banking system.

Microfinance also witnessed growth in its market share and added to the access to finance as both the depositors and borrowers of this sector recorded healthy growth during CY06. Total number of microfinance institutions increased to 6 from 5, whereas the number of branches increased to 145 from 91 in CY05. The share of advances also increased to 33 percent from 27 percent in CY06, whereas the infection ratio of the loans stayed below 2 percent. However, these banks need to enhance their focus on scaling up their core business activities, improving operational efficiencies and building professional expertise.

During past few years, significant progress has been made in terms of serving some previously underserved segments like agriculture, SMEs, consumer finance, Islamic banking and microfinance. However, by and large, a significant portion of the adult population remains financially exclusive. Presently, around $2/3^{rd}$ of the adult population is un-banked and the problem is more pronounced in rural areas. The rural areas despite having $2/3^{rd}$ share in population have only $1/3^{rd}$ of the bank branches catering to their needs. Realizing the importance of access to financial services, SBP is making it the cornerstone of its future strategy. Further, to improve penetration of the aforesaid sectors, SBP has restructured itself and created a special group named Development Finance Group to enhance focus on these areas.

State Bank of Pakistan; being cognizant of the increasing complexities of the financial landscape, rapidly changing ways of conducting business and to adopt international best practices; has continuously been updating/ realigning its regulations. On this front, one major development was further strengthening of regulations on corporate governance by modification the Fit and Proper Criteria by enhancing its scope to include sponsors and strategic investors and necessitating its formal clearance for change in ownership of a bank/DFI beyond certain limit. Moreover, a comprehensive policy framework has been issued to ensure that banks/DFIs have policies in diverse areas that are synchronized and have uniformity according to varied nature of their respective operations. Another important development was regarding adoption of Base-II; as SBP, further to the roadmap for Basel-II implementation, issued detailed instructions for adoption of various approaches for calculating capital adequacy requirements for credit, market and operational risks under Pillar I of Basel II Capital Accord. Further, necessitated by the significant regulatory developments, amendments in the International Financial Reporting Standards and enhanced disclosure requirements under Basel-II, SBP has revised its prescribed forms of accounts and balance sheet and made it mandatory for the DFIs as well.

Future Outlook

The future growth projections of the economy suggest that the current growth momentum in the banking system may prevail in the near future. The deposits are expected to maintain their previous growth trend on the back of steady flow of workers' remittances and substantial foreign exchange inflows in the form of FDI. Loans may follow growth trends of major sectors of the economy and would heavily depend upon the demands of both the corporate and consumer sectors and also the movements in interest rates. The demand from SMEs and agriculture segments of the economy, which presently have great potential, would also pave the trend in the loans growth. Some supply side factors like the banks' internal limits to a borrower, concentration of exposures etc. may constrain significant expansion with the existing base. This can have an important bearing on the asset mix, which may experience a shift more towards investments, not only because of the expected slow down in loans demand in near future but also due to the increasing borrowing needs of Govt. this year. This, in turn, may put some pressure on net interest margins of the banks. However, the promising growth in deposits and the increasing capital base may encourage banks to increase their business volumes in their core business activity in order to maintain the trends in their profits and ROE. The profits would mainly depend upon the volume of core business activity, hence the level of NIM as well as the quality of the existing portfolio. Particularly, the trends in the quality of consumer loans, due to its risky nature, may have a significant bearing on the existing quality of assets portfolio. On capital front, since the banks would further need to increase the capital base in order to meet the Rs4 billion requirements by the end of CY07, the strengthening of solvency profile of the banking system is expected to continue for this year too.

The higher loan growth during the last few years, which has also resulted into outstanding performance of the banking system, may have become a concern as well as a challenging target. Specifically speaking, on one hand, the aggressive loan growth has started to take its toll in the form of some deterioration in the asset quality of commercial banks, thus raising a concern both for the regulator and banks. On the other hand, the maintenance of the growth trends would become a challenge for the banks in their quest of maintaining the ROE, especially when the capital base is also increasing. Striking a balance on this trade off will continue to pose a challenge for the banking system in CY07 and in future as well. Tapping into new and less risky areas, broadening the base of the credible borrowers, adoption of strict standards of monitoring and internal control and lifting up of the corporate governance standards may help achieve a good balance between the better yields and contained credit risk.

Capital position of the banks is expected to further fortify given the enhanced MCR for the next couple of years and sustained earnings support. Growing mergers and consolidation, which have greatly shaped our banking system during the last few years, are expected to further consolidate and hence contribute towards the stability of the banking system. Besides weeding out the smaller banks, these have helped in increasing the healthy competition, improving the governance standards promote efficiency and productivity.

Going forward, the implementation of Basel II would be a great challenge both for the regulator and the banks. Basel II is not only aimed to strengthen the risk management standards but also help the banks to align their risk with the capital. In line with the roadmap, the parallel run has started in July 06. Initially, since the banks are to go on standardized approach, the impact on CAR and hence the regulatory capital under this approach is expected to be relatively low. Total risk weighted assets may experience some increase due to the inclusion of operational risk charge, whereas, the credit risk weighted assets are expected to decrease with the share of good rated borrowers of the banks. On overall basis, the CAR under Basel-II may experience shedding of a few basis points; however, the existing level of CAR of the banking system can easily sustain such a small dip.

While the banking system has been performing well for quite a few years and has been reaping the benefits of increased financial soundness, improved resilience, enhanced competition, increased efficiencies, growing penetration and hence widening the outreach, it has, nevertheless, become imperative that it can sustain these gains and also build on. This calls for the need of a focused approach on number of fronts. Financial soundness should be fortified by converging on the effective risk management, improved corporate governance standards, and focusing on the quality of assets and the earnings.

2 Macroeconomic Environment

The economy of Pakistan has persistently been experiencing strong growth for the last couple of years at rates higher than its long term average (see **Figure:-2.1**). The trend has persisted, rather improved compared to FY06, as the economy has registered a growth rate of 7 percent during FY07. This consistent high performance of the economy has comfortably placed Pakistan among the top half of the rapidly growing Asian economies (see **Table:-2.1**). The growth during FY07 is broad-based with strong performance of all the major sectors. The banking sector has not only been instrumental to the economic growth, but also benefited from strong economic performance - a reflection of two-way causality between financial and economic activities.[3]. Banking sector has grown both in size and strength and is positioned well to meet the economy's requirements as it grows.

Figure-2.1:- Growth in Pakistan's Economy (in%)

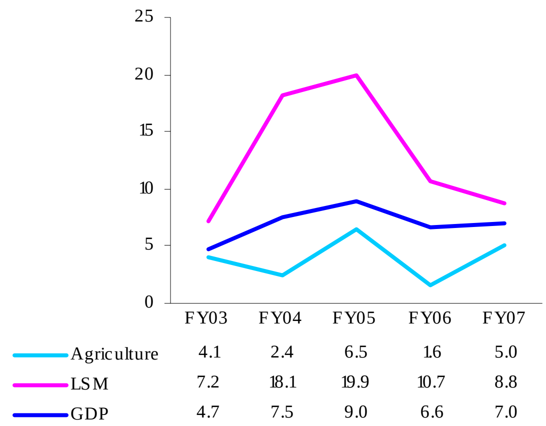


Table: 2.1 GDP Growth Rates in Various Countries

	2002	2003	2004	2005	2006	2007 (P)
East Asia						
China	9.1	10	10.1	10.4	10.7	10
Hong Kong, China	1.8	3.2	8.6	7.5	6.8	5.4
Korea	7	3.1	4.7	4	5	4.5
South Asia						
Bangladesh	4.4	5.3	6.3	6	6.7	6.5
India	3.8	8.5	7.5	9	9.2	8
Nepal	-0.4	3	3.5	2.3	2.3	2.8
Pakistan	**3.1**	**4.7**	**7.5**	**9**	**6.6**	**7%**
Sri Lanka	4	6	5.4	6	7.2	6.1
Southeast Asia						
Indonesia	4.5	4.8	5	5.7	5.5	6
Malaysia	4.4	5.5	7.2	5.2	5.9	5.4
Philippines	4.4	4.9	6.2	5	5.4	5.4
Singapore	4.2	3.1	8.8	6.6	7.9	6
Thailand	5.3	7.1	6.3	4.5	5	4
Viet Nam	7.1	7.3	7.8	8.4	8.2	8.3

Looking at sectoral composition of growth indicates that strong growth in services and agriculture sectors played a key role in overall economic growth. Specifically, services sector grew at 8 percent during FY07 against the target of 7.1 percent. Its contribution to overall growth is more than 60 percent. Like services, agriculture sector also witnessed above-target growth of 5.0 percent during FY07, which is more than three-fold compared 1.6 percent during FY06. The strong performance of these two sector masked the under performance of industry sector, which grew at 6.8 percent against the target of 9.1 percent for the year. The good news is that the industry has also witnessed some improvement over the previous year.

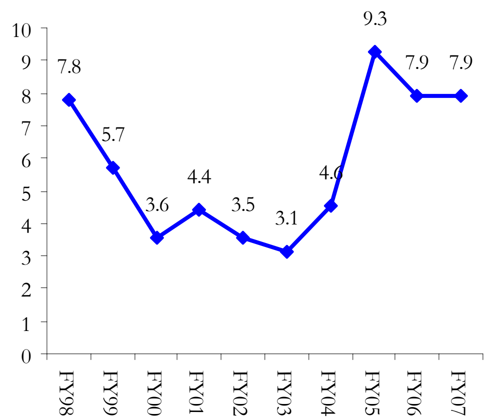
Another encouraging sign remained the continuously high investment to GDP ratio. Particularly, investment to GDP ratio for FY07 is 21.4 percent. Foreign Direct Investment (FDI) flows continued their upward trend and reached US$5.124 billion in FY07 as compared to mere US$484 million in FY02. Most of the FDI during FY07 came into telecommunication and financial sectors. Besides FDI, the portfolio investment, both private and public, also registered an impressive growth and crossed US$1.8 billion upto May 2007. Besides investment in equity market through SCRAs, the growth was mainly attributed to the issuance of GDRs by OGDCL and a local private bank. The investment in equity market through

[3] Banking sector facilitate economic activities by matching the credit needs of growing economy. At the same time, strong economic growth effect banks by improving the ability of the borrower to repay their loans at one end and by increasing the supply of loan funds through deposit growth on the other.

SCRA crossed US$978 million in FY07 which was more than double as compared to the corresponding period of FY06. The increased inflow of foreign investment reflects the international community's optimism about future growth prospects of Pakistan's economy. The optimism is also evident from the fact that the rating agencies have continued to maintain a positive outlook for Pakistan.

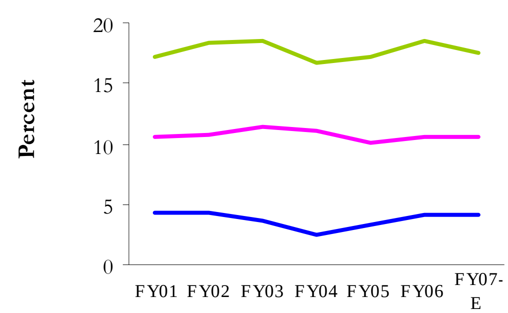
The increased non-debt creating foreign exchange inflows helped in bridging saving-investment gap in the economy. Compared to investment rate of 21.4 percent, domestic savings are only 18.0 percent of GDP. The notable point is the rise in savings rate as compared to FY06. This is a favorable development for the banking sector of Pakistan.

Figure-2.2:- Trends in Inflation-CPI (in %)



Besides positive economic aspects, there have been some key areas of concern. Despite continued tight monetary policy stance of the State Bank, the inflation level has remained high. State Bank, in pursuit of tight monetary policy stance, raised the discount rate as well as CRR and SLR in July 2006. The tightened monetary policy has been able to curb non food part of CPI (see **Figure:-2.2**) as well as WPI inflation, which on YOY basis reduced to 5.1 percent from 7.5 percent and 4.6 percent from 10.7 percent respectively during the period June 06 –June 07. However, the reduction in non food inflation has been offset by a corresponding rise in food CPI, which increased to 9.7 percent from 7.8 percent during the same period. Food inflation, being not very responsive to the monetary policy changes, nevertheless built into inflationary expectations and thus contributed towards continuity of inflationary pressures in the economy.

Figure-2.3:- Fiscal Performance



	FY01	FY02	FY03	FY04	FY05	FY06	FY07-E
Fiscal Deficit	4.3	4.3	3.7	2.4	3.3	4.2	4.2
Tax Rev	10.6	10.7	11.4	11	10.1	10.6	10.5
Total Exp	17.2	18.3	18.5	16.7	17.2	18.5	17.6

On fiscal side there is a need to keep the deficit within limit while sustainability of the growth requires simultaneously huge infrastructure and social sector investments. Tax revenue, despite increasing in absolute terms, has not increased in proportion to GDP which is evident from declining tax to GDP. In recent times, the decrease in fiscal deficit to GDP ratio has largely been due to decline in total expenditure to GDP ratio (**see figure 2.3**). For FY07, the fiscal deficit is budgeted at 4.2 percent and the Government has reiterated its resolve to hold fiscal deficit at 4 percent of GDP in future.

On the other hand, current account deficit continued to be one of the major concerns. After FY05, the current account has been in deficit largely owing to sharp increase in imports and slows down in exports. The exports recorded a growth of only 3.4 percent in FY07 against annual target of 12.9 percent. Imports growth, through decelerated to 8 percent in FY07 compared to 40 percent in FY06, outpaced the exports growth. Consequently, trade balance continued to worsen and crossed US$9.8 billion in FY07[4]. The current account deficit also widened and crossed US$7 billion despite increase in workers' remittances which crossed US$5.4 billion during FY07. However, deficit has so far been comfortably financed through huge capital and financial account surpluses on the back of increased FDI and portfolio investment inflows. However, despite rising capital inflows, the eventual solution remains to be increasing the exports.

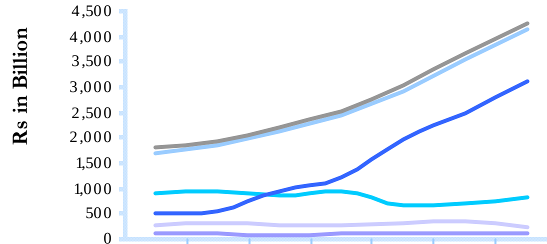
Under such macro economic conditions which are marked by inflation and rising fiscal and current account imbalances, the onus will disproportionately fall on the monetary policy. The environment can be challenging for the banking sector. The banking sector should play an active role for increasing resource mobilization and more efficient financial intermediation. Moreover, since Pakistan needs to make substantial long term investments in near future, the banking system would also need to improve its deposit structure to avoid any maturity mismatches.

[4] Provisional BOP figure

3 Assets and Funding Structure of the Banking System

The banking system continued to grow for yet another year, while its balance sheet size crossed the level of Rs4 trillion. The pace of growth of total assets i.e. 17.0 percent was almost in line with the last couple of years (see **Figure-3.1)**. The persistent growth in assets was mainly funded by continued inflows of deposits, borrowings and equity of the banking system. Deposits being the main funding source contributed around 60 percent of the growth in total assets whereas equity and borrowings jointly accounted for 32 percent.

Figure-3.1:- Total Assets of the Banking System



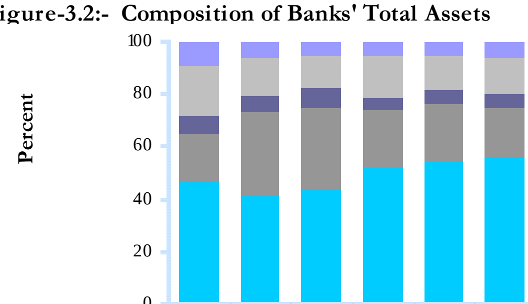
	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	902	947	878	959	653	724	836
LPBs	513	566	967	1,212	1,980	2,483	3,102
FBs	281	324	280	272	304	339	224
CBs	1,696	1,836	2,125	2,443	2,937	3,547	4,162
SBs	112	106	98	100	106	113	120
All	1,808	1,942	2,223	2,542	3,043	3,660	4,282

Besides strong growth, the share of LPBs in total assets has further increased due to shift of couple of FBs, as result of merger and acquisition, to LPBs. Accordingly, their share in total assets of the banking system surged to 72.4 percent from 67.8 percent in CY05. On the other hand, all the remaining groups witnessed further squeeze in their shares, as share of PSCBs, SBs and FBs respectively stood at 19.5 percent, 2.8 percent and 5.2 percent.

Looking at various groups respective pies, the largest decrease was in the share of FBs which reduced from 9.3 in CY05 to 5.2 percent in CY06. The main reason was shift of four of the FBs viz. Rupali Bank Limited, American Express Bank Limited, Habib Bank AG Zurich and Standard Chartered Bank to LPBs category in view of their merger/acquisition. The aggregate share of these banks in total assets was 4.5 percent in CY05. The share of remaining FBs has slightly increased from 4.8 percent in CY05 to 5.2 percent in CY06.

The cross-sectional analysis of assets structure of the banking system reveals that major flow of funds remained towards advances. Though their pace of growth was slow as compared to previous year, the incremental advances accounted for around 60 percent of assets growth. Consequently, the share of net advances in total assets increased to 55.8 percent from 54.4 percent in CY05 (see **Figure-3.2**). On the other hand, the investments, despite increase in volume, witnessed further loss in their share due to relatively larger increase in advances of the banking system.

Figure-3.2:- Composition of Banks' Total Assets



	CY01	CY02	CY03	CY04	CY05	CY06
Other Assets	9.4	6.4	5.2	5.1	5.2	6.4
Cash & Bank Balances	18.7	14.0	12.6	16.1	12.8	13.7
Lending to FIs	7.0	6.6	7.7	4.7	5.8	4.9
Investments	18.1	31.5	30.9	22.3	21.9	19.2
Advances	46.9	41.4	43.6	51.7	54.4	55.8

A further analysis of total assets as per size of banks shows that the assets distribution is concentrated into five largest banks. Although the scenario has been improving and this concentration is gradually declining, more than half of the total assets of the banking system are still held by the five banks (see **Figure-3.3**). These five banks held 52 percent of total assets in CY06 as against 54 percent in CY05. Whereas, the share of next large five banks in total assets has increased from 18 percent in CY05 to 23 percent in CY06. Hence, the top 10 banks collectively hold 75 percent of total assets of the banking system. Apart from concentration of assets towards large Tier-I and Tier-II banks, the skewness within this block of banks is expected to improve further on the back of growing competition form Tier-II banks, improvement in efficiency and delivery of banking services, synergies and economies of scales induced by the consolidation process.

On the other hand, the share of banks next to the above mentioned Tier-I and Tier-II banks has further reduced from 28 percent in CY-05 to 25 percent in CY-06. Out of total 39 banks, 20 banks have an asset base of below Rs50 billion. This reveals a considerably high degree of segmentation in the banking industry. These banks hold a mere 8 percent of total assets of the banking system (see **Figure-3.4**). In view of the growing competition in the market, the survival of these smaller banks depends on mutual consolidation.

Looking at the liability side of the balance sheet, analysis reveals that a major portion, around 74 percent, of the assets growth of Rs622.6 billion over CY05 was funded through deposits and borrowings, which surged by Rs370.1 billion and Rs88.9 billion respectively. Whereas, an increase of Rs108.6 billion in the equity of the banking system over CY05 funded around 18 percent of the growth in total assets

Figure-3.3:- Tier-wise Classification of Banks

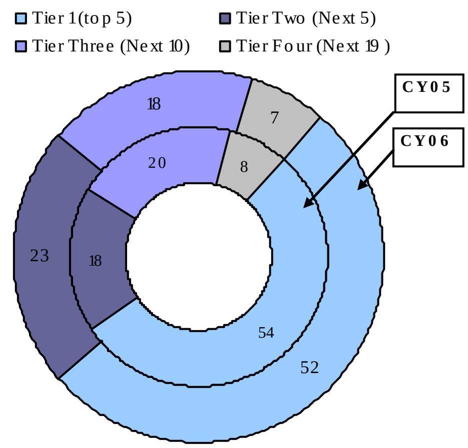
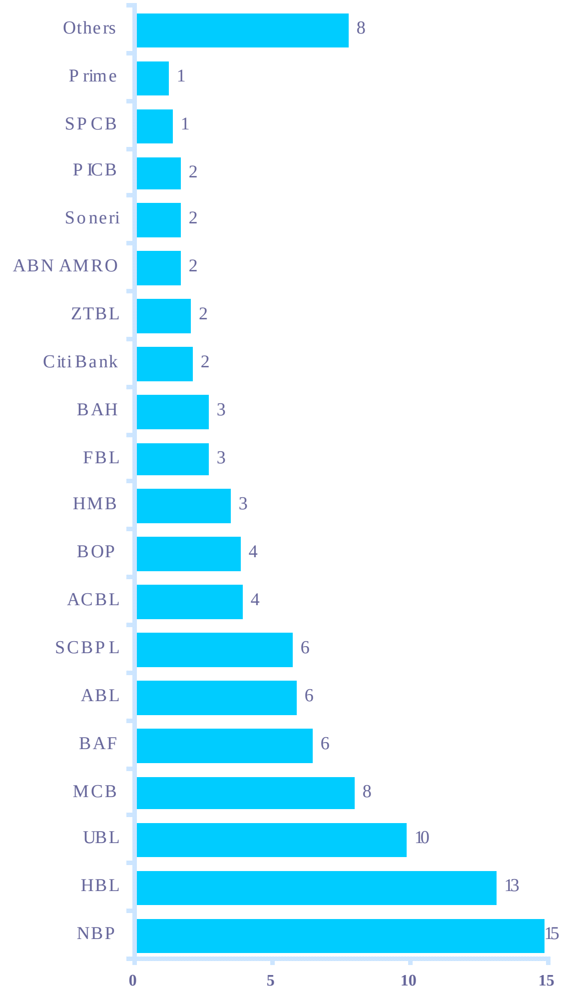
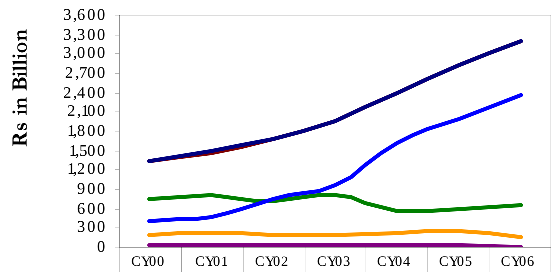


Figure-3.4:- Share of Banks with Assets Above Rs50 Billions



For the last couple of years, sustained **deposits** growth has remained one of the most significant factors behind the robust banking activities and has contributed greatly in accomplishment of strong and sustained bottom line. During CY06 as well, deposits of the banking system grew strongly, however pace of growth remained a bit slower i.e. 13.1 percent against 18.3 percent in CY05 (see **Figure-3.5**). The factors contributed towards sustained deposits growth also include the higher foreign inflow in the form of workers' remittances, and FDI, expanding branch network, product innovation and enhanced marketing efforts.

Figure-3.5:- Deposits of Banking System



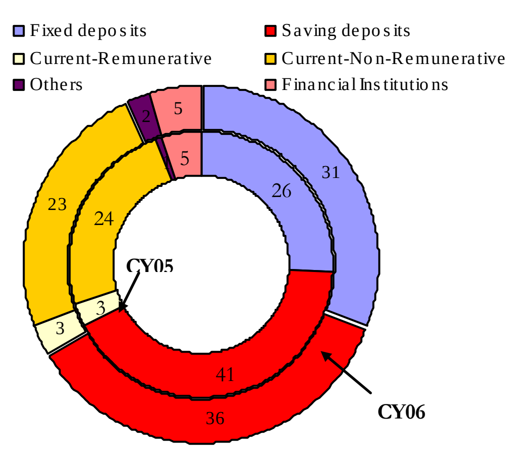
	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	744	795	722	799	545	578	666
LPBs	394	454	757	954	1,604	1,993	2,373
FBs	187	208	183	194	227	245	150
CBs	1,325	1,457	1,662	1,947	2,376	2,816	3,188
SBs	16	18	16	17	17	16	13
All	1,341	1,475	1,678	1,964	2,393	2,832	3,202

The review of group-wise contribution of banks in deposit mobilization shows that the largest growth of 19.1 percent was in LPBs followed by PSCBs at 15.2 percent. Whereas, decline was observed in the case of FBs and SBs. Resultantly, the share of LPBs in the deposits base of the banking system has increased to 74.1 percent from 70.4 percent in CY05. One of the factors behind this increase was, as mentioned earlier, shift of four FBs into LPBs category. The aggregate share of these banks in total deposits was 4.3 percent in CY05. The comparison of share of remaining FBs in total deposits reveals that it has slightly increased from 4.3 percent in CY05 to 4.7 percent in CY06. In the case of SBs, almost the whole decline in deposits can be attributed to a single institution in the SBs category.

Analysis of deposits as per size of banks shows that growth in deposits of five Tier-II banks was 37.4 percent as compared to 9.4 percent for top five Tier-I banks. It reflects an improving scenario depicting a dilution of deposits and emergence of competitive Tier-II segment of banks. It can be further substantiated from the fact that share of five Tier-II banks in deposits has increased to 23.0 percent in CY06 from 18.9 percent in CY05, whereas the share of top five Tier-I banks has declined to 55.4 percent from 57.2 percent in CY05. The emergence of a competitive Tier-II banks segment is expected to induce competition in deposit mobilization and eventually better returns on deposits. The remaining 29 banks hold mere 21.7 percent of the total deposits. These banks, to get competitive in such a challenging environment, will have to explore better alternatives to broaden their deposit base in terms of size, product array and outreach.

Deposits structure of the banking continued the transformation on the pattern of CY05 as the share of fixed deposits increased significantly at the expense of saving deposits (see **Figure-3.6**). Fixed deposits, maintaining the trend of CY05, increased to 31 percent from 26 percent in CY05. On the other hand, saving deposits, which continue to occupy the largest pie, declined to 36 percent from 41 percent in CY05. However, the share of remunerative

Figure-3.6:- Deposits Structure



and non-remunerative current deposits has remained almost same.

This shift in the deposits structure of the banking system was an eventual response to the gradual rise in the rate of return offered on fixed deposits (see **Figure-3.7**). The weighted average deposits' rates, in the backdrop of increased market competition, are persistently rising. This is evident by an increase of 111 bps in the weighted average deposits rates[5] over December 2005. However, the increase in rates for the fresh deposits was yet higher viz. 135 bps over December 2005 (see **Figure-3.8**). The peculiar deposits structure of the banking system with significant preponderance of zero or low yield current and saving deposits can also be held responsible for still overall low return on the deposits. The combined share of such deposits, although reduced from 68 percent in CY05 to 62 percent, is still quite high. Such dominance of zero or low yield current and saving deposits undermined the weighted average deposits' rate for the CY06 by 128 bps. However, the rates are expected to rise further due to stiffening competition for funds and growing pressures from market forces. Due to banks eagerness for raising longer term deposits to match their assts maturity profiles, it is expected that the share of fixed deposits in total deposits of the banking system would continue to further increase in days ahead.

Figure:-3.7:- Comparative Rate Trend (On Stock)

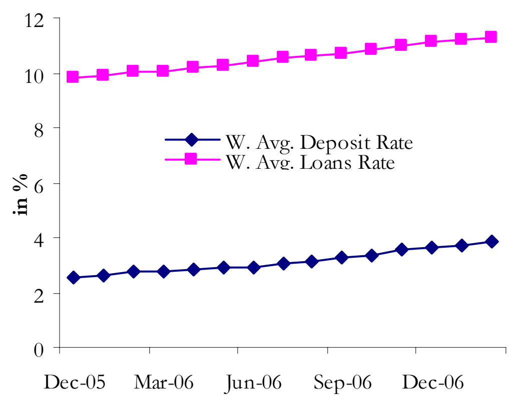
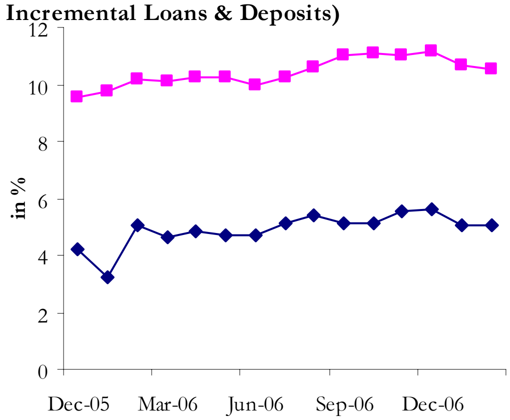


Figure-3.8:- Comparative Rate Trend (on Incremental Loans & Deposits)



Besides deposits, the rising **equity** of the banking system has also been an important source of funds for the banks. During CY06, 17.4 percent growth in total assets was funded by the equity of the banks. This is reflected by an increase of Rs108.6 billion in the equity of banks in CY06 as compared with an increase of Rs90 billion in CY05. The rising contribution of equity is because of the banks' practice to plough back major share of their profits into the system to augment their capital base to meet the enhanced MCR.

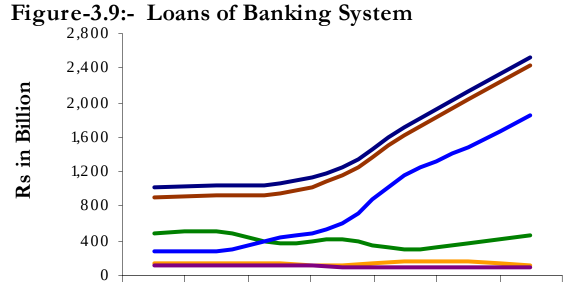
The borrowings, another major funding source for the assets growth of the banking system, have witnessed persistent increase in demand by the banking system. During CY06, total borrowings of the banking system increased by Rs88.9 billion and contributed towards 14.3 percent of assets growth of the banking system. The break up shows that borrowings against repurchase agreement (Repo) and export finance together made up 60 percent of total borrowings against 63 percent in CY05. The borrowings against both these heads increased by Rs9.5 billion and Rs31.5 billion respectively.

[5] Total outstanding deposits including zero rate deposits.

The **loan** portfolio of the banking system grew at a relatively lower rate of 18.8 percent in CY06 as compared to 24 percent in CY05. The slow down was mainly due to deceleration in credit to private sector during CY06. The analysis reveals that the slowdown originated primarily from a deceleration in fixed investment loans, as the working capital requirements have actually accelerated. The deceleration in demand for fixed investment loans was mainly due to sluggishness in some sub-sectors of the real sector of the economy that reduced its ability to absorb additional credit at the same pace as in the last couple of years. The impact of this on aggregate growth of loans was also compounded by the recent mergers /acquisitions in the banking sector, and consequent slowdown in credit operations.

Though, the momentum of growth has relatively reduced in CY06, the absolute increase of Rs399 billion in loans of the bank ing system is still very high **(see Figure-3.9)**. Notwithstanding the tight monetary policy stance of the State Bank, sustained funds inflow enabled the banking system to extend credit to various segments of the economy.

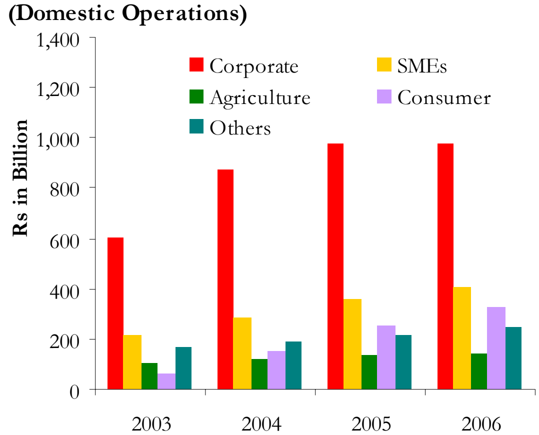
Figure-3.9:- Loans of Banking System



	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	476	501	374	422	302	379	465
LPBs	282	281	435	597	1,153	1,486	1,843
FBs	138	143	135	127	162	171	123
CBs	896	926	945	1,146	1,616	2,036	2,430
SBs	124	118	117	97	99	91	95
All	1,020	1,044	1,062	1,243	1,715	2,126	2,526

The major chunk of growth in loans portfolio was attributed to LPBs. Loans of LPBs, by growing at a rate of 24.0 percent, contributed 89.3 percent of the overall loans growth. Resultantly, the share of LPBs in total loans of the banking system increased to 73 percent from 70 percent in CY05. PSCBs also kept up the pace and grew by 22.9 percent in CY06. The share of PSCBs increased fractionally from 17.8 percent in CY05 to 18.4 percent in CY06. On the other hand, loans portfolio of FBs decreased by 28.5 percent. The decrease was again, as discussed earlier in funding structure, attributed to the shuffling among categories of banks.

Figure-3.10:- Sector-wise Loans Trends (Domestic Operations)



Sector-wise loans trend reveals that the banking system has been carrying on the broad-basing of the loans portfolio as disparity among the quantum of loans in various sector has narrowed down over the last couple of years. It has further broadened the risk diversification and financial access besides generating more productive alternative avenues of earnings. During CY06, the largest increase in loans has been observed in corporate sector i.e. Rs202.9 billion followed by consumer finance of Rs72.4 billion (see **Figure-3.10**).

The credit demand has further moderated during CY06 and deceleration has been witnessed in loans to all the sectors. Consumer finance and SME sectors remained the main sufferer of the deceleration. The consumer finance portfolio of the banks increased by Rs72.4 billion as compared to increase of Rs100.2 billion in CY05. In other words, consumer finances grew by 28.6 percent against 65.7 percent in CY05. Likewise, SME finance witnessed a growth rate of 13 percent in CY06 against 27.2 percent in CY05. However, the pattern of share of various sectors in total loans of the banking system remains more or less unchanged **(see Figure-3.11)**.

An insight of consumer finance reveals that all the consumer financing products registered slowdown. The magnitude of deceleration in CY06 suggests that the overall consumer credit demand has moderated somewhat. In relative terms, a major slow down was witnessed in auto loans and personal loans for which the growth rate reduced from 65.6 percent and 53.2 percent in CY05 to 26.7 percent and 21.6 percent respectively. The slowdown in consumer financing can be attributed mainly to increase in interest rates and rising level of indebtedness.

Slowdown in some of the consumer finance products has lead to some shift in the pattern of their respective share in overall consumer finance. Personal loans continued to have the dominant share, which however, decreased from 42.7 percent in CY05 to 40.4 percent. Whereas, the share of credit cards and mortgage loans has expanded over the year (see **Figure-3.12**). Such pattern of growth has lead to somewhat diversification within the consumer finance.

During CY06, credit cards and mortgage finance witnessed the highest growth of 44.3 percent and 44.0 percent respectively and remained the main factor behind their increased pie in overall consumer finance.

The end-use distribution of loans reflects more or less same pattern as that of CY05, except for the loans for fixed investment and working capital. The share of fixed investment loans was reduced to 21 percent from 23.2 percent in CY05, whereas share of working capital loans increased to 35.3 percent from 33.2 percent in CY05 (see **Figure-3.13**). As discussed earlier, the overall credit slowdown originated primarily from a deceleration in fixed investment loans, as the working capital requirements have actually accelerated.

Figure-3.11:- Loans by Type of Borrowers-CY06 (Domestic Operations)

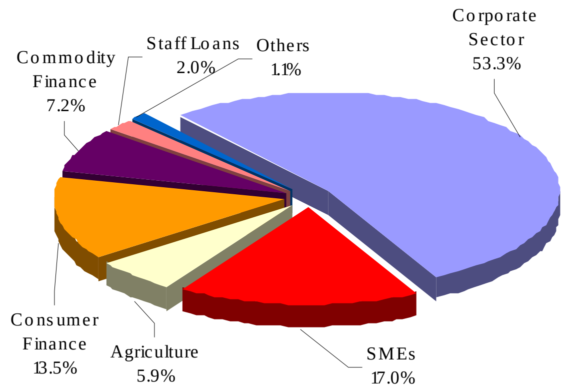


Figure-3.12:- Category-wise Consumer Finance

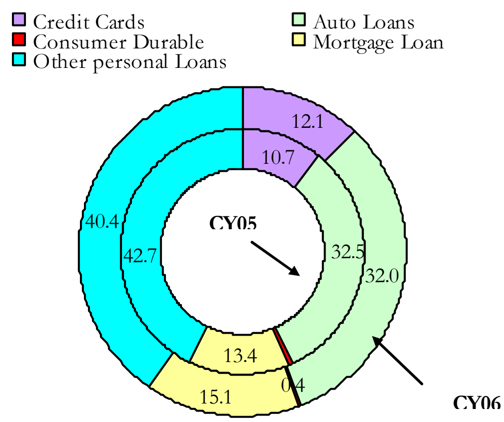
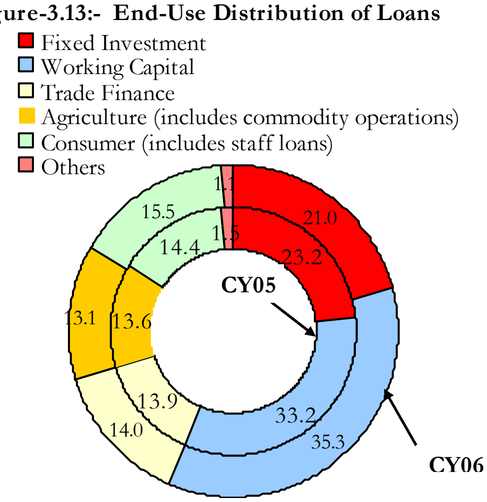
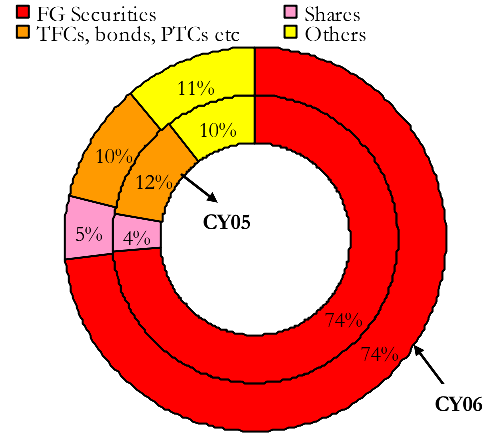


Figure-3.13:- End-Use Distribution of Loans



During CY06, a slight shift has also been observed in assets mix of the banking system. In contrast to the loans, which held share of 55.8 percent against 54.4 percent in CY05, the share of **investments** portfolio decreased to 19.2 percent from 21.9 percent in CY05. Although the slowdown has been witnessed in loans as well, it was more significant in the case of investments. In contrast to CY05, the growth in investments significantly slowed down. During the year, total investments of the banking system grew by 2.9 percent as compared to 17.8 percent in CY05. The analysis of investments portfolio reveals that the share of all the major components remained unchanged. However, the share of TFCs/bonds and other investments decreased slightly (see **Figure-3.14**).

Figure-3.14:- Break-up of Investment



A further analysis of investments in federal government securities reveals that MTBs contributed the largest in their growth. With an increase of Rs22.1 billion, MTBs managed to offset the decline of Rs11.8 billion witnessed by PIBs. Resultantly, the share of MTBs in total government securities of the banking system increased to 66.3 percent from 64.4 percent in CY05. Whereas, the share of PIBs further declined to 23.5 percent from 26.1 percent in CY05. Group-wise, LPBs were the only contributor towards the moderate growth in investments in government securities; rather they offset the decline in all the remaining groups of banks. LPBs registered an addition of Rs52.1 billion in their investments portfolio in government securities. On the other hand, the largest reduction was witnessed in FBs.

4 Sectoral Analysis

4.1 Corporate Sector

Corporate sector, being the largest consumer of the loans of banking system, holds significant importance. The performance of corporate sector has direct bearing on the overall financial health and stability of the banking system as the banks' overall exposure towards this sector is increasing (see **Figure-4.1.1**) and presently it holds a share of around 53 percent. During the period under review, the overall performance of the corporate sector has been quite encouraging. The NPLs to loans ratio for the corporate sector reduced to 6.5 percent from 7.0 percent in CY05. However, there remained some concerns over sustainability of performance of the corporate sector in the backdrop of going up energy cost as well as the rising interest rates scenario which may adversely affect their cash flows.

The increased economic activity and aggregate demand, internal as well as external, have resulted in increased sales and higher profits of the corporate sector. The net profit margins have further improved for all the major contributory sectors of the economy (see **Figure-4.1.2**).[6] Particularly, the cement sector has shown good performance during the last couple of years, as its sales and net profits have increased significantly.

Return on assets (ROA) for the corporate sector, another performance indicator, reflects that the sector has been quite successful in earning reasonable returns on the back of improved production capacities and strong demand (see **Figure-4.1.3**). The return on assets for the cement sector has almost remained unchanged, whereas chemical and sugar sectors have witnessed downward trends during CY06. However, the consolidate position on ROA front has improved.

Figure-4.1.1:- Growth in Corporate Financing

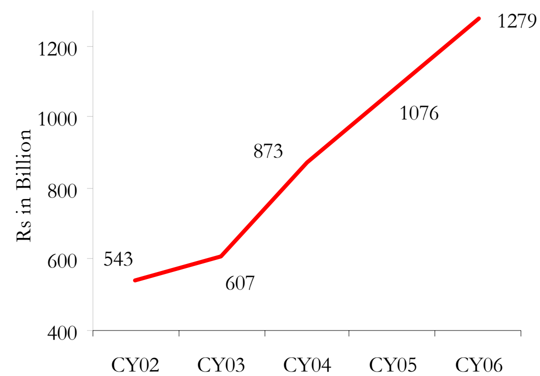


Figure-4.1.2:- Net Profits to Sales

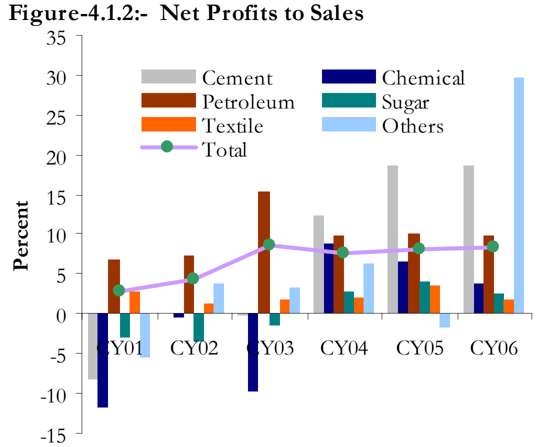
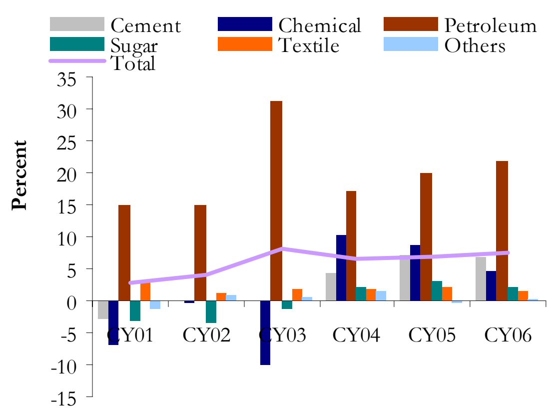


Figure-4.1.3:- Return on Assets

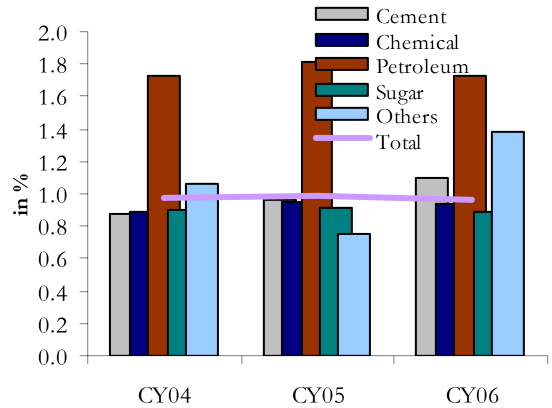


[6] Others include Transport and Engineering Sectors.

While gauging the liquidity position, it is revealed that the current ratio for all the sub-sectors of the corporate sector has further improved (see **Figure-4.1.4**). Such an improvement over the period indicates the effective utilization of current assets by the respective sectors.

The improved profitability of the corporate sector has supported the fresh capital injection to realize the growth potentials in coming years. Resultantly, the financial leverage ratio of the sector has further improved (see **Figure-4.1.5**).

Figure-4.1.4:- Current Ratio of Corporate Sector



Further, the debt-equity ratio also improved as a result of increased owners' funds to finance the long term needs of the sector. The ratio shows a significant decline, indicating an improved solvency position of the sector (see **Figure-4.1.6**).

Figure-4.1.5:- Financial Leverage of Corporate Sector

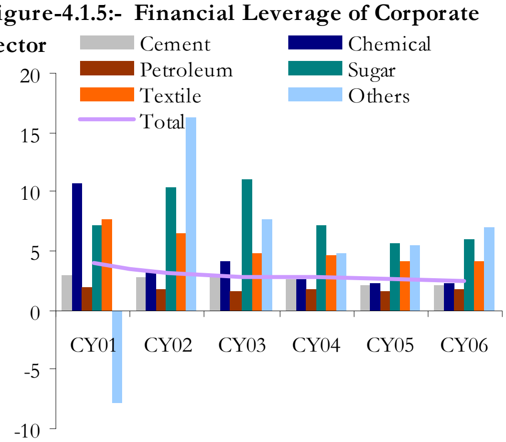
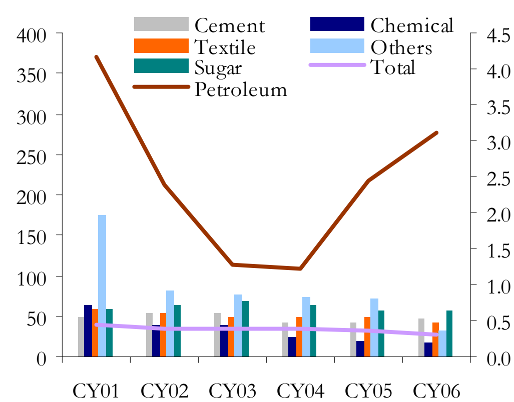


Figure-4.1.6:- Debt to Equity Ratio



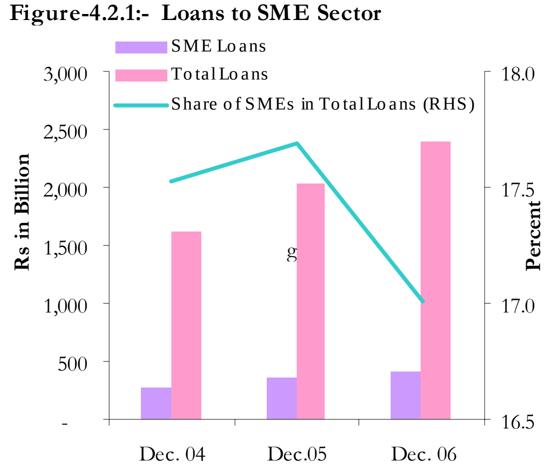
Conclusively, the recent high economic growth, both domestic as well as key trade partner's economies, has bearing on overall performance of the corporate sector. The growth in the manufacturing sector especially the large scale manufacturing has positive impacts on the overall growth of the economy. The performance of the corporate sector is expected to further improve in coming years on the back of increased demand.

4.2 SME Sector

Small and Medium Enterprises (SMEs) play a pivotal role in giving necessary impetus to employment generation, GDP growth and poverty alleviation and hence have been recognized increasingly all over the world. Their size in each country may differ, depending upon the size of the economy however, their contribution in the employment and to innovation in the developed economies make them backbone of the economy. SMEs help to improve forward and backward linkages among social and economic activities, which ultimately create and promote entrepreneurial culture that helps transform economies from low to middle income levels. SMEs' ability to adapt quickly to changes and to identify market niches, apart from their innovative potential, has placed them at a key point within the labor market. These have played key role in the development of economies such as Japan, China, Malaysia and now India. They had also played a key role in providing impetus to the development of some of the world's top economies such as USA, UK, Germany, Taiwan, Korea, and Hong Kong etc.

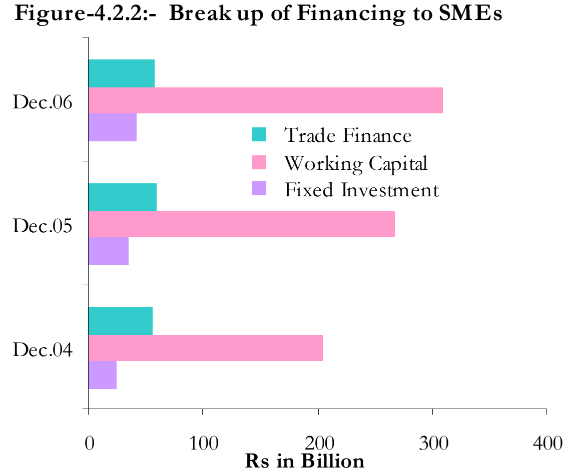
In Pakistan, the sustained focus of banks on SME, Consumer, and Agriculture sectors reflect their desire for loans diversification as well as enhancing their earning base, which previously remained heavily dependent on financing to the corporate sector. Besides substantial surge in consumer finance, rising demand from SME sector has mainly contributed towards persistent and broad-based loan growth in last couple of years. SME sector, in terms of banks' exposure, is the second largest after corporate sector. In absolute terms, the loans to SME sector have increased by Rs47 billion to Rs408 billion, witnessing a 13 percent annual growth during CY06 (see **Figure-4.2.1**). However, since the growth in credit to other components of the private sector like consumer finance was at a rate faster than the growth in the lending to SMEs, this has resulted into a slight reduction in the share of SMEs' in bank credit from 17.7 percent to 17.0 percent[5] in CY06.

Figure-4.2.1:- Loans to SME Sector



The break up of financing to SMEs reveals that around 75 percent of the total SME loans have been extended under working capital (see **Figure-4.2.2**). Trade finance, being the second large component, carry the share of around 14 percent and the rest comes under fixed investment category.

Figure-4.2.2:- Break up of Financing to SMEs



In terms of outreach, it is encouraging to note that the number of borrowers under SMEs has increased from around 67 thousand in 2002 to 168 thousand (see **Figure-4.2.3**) or a growth of 149.2 percent in CY06 over CY02. On the face of it, this level of growth in number of borrowers is quite significant. However, given the total number of SMEs business establishments, the banking sector needs to further increase its outreach to the SME enterprises.

The analysis of quality of loan portfolio reveals that, the quality of SME loans has improved over the year. In absolute terms, the NPLs of the SMEs have declined to Rs36 billion from Rs42 billion in CY05 (see **Figure-4.2.4**). In terms of other sectors, the share of NPLs of SME sector also declined to around 23 percent from 24 percent in CY05. NPLs to loans ratio of this sector went significantly down to 9 percent from 12 percent in CY05 (see **Figure-4.2.5**).

Although the performance of SME sector in Pakistan is quite encouraging, however due to some inherent and structural weaknesses and problems, its access to credit from the formal sector has been inadequate. Lack of information and documentations, reluctance to disclose the financial position, dependence on collateral based lending, lack of awareness programs for SMEs, complexity of lending procedures and process, etc. are some of the common reasons for this lack of access to finance on the demand side.

In order to promote SME Finance, banks need to focus on developing SME specific products, program based lending, and to standardize and simplify the documentation for SME borrowers besides giving due attention to traditional relationship based banking. Since Credit Information Bureaus is capturing all the borrowers, it can play an important role in encouraging the banks to further penetrate this underserved but vital sector of the economy. Further, there is a need to improve delivery mechanisms and channels for SMEs' access to resources in Pakistan in areas such as access to finance, business development services, qualified human resources, and technology to improve their productivity and capacity for employment generation. Market driven support programs are important to attain sustainability, maximize potential for cooperation with the private sector, and to minimize distortions in the economy. Yet the structures for such a system still need to be mutually agreed and implemented in Pakistan.

Figure-4.2.3:- No. of Borrowers of SME Sector

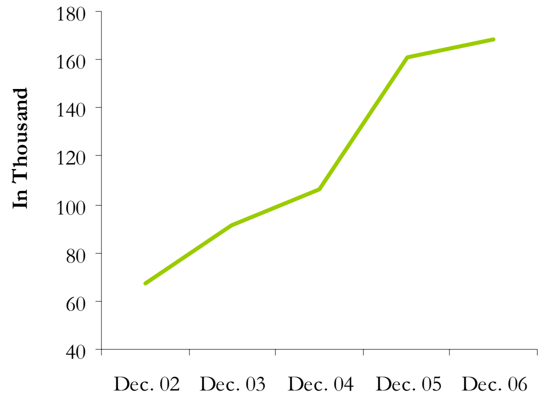


Figure-4.2.4:- Loans to SME Sector

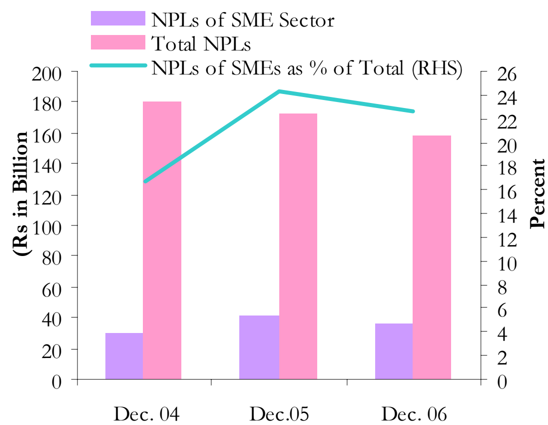
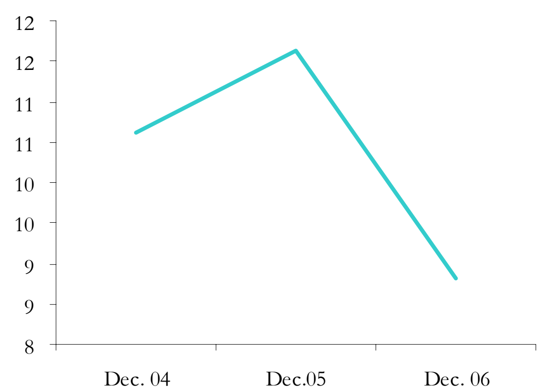


Figure-4.2.5:- NPLs to Loans Ratio of SME Sector (in %)



4.3 Agriculture Sector

Agriculture is the mainstay of Pakistan's economy and is the most important sector for employment and income generation. Nearly twenty-one percent of total output (GDP) and 43.4 percent of total employment is generated in agriculture. It also contributes 66 percent to livelihood of rural population and contributes directly or indirectly up to 60 percent of country's exports. Agriculture also contributes to growth as a supplier of raw materials to industry as well as market for industrial products. Country's GDP is heavily dependant on this sector. The years which witnessed a positive growth in this sector, also observed a healthy growth in GDP and vice versa.

Due to limited access to formal financing modes, a major portion of credit needs of this vital sector of the economy are fulfilled through informal financial arrangements which are not only very expensive but also very exploitive. Despite SBP and Government's extensive efforts, the financing to agriculture has been very low. Historically, specialized banks had been the dominant source of formal credit to the agriculture. To enhance the scope & coverage of agricultural credit scheme, SBP in consultation with participating banks and farmers' representatives totally revamped the scheme. In addition to five major commercial banks, PPCBL and ZTBL, 14 domestic private commercial banks have also been included for financing to agriculture sector as a result agricultural credit disbursements has been increased significantly. The target of Rs160 billion for FY07 has been comfortably achieved.

The share of agricultural credit compared to overall credit portfolio of banks is around 6 percent, which is a very low (see **Figure-4.3.1**). The share further declines to 3 percent if we exclude the share of specialized banks. Of the total loans extended by the specialized banks around 96 percent have been extended to the agriculture sector.

In absolute terms, total loans to agriculture have been increased to Rs142 billion (11 months) from Rs138 billion in FY05 (see **Figure-4.3.2**). However, since the overall loan portfolio grew with much greater pace, the share of agriculture loans to total loans has declined to around 5.9 percent from 6.8 percent in CY05 and 7.4 percent in CY04. The outstanding NPLs of agriculture sector have dropped significantly and stand at Rs29 billion in CY06 as compared to Rs43 billion in CY05. However, in percentage terms, they are still highest among all the sectors i.e. corporate, consumer and SMEs. Besides some inherent weaknesses, a relatively higher rate of default in agriculture sector may be the reasons for banks

Figure-4.3.1:- Share of Agriculture Financing

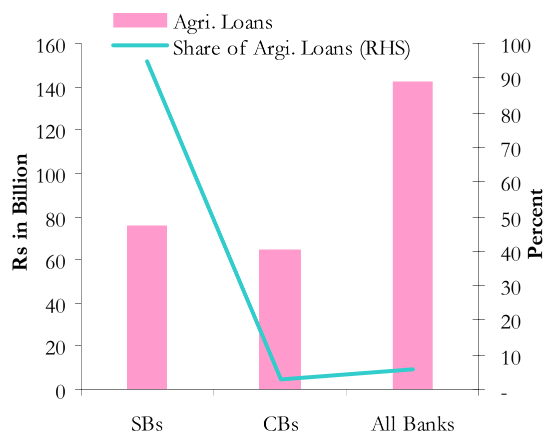
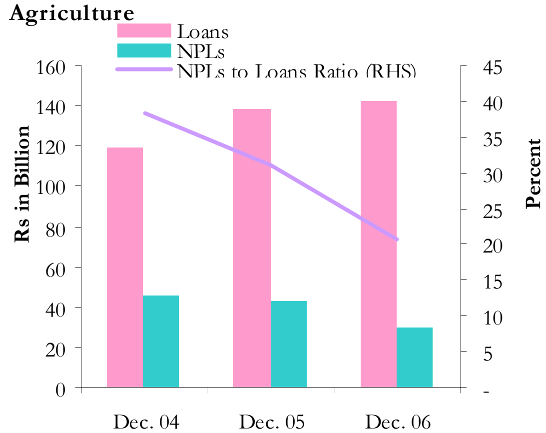


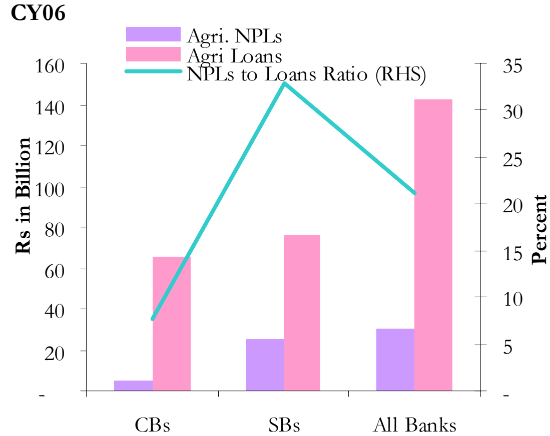
Figure-4.3.2:- Loans & Quality of Loans to Agriculture



disinclination towards taking significant exposure in this volatile sector.

Group wise position shows that, the infection ratio of commercial banks, although quite high when looked in isolation, is better than that of specialized banks (see **Figure-4.3.3**). NPLs to loans ratio of specialized banks is at around 33 percent while in case of commercial banks it stays at 8 percent.

Figure-4.3.3:- Quality of Agriculture Financing-CY06



The global order is changing fast and consequently challenges facing agriculture sector are becoming increasingly demanding. The future of this sector and its contribution to the national economy will depend on how agriculture is positioned to meet the internal and external market challenges. In Pakistan, agriculture has a unique role to play in growth, poverty alleviation, employment, and environmental protection. In recent past, agriculture growth has varied. The crop sector growth has been on the decline but the robust growth of Livestock sector is positive indicator. The appropriate role of Government is to become the enabler of smoothly functioning markets through institutional and regulatory reforms that facilitate private sector activities and market efficiency. Pakistan requires new strategies to enhance input efficiency and to maintain and improve the quality of the resource base. Productivity and sustainability are being enhanced by improvement in crop and resource-management research. The reform program will ensure coordination among both national and provincial research institutions improved, so that unnecessary duplication is avoided.

Challenges Faced by the Agriculture Sector

While there have been significant improvements in the competitiveness of agriculture through policy reforms, the characteristics of seasonality, dispersed farm settlements, widespread and deep poverty and covariant risks make agriculture overall less attractive for financial intermediaries. Agriculture sector in Pakistan is still facing a number of serious problems, among others; non-availability of sufficient credit has been one of the major impediments in the development and growth of the sector. The challenges faced in the enhancement of flow of credit to the agriculture are:

Non diversification and concentration of credit to farm sector: Although farm and non- farm sectors' contribution is almost equal in GDP, however, in flow of credit there is a great disparity among these to sub sectors of agriculture. Farm sector share in total disbursement was 92 percent in FY02 declined to 84 percent in FY06, similarly share of non-farm sector increased from 8 percent to 16 percent during this period.

Limited institutional capacity: Agricultural finance has been a neglected area till the recent past and banks in general had not considered it as a business segment leading to a lack of related institutional capacity building to operate in the field as a viable business proposition. This has been one of most important factors responsible for limited penetration of banks in the rural financial markets. Some of the key dimensions of the capacity limitations are:

Passbook issues: The most common collateral available to farmers is the passbook issued by the provincial revenue authorities. Non availability of passbooks, issues of fake passbook and non-cooperation of revenue authorities with the banks and borrowers are one of the major bottlenecks fast credit penetration in agriculture sector.

Lack of awareness of financial services on offer: Farming community, particularly small farmers, are unaware of the products and services offered by financial institutions and are still using the informal sector services for meeting their financial needs at very high costs. Moreover small farmers are considered as un-bankable/unviable due to their inability to meet the loan collateral requirement and lengthy procedure for loaning.

Viability of the borrower: The geographical distribution of land is very uneven in Pakistan. Above 39 percent of the farm area (81 percent of the Farms), comprise of uneconomic size farms. Costs of inputs are high and farm gate prices are very low, which are major disincentives to the farmers. Antiquated farming practices prevail in over 50 percent of the farm area and use of substandard inputs result in low yield. This makes the borrowers unviable for the credit. In addition, they have to bear the unforeseen losses in case of natural calamities due to non- availability of loan insurance.

Weak infrastructure: Weak research and limited capacity of the concerned departments to disseminate the research findings to farmers at the grass roots; limited or non-existent marketing channels inhibiting farmers' ability to fetch better prices of their produce; fragile rural infrastructure with limited farm to market roads network; inadequate health facilities; limited availability of veterinary hospitals and animal health facilities are factors contributing to under performance of the sector as a whole. There is also insufficient storage capacity at the time of harvest and as a consequence at times farmers have to sell their produce at throw away prices.

Inadequate and substandard inputs supply: In addition to other problems, the farmers are unable to get good quality seeds, fertilizers and pesticides despite paying high prices. This has resulted in low yield and loss of crops and labor of the farmers. There is lack of research for innovative highbred seeds, organic as well as inorganic cropping techniques, effective pesticides and fertilizers and other related services.

Improper marketing & lack of marketing information systems: The worst comes to the farmers at the time of harvest. They need to get timely and good price for his produce. There are no proper marketing systems. The farmers are unaware with the current as well as future prices. Improper marketing and lack of market information system result in high rate of waste of produce and unfavorable prices to the farmers.

Lack of farm management knowledge: Lack of farm management knowledge including record keeping, basic accounting, financial planning and appraisal is another factor responsible for low growth in this sector. There is lack of coordination among various institutions, agricultural departments, extension services and allied projects, these players provide little insight to the banks for developing long term plans and vision at the top management levels and also to the farming community to develop fragmented linkages within the agricultural commodity value chains to have more value added products for local consumption as well as for exports.

Non availability of collateral: Small farmers usually do not have any collateral to offer as such they can not have access to the banks' credit. SBP has already allowed banks to extend credit to rural population on personal sureties and hypothecation of crops/animals. However, most of the farmers particularly working on rented farms are still not be able to provide collateral to banks.

Measures Taken by SBP to Promote Agriculture Financing

In line with the Government's declared priority of uplifting the agriculture sector, State Bank of Pakistan has taken several initiatives during the last 5-6 years to ensure adequate flow of agricultural credit through banks which inter alia include:

Revamping of the Supervised Agricultural Credit Scheme: SBP in consultation with participating banks and farmer representatives revamped the credit scheme to enhance the scope & coverage of agricultural credit scheme. The scheme now includes a complete value chain of activities from farm inputs, transportation, storages, godowns, processing of fruits and vegetables, agriculture equipments, machinery & implements, polishing, crating, grading, livestock, dairy products, forestry, fisheries, poultry, orchards to distribution and exports. In addition to traditional five major commercial banks, two specialized bank, 14 domestic private commercial banks have also been included for financing of agricultural credit. Local advisory committees have been established at 16 SBP-BSC offices to resolve problems of the farming community locally.

Simplification of Rules & Regulations: To enable the banks to finance aggressively in agriculture sector SBP has withdrawn restriction on territorial jurisdiction for lending agricultural credit. Banks were allowed to finance against market / realizable /forced sale value of the agriculture land, urban properties , gold/silver ornaments, DSCs, SSCs etc. and also against two personal sureties (up to Rs.500,000) in addition to passbook and PIU value of the land.

Revolving Credit Scheme: Revolving Credit Scheme was introduced in 2003 to meet the seasonal requirements of the farming/rural community and to avoid unnecessary delays in the documentation procedures. This is a running finance scheme for a period of 3 years for production loans with one time documentation. The limit automatically renews on the cleaning of the account (Principal and Mark-up), with date convenient to borrower, once a year. The scheme is a huge success and most of the agricultural financing products are being covered under this structure. It constitutes almost 65 percent the agricultural credit portfolio of the banks.

Dissemination of Information, Special Outreach Training Programs: For awareness of the farming community and banks, SBP has published brochures about agricultural loans scheme/ revolving credit scheme which were translated into Urdu and regional languages and distributed among stakeholders. Moreover, special outreach and training programs organized in collaboration with commercial banks are a part of SBP campaign to create awareness among the farming/rural community about agri-financing facilities they can access and also to enhance the capacity of commercial banks in agricultural & rural finance by providing training to local agricultural credit officers of the banks. The campaign started in 2003 and has covered 40 centers in 5 phases so far.

Standardization of Documents: With the consensus of all the banks, SBP has simplified/ standardized agricultural loans documents for the benefit and convenience of farming community. For production loans numbers of documents have been reduced from 14 to 5, and for development loans, from 21 to 6. These documents /forms have also been translated/ printed in Urdu and other regional languages for their benefit.

Prudential Regulations for Agriculture Financing: Separate prudential regulations for agriculture financing, prepared in consultation with banks and other stakeholders were issued to banks during in FY06. PRs will provide a broader regulatory framework to the banks/DFIs. PRs encourage banks to diversify their agricultural portfolio in terms of geographical areas, types of financing, etc. to avoid the risks of concentration of credit. Banks are also encouraged to extend agricultural financing on the basis of future cash flows, instead of relying solely on the collateral.

Guidelines for Livestock and Fisheries Financing : SBP has also issued guidelines for livestock financing in August 2006 and for fisheries financing in March 2007, to facilitate and encourage Banks/FIs in enhancing credit flow to these sectors. The Guidelines cover all areas of the livestock and fisheries financing business including products development and their review, purposes and objectives of the loan, eligibility of borrowers, delivery channels, monitoring mechanism, etc.

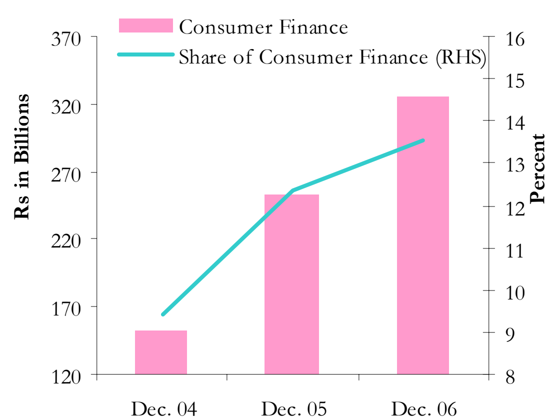
In addition to these a number of other steps have been taken which includes; strengthening of ACAC, Crop Loans Insurance Scheme, development of Islamic products for agriculture financing, group based/collateral free lending to small farmers, scheme for poultry financing etc. Further, SBP has continuously been in liaison with federal /provincial revenue authorities, banks and farming/ rural community. The consultative process through biannual meetings of ACAC remains most effective since the last few years. The stakeholders have appreciated the efforts of SBP in increasing the flow of credit to agriculture sector through various initiatives

4.4 Consumer Sector

Banking sector in Pakistan has undergone a significant transformation in the recent years and has also acted as a catalyst in the revival of the economy. The improvement in the banking sector has been not only in terms of asset growth and profitability but also in terms of diversification of products and risk profile. The banks have penetrated into some of the previously underserved areas like consumer finance which has witnessed substantial growth in recent years. This trend was not exceptional in Pakistan, since across many emerging market countries, the growth rate of consumer credit even has outpaced other sectors. The contributing factors behind such a high growth in consumer finance may includes low interest rates, flush of liquidity, product innovation, increased competition, financial liberalization, and growing income level in the back of on going high economic growth. Besides higher return and risk diversification considerations, banks' may have been taking higher exposures in consumer finance to avail the benefits under Basel II, as consumer finance products relatively require lower capital charge under credit risk (consumer 75 percent and mortgage 35 percent) compared to unrated corporate loans which carry a charge of 100 percent.

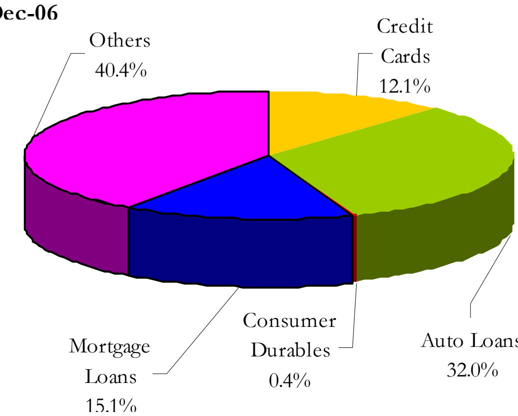
It is widely acknowledged that consumer credit, within prudent and sustainable limits, is desirable for economic growth, smoothing consumption and improving credit risk diversification. At the same time, unsustainable consumer growth in weak macroeconomic environment, ineffective prudential and regulatory framework, weak risk management system and legal infrastructure can create systemic vulnerabilities. However, such potential systemic vulnerabilities in a particular economy can be assessed in the context of the level of consumer finance in terms of total credit and GDP, its trends, composition and structure, major credit provider, level of indebtness of the consumer, effectiveness of regulatory /supervisory/legal framework and adequacy of relevant infrastructure.

Figure-4.4.1:- Trend in Consumer Finance



In Pakistan, consumer finance has been growing both in absolute and relative terms in recent years. During CY06, consumer loans have witnessed an increase of Rs72.4 billion or 29 percent and reached to Rs325 billion (see **Figure-4.4.1**). On the back of persistent higher growth, the share of consumer finance in overall loans has increased to 13.5 percent in CY06 from 9.4 percent in CY04.

Figure-4.4.2:- Category wise Consumer Finance-Dec-06



Product wise analysis of consumer finance revealed that personal loans carried the highest share i.e. 41 percent followed by auto finance, mortgage loans and credit cards (see **Figure-4.4.2**). Though, in rupee terms, the value was not that high, however, in growth terms both credit cards and mortgage loans witnessed the highest growth (see **Figure-4.4.3**) during last couple of years. Consumer durables, which already carried an insignificant share, have further declined in CY06. In value terms, auto loans registered highest increase.

In terms of exposure, the level of indebtness of consumers in all the products except auto and consumer durable has been rising persistently (see **Table 4.4.1**). As per the nature of the product, the average per borrower exposure of mortgage loans was the highest, followed by auto loan, other personal loans and credit cards. Since mortgage and auto loans are adequately secured, the rising exposures in these products may not pose serious credit risk threats to the banks. However, rising level of consumer's indebtness on account of personal loans and credit cards, which are considered unsecured lending, warrant attention of the banks management. The analysis of total credit cards issued i.e. 1.5 million and number of borrowers reveals that on an average, each credit card borrower has two cards from different banks. When compared with the total number of bank depositors having deposit size of Rs10, 000 and above, the number of credit card customers is significantly lower i.e. less than 10 percent.

Though the overall quality of the consumer finance has been good, it has started some weakening. During CY06, the quality of consumer portfolio witnessed some deterioration as NPLs of this sector increased to Rs7.0 billion from Rs3.1 billion in CY05. In terms of loans, this ratio increased to 2.2 percent from 1.2 percent in CY05 (see **Figure-4.4.4**). Though the infection ratio of the consumer sector is rising, it is still lowest among all the borrowing sectors. Further, this level of 2.2 percent is considerably lower than the weighted average level of general provisioning required to be provided against consumer finance. Product wise, the infection ratio of all the categories remains below 3 percent except that of consumer durables, the share of which is negligible.

Figure-4.4.3:- Trend in Category wise Consumer Finance (Rs in Billion)

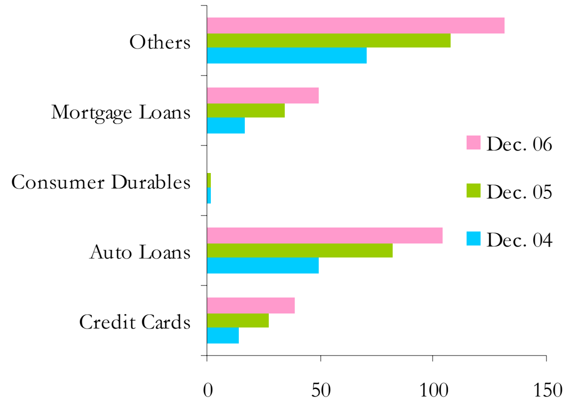
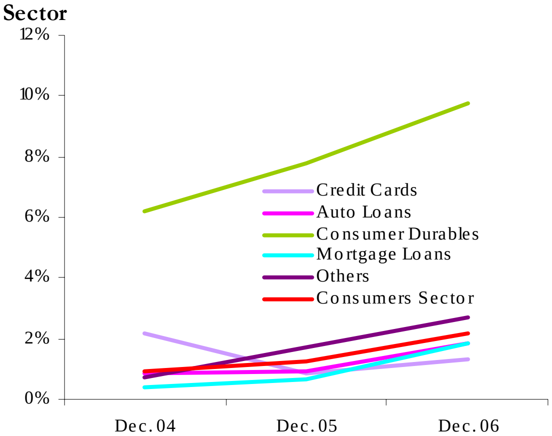


Table-4.4.1:- Exposure per Borrower Rs. in '000'

	CY04	CY05	CY06
Credit Cards	23	26	32
Auto Loans	423	430	411
Consumer Durable	37	29	22
Mortgage Loan	1,572	1,982	2,025
Other personal Loans	82	89	100
Total Consumer Finance	**94**	**105**	**121**

Figure-4.4.4:- NPLs to Loans Ratio of Consumer Sector



This is also evident from the fact that, while the amazing growth in consumer finance has contributed to a surge in banking profitability, it has also raised concerns from certain quarters. The increasing loan infection ratio of this segment does merit some critical inquiry as the stability of the banking sector due to its close proximity with the real sector and its importance as a saving medium is critical for the sustained growth of any economy.

However, it is also imperative to look the share of consumer portfolio in overall context i.e. in terms of total loans or GDP, compare it with the trends in other economies/regional countries, examine key factors like legal and regulatory framework, information sharing arrangement and of course overall macro-economic environment, before taking it as a serious concern.

In Pakistan, despite exceptional growth trend in recent years, consumer finance accounts for less than 14 percent of the total outstanding credit of the banking sector. When compared to the emerging economies, Pakistan still falls below the international norms and is still lower than most of its regional peers (see **Figure-4.4.5**). In contrast by 2005, in emerging Asian economies the share of consumer credit was close to 31.4 percent, in mature financial markets it was 41.5 percent and in Latin American economies it was 35.7 percent

Moreover, it would be interesting to know that average quantum of consumer credit to GDP ratio of Pakistan is also quite low i.e. at 5.86 percent in CY06 (see **Figure-4.4.6**). As for the emerging Asia by 2005, it was around 27 percent (see **Figure-4.4.7**[7]) and even countries with similar per capita income levels to Pakistan, have relatively higher ratios.

Figure-4.4.5:- Share of Consumer Credit in Total Private Sector Credit (in %)

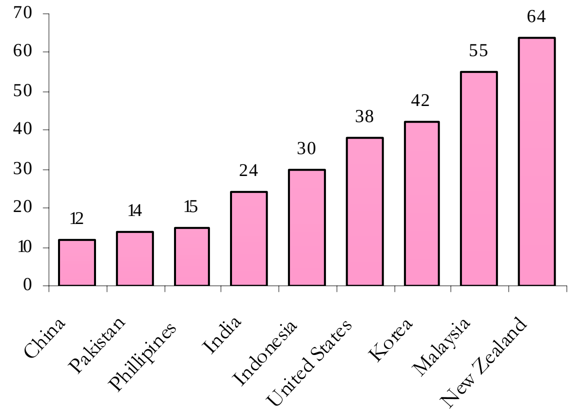


Figure-4.4.6:- Consumer Finance to GDP Ratio

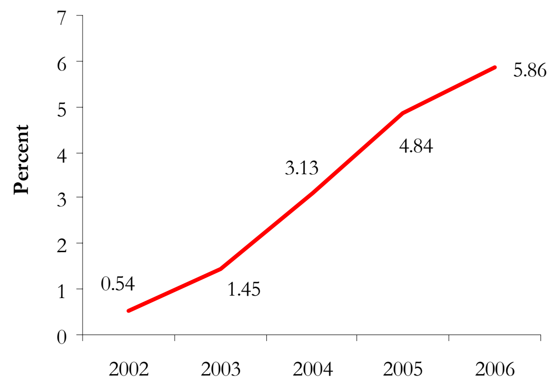
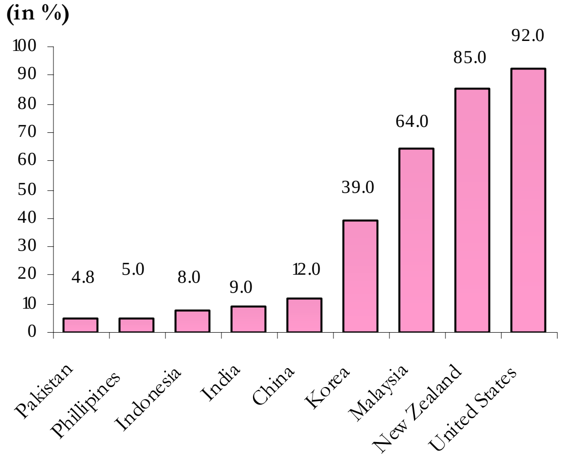


Figure-4.4.7:- Consumer Credit to GDP Ratio-2005 (in %)



[7] Sources: IMF, *World Economic Outlook*; CEIC; and IMF staff estimates based on data from country authorities.

As compared to other sectors, consumer finance has so far shown a very low level of NPLs in Pakistan. In fact at 2.2 percent, the NPL ratio is lower than Corporate (6.5 percent), SME (8.8 percent) and Agriculture (21 percent). This level of NPL of the sub components of consumer credit are considered well within the sustainable limits. In addition, this level is also lower than many countries including Malaysia, Philippines and United States.

Conducive macroeconomic environment is a must for the healthy development of credit markets including consumer credit. In Pakistan, healthy growth in the economy and the low interest rate environment over the past few years kept up this significant growth in consumer finance. However, the recent inflationary tendencies and the subsequently rising interest rates in response to curb the inflationary pressures may hurt not only the growth of consumer finance in future, but may also impact the repayment capacity of the borrower.

Summing up, the consumer finance though is a growing area of activity in Pakistan, is still smaller in terms of its volume and share. Its present level of infection is low and manageable. Since the quality of consumer finance has experienced some deterioration, the concern, that if it continues to increase to alarming level it may directly affect the assets quality and profits of the banks, holds some merit considerations. In this respect, cognizant of the riskier nature of this business, SBP has taken prudent stance in supervising and monitoring banks this area of financing, by issuing a separate set of PRs - limiting the exposures in terms of equity, devising a pre-defined criteria for the banks going into this area and implementing a comprehensive and modern CIB reporting. Therefore, so far Pakistan has not depicted any visible signs that banking sector stability is vulnerable due to high exposures in consumer credit as the level is still below the international norms. The banks should nevertheless, remain vigilant to ensure that exposures in consumer finance should be within sustainable limits perfectly inline with their risk appetite.

Box 4.4.1

Consumer Finance-Legal/Regulatory and Supervisory Framework

In Pakistan, compared to some of other emerging economies, the consumer credit has been chiefly provided by the formal banking sector which is relatively better regulated and supervised. From the very beginning, consumer credit in Pakistan has been properly regulated and supervised. Acknowledging that the consumer credit would need a different kind of prudential and regulatory framework, SBP issued separate prudential regulations (PRs) for consumer credit. These regulations have been formulated with the aim of strengthening risk management capacity specific for the consumer financing. These PRs explicitly define pre-operation requirements for the banks before venturing into the business of consumer financing which include preparation of comprehensive consumer credit policy duly approved by the Board of Directors of the banks, development of specific program for every type of consumer finance activity, development and implementation of efficient computer based MIS for consumer finance activity, development of comprehensive recovery procedures for the delinquent consumer loans, imparting sufficient training to the banks' staff, preparation of standardized set of borrowing documents and recourse documents and become member of at least one Consumer Credit Information Bureau.

These PRs have continuously been updated to incorporate the emerging innovative products and risks emanating from them. The PRs link the consumer credit exposures of the banks to their track record of NPLs and equity. Exposure limits have been set on part of both the borrowers and lenders. According to the PRs, banks are limited to a maximum consumer credit exposure of 10 times of their equity provided the ratio of their classified consumer loans to total loans is below 3 percent. However, if it is higher, the exposure limit is accordingly reduced. For example for the ratio at 3-5 percent, the maximum limit reduces to 6 times of the equity and for up to and above 10 percent, it is reduced to merely 2 times of the equity). This linkage ensures that the total exposure to consumer credit remains within limits and is tied further to the bank's risk mitigation ability. Moreover, in addition to the required provisiong, PRs require an additional general reserve of 5 percent for unsecured and 1.5 percent for secured consumer loans as additional risk premium for this risky venture so that additional losses incurred could easily be absorbed without taking additional hit on capital. During 2006, the level of the banks and DFIs was also assessed and these institutions were categorized into Largely Compliant, Partially Compliant and Non Compliant with respect to meeting these preconditions. Based on these, the steps have been taken to contain the exposures of the non-compliant banks.

Further, this overall regulatory environment is well supported through a comprehensive credit information bureau (CIB) which covers a complete set of financial and personal information of the borrower including positive and negative, which helps in assessing the credit worthiness and default history of the consumer. All banks, including those engaged in consumer fiancé are required to be members of credit bureaus.

A comprehensive supervisory framework comprising of onsite inspection and offsite surveillance in SBP also helps in effective and proactive monitoring of the banking system. Vigilant about the risk appetite of the banks, and cognizant about the level of risk in the area of consumer finance, SBP warranted and limited the credit exposures of some of the banks in this area on the basis of level of compliance with pre-defined criteria. This proactive supervisory approach lessens the otherwise foreseeable threats to this sector.

GENERAL GUIDELINES FOR CONSUMER FINANCE	
Minimum requirements for consumer financing	1. Banks/DFIs shall establish separate Risk Management capacity for the purpose of consumer financing, which will be suitably staffed by personnel having sufficient expertise and experience in the field of consumer finance /
	2. The banks / DFIs shall prepare comprehensive consumer credit policy duly approved by their Board of Directors (in case of foreign banks, by Country Head and Executive / Management Committee), which shall interalia cover loan administration, including documentation, disbursement and appropriate monitoring mechanism. The policy shall explicitly specify the functions, responsibilities and various staff positions' powers / authority relating to approval / sanction of consumer financing facility.
	3. For every type of consumer finance activity, the bank / DFI shall develop a specific program. The program shall include the objective / quantitative parameters for the eligibility of the borrower and determining the maximum
	4. Banks / DFIs shall put in place an efficient computer based MIS for the purpose of consumer finance, which should be able to effectively cater to the needs of consumer financing portfolio and should be flexible enough to generate necessary information reports used by the management for effective monitoring of the bank's / DFI's exposure in the area. The MIS is expected to generate the following periodical reports:
	• Delinquency reports (for 30, 60, 90, 180 & 360 days and above) on monthly basis
	• Reports interrelating delinquencies with various types of customers or various attributes of the customers to enable the management to take important policy decisions and make appropriate modifications in the lending program.
	• Quarterly product wise profit and loss account duly adjusted with the provisions on account of classified accounts. These profit and loss statements should be placed before the Board of Directors in the immediate next Board Meeting. The branches of foreign banks in order to comply with this condition shall place the reports before a committee comprising of CEO / Country Manager, CFO and Head of Consumer Business.
	5. The banks / DFIs shall develop comprehensive recovery procedures for the delinquent consumer loans. The recovery procedures may vary from product to product. However, distinct and objective triggers should be prescribed for taking pre-planned enforcement / recovery measures.
	6. The banks/DFIs desirous of undertaking consumer finance will become a member of at least one Consumer Credit Information Bureau. Moreover, the banks / DFIs may share information/data among themselves or subscribe to other databases as they deem fit and appropriate.
	7. The financial institutions starting consumer financing are encouraged to impart sufficient training on an ongoing basis to their staff to raise their capability regarding various aspects of consumer finance.
	8. The banks / DFIs shall prepare standardized set of borrowing and recourse documents (duly cleared by their legal counsels) for each type of consumer.
Limit on exposure against total consumer financing	Limit has been set and linked with the ratio of classified consumer financing to total consumer finance. If this ratio is more than 10 percent then total exposure in consumer finance is capped at 2 times of equity. Whereas for the ratio below 10 percent, below 5 percent and below 3 percent, this cap is increased to 4 times, 6 times nad 10 times of equity respectively.
CREDIT CARDS	
Statement of accounts	Banks / DFIs shall provide to the credit card holders, the statement of account at monthly intervals, unless there has been no transaction or no outstanding balance on the account since last statement.
Maximum card limit	Maximum unsecured limit under credit card to a borrower shall generally not exceed Rs 500,000/.
Classification and provisioning	Only one category of classification i.e. "Loss". Provision of 100% of the difference resulting from the outstanding balance of principal less the amount of liquid securities with the bank/DFI.
AUTO LOANS	
Prohibition on financing commercial vehicles.	The vehicles to be utilized for commercial purposes shall not be covered under the Prudential Regulations for Consumer Financing.
Maximum tenure of loan	The maximum tenure of the auto loan finance shall not exceed seven years.
Minimum down payment	While allowing auto loans, the banks / DFIs shall ensure that the minimum down payment does not fall below 10% of the value of vehicle.
Repossession of vehicles	The clause of repossession in case of default should be clearly stated in the loan agreement mentioning specific default period after which the repossession can be initiated.
Financing the purchase of used cars	In no case the bank / DFI shall finance the cars older than five years.
Classification and provisioning	Limit has been set and linked with the ratio of classified consumer financing to total consumer finance. If this ratio is more than 10 percent then total exposure in consumer finance is capped at 2 times of equity. Whereas for the ratio below 10 percent, below 5 percent and below 3 percent, this cap is increased to 4 times, 6 times nad 10 times of equity respectively.
HOUSING FINANCE	
Maximum per party limit	Banks / DFIs shall ensure that the total monthly amortization payments of consumer loans, inclusive of housing loan, should not exceed 50% of the net disposable income of the prospective borrower.
Debt-equity ratio	The housing finance facility shall be provided at a maximum debt-equity ratio of 85:15.
Maximum tenure of loan	Banks / DFIs are free to extend mortgage loans for housing, for a period not exceeding twenty years.
Mortgage	The house financed by the bank / DFI shall be mortgaged in bank's / DFI's favour by way of equitable or registered mortgage.
Classification and provisioning	Provisions are set as 25 percent, 50 percent and 100 percent for the substandard, doubtful and loss categories respectively.
PERSONAL LOANS	
Per party limit	The clean limit per person for personal loans will generally not exceed Rs 500,000/-
Hypothecation	In cases, where the loan has been extended to purchase some durable goods / items, including personal computers and accessories thereof, the same will be hypothecated with the bank / DFI besides other securities, which the bank / DFI may require on its own.
Maximum tenure of loan	The maximum tenure of the loan shall not exceed 5 years. However, this period may be extended to 7 years for loans / advances given for educational purposes.
Classification and provisioning	Provisions are set as 25 percent, 50 percent and 100 percent for the substandard, doubtful and loss categories respectively.

5 Financial Soundness of the Banking System

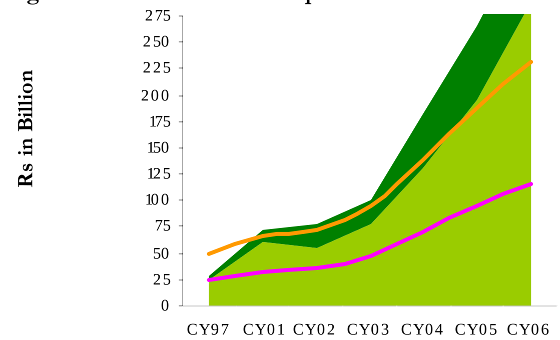
5.1 Solvency

Solvency position of the banking system further strengthened and hence set new standards for the industry during CY06. Major support came from the persistent strong profits and capital injections to meet the enhanced minimum capital requirement, which was Rs3 billion as of December 31, 2006[8]. Further, the process of mergers & consolidation in the banking system also extended hand to strengthen the solvency of the banking system.

Of the key solvency indicators, the qualifying risk-based capital witnessed a marked increase of Rs99.4 billion to reach the level of Rs364.5 billion during CY06. In percentage terms, it grew by about 37 percent. The quality of risk based capital also strengthened further as around 93 percent of this increase came from the core capital, which increased by Rs90 billion to Rs288 billion (see **Figure-5.1.1**) In percentage terms, the core capital, maintaining its historical trend, grew by around 48 percent in CY06. However, the supplementary capital witnessed a growth of 9 percent against the 37 percent in CY05. Resultantly, the share of core capital in the total risk-based capital increased to 79 percent from 74 percent in CY05 (see **Figure-5.1.2**).

Despite significant growth in risk weighted assets, capital adequacy ratio (CAR) further strengthened over the year. Total risk-weighted assets of the banking system increased by Rs527 billion during CY06, as a result the share of RWAs in total assets increased to 67.3 percent from 64.3 percent in CY05 (see **Figure-5.1.3**). The growth in risk weighted assets at around 22 percent was lower than that of the previous year's

Figure-5.1.1:- Risk-based Capital Position



	CY97	CY01	CY02	CY03	CY04	CY05	CY06
Supplementary Capital	2.9	12.0	23.5	23.3	50.8	69.7	76.2
Core Capital	25.4	60.5	55.2	77.0	131.7	195.3	288.3
Required Core	25.0	33.1	35.9	47.3	69.6	94.2	115.2
Required Total	50.0	66.2	71.8	94.7	139.3	188.3	230.5

Figure-5.1.2:- Capital Structure and Capital Adequacy

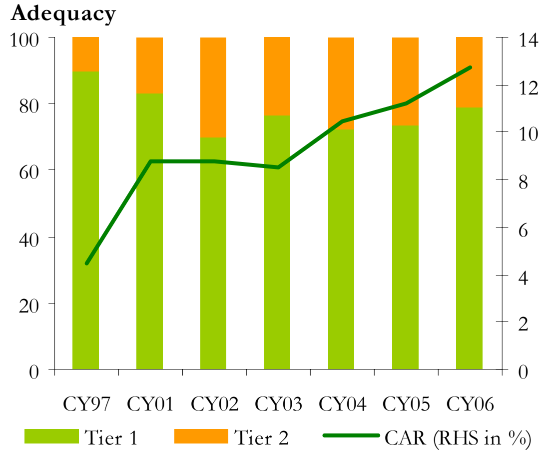
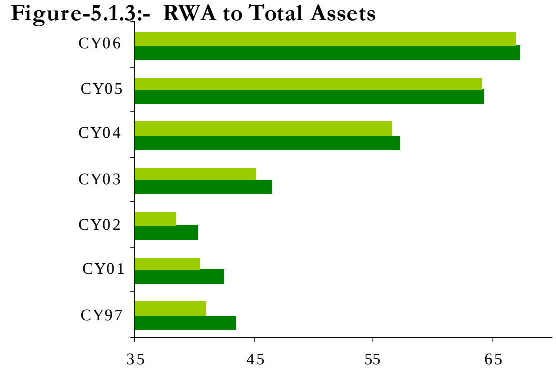


Figure-5.1.3:- RWA to Total Assets



	CY97	CY01	CY02	CY03	CY04	CY05	CY06
Comm. Banks	41.1	40.5	38.6	45.2	56.6	64.1	67.0
All Banks	43.5	42.6	40.3	46.5	57.2	64.3	67.3

[8] The banks are required to raise their Paid-up capital free of losses to Rs3 billion by the end of December 2006. They are further required to raise it, in a phased manner, to Rs6 billion by the end of December 2009 by increasing Rs1 billion each year.

growth of 35 percent mainly due to relative slow down in credit growth.

Since the growth in capital surpassed that of the risk-weighted assets, capital adequacy ratio of the banking system increased by more than 1 percentage point to 12.7 percent from 11.3 percent in CY05 (see **Table-5.1.1**).

Since, the growth in core capital was higher, core capital to risk weighted assets ratio also witnessed a remarkable increase to 10.0 percent from 8.3 percent in CY05. The considerable increase in these two benchmark ratios raised them significantly above the generally acceptable benchmark for well capitalized banks.

Capital in terms of total assets, another capital assessment indicator, also increased to 9.4 percent as compared to 7.9 percent in CY05. The increasing trend in this ratio signifies the decreasing leverage. Further, the capital coverage ratio i.e. capital free of net NPAs to total assets ratio has also strengthened and increased to 8.5 percent from 6.7 percent in CY05. It signifies that even if a provision of 100 percent is created against the entire existing infected portfolio, the banking system would still be able to meet the minimum benchmark of capital.

This is well supported by the improved asset quality reflected in the declining NPLs indicators. The gradually falling infection ratios coupled with the fortifying capital base have been rightly translated into lower net NPLs to capital ratio. This ratio declined to its historical low level of 9.7 percent in CY06 (see **Figure-5.1.4**), reflecting reduced potential threat to the capital from asset quality of the banking system.

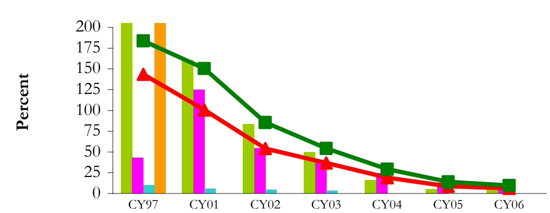
Group wise, both the major groups i.e. PSCBs and LPBs registered an increase in their CAR during CY06. However, due to the shift of four foreign banks to LPBs, the risk-based capital and risk-weighted assets of the FBs actually declined. A greater fall in the capital pushed the CAR of FBs down to 15.0 percent from 16.4 percent in CY05. The CAR of PSCBs stood the highest at 15.2 percent.

An analysis of top 5 banks, which also hold a share of more than 50 percent, reveals that solvency indicators of these banks also strengthened in CY06. The risk-based capital to RWAs ratio of this group increased significantly to 14.0 percent from 11.4 percent in CY05. Tier-1

Table-5.1.1: Capital Adequacy Indicators

Percent	CY97	CY01	CY02	CY03	CY04	CY05	CY06
CAR							
PSCBs	(1.3)	9.6	12.3	11.0	13.4	14.5	15.2
LPBs	11.9	9.5	9.7	9.0	10.1	10.6	12.7
FBs	14.6	18.6	23.2	23.0	17.4	16.4	15.0
CBs	6.0	11.3	12.6	11.1	11.4	11.9	13.3
SBs	(6.2)	(13.9)	(31.7)	(28.2)	(9.0)	(7.7)	(8.3)
All banks	4.5	8.8	8.8	8.5	10.5	11.3	12.7
Tier 1 Capital to RWA							
PSCBs	(2.0)	7.1	8.6	8.2	8.6	8.8	11.1
LPBs	11.4	8.4	6.6	7.0	7.5	8.3	10.4
FBs	14.4	18.6	23.0	23.0	17.1	16.1	14.3
CBs	5.5	9.7	9.7	9.1	8.6	9.1	107.3
SBs	(6.3)	(13.9)	(31.7)	(28.7)	(15.0)	(13.6)	(13.3)
All banks	4.1	7.3	6.2	6.5	7.6	8.3	10.0
Capital to Total Assets							
PSCBs	0.3	3.7	5.6	6.1	8.7	12.6	12.2
LPBs	4.9	3.8	5.2	5.3	6.5	7.0	9.2
FBs	7.9	8.5	10.6	9.9	8.9	9.5	10.1
CBs	3.1	4.6	6.1	6.1	7.2	8.4	9.9
SBs	8.8	(10.3)	(23.0)	(10.0)	(9.4)	(8.1)	(8.0)
All banks	3.5	3.8	4.8	5.5	6.7	7.9	9.4
Capital (free of net NPLs) to Total Assets							
PSCBs	(6.8)	(2.2)	0.9	3.1	7.3	12.1	11.4
LPBs	2.8	(1.0)	2.4	3.2	4.9	6.2	8.6
FBs	7.1	8.0	10.1	9.6	9.0	9.8	10.7
CBs	(1.4)	(0.0)	2.8	3.9	5.9	7.8	9.3
SBs	(24.6)	(34.4)	(44.5)	(30.9)	(27.2)	(21.1)	(19.1)
All banks	(2.9)	(1.9)	0.7	2.5	4.7	6.7	8.5

Figure-5.1.4:- Net NPLs to Capital Ratio (in %)

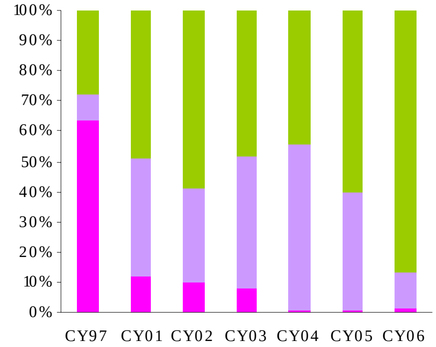


	CY97	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	2,081.0	160.2	83.4	50.0	16.2	5.4	6.36
LPBs	43.3	125.2	54.8	39.1	24.3	12.7	7.09
FBs	10.0	5.8	4.7	3.2	(0.2)	-3.0	(5.07)
SBs	380.0	-	-	-	-	-	-
CBs	143.6	100.7	54.2	36.9	19.0	8.8	6.24
All Banks	183.8	150.5	85.5	54.4	29.2	14.1	9.72

capital in terms of RWAs and balance sheet capital to total assets also fortified to 10.9 percent and 9.7 percent as compared to 7.8 percent and 8.4 percent respectively, in CY05.

On individual front, the analysis reveals that generally the banks have improved their CAR in CY06. The share of well capitalized banks, the banks maintaining CAR above the level of 10 percent, increased to 87 percent as compared to 61 percent in CY05 (see **Figure-5.1.5**). The number of such banks has also increased to 32 as compared to 30 in CY05 (see **Table-5.1.2**). Corollary to this, banks maintaining CAR less than 10 percent have come down to 7 from 9 in CY05. The banks with the highest market share have their CAR at around 14 percent and the banks with lowest market share generally have much higher CAR (see **Figure-5.1.6**). As regards meeting the MCR of Rs3 billion by the end of December 2006, 30 out of 39 banks were compliant with this requirement. Of the remaining banks, two banks are expected to go for the privatization process and the rest are expected to meet this requirement by the end of June 2007.

Figure-5.1.5:- Banks' Market Share by CAR



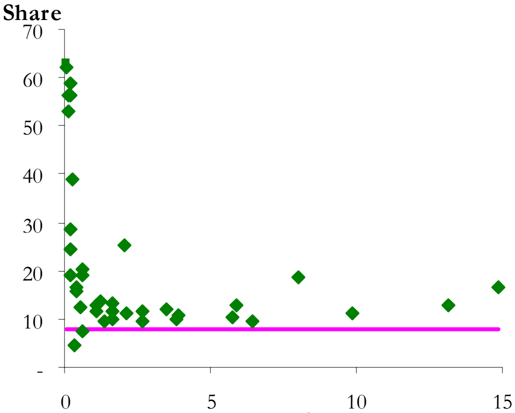
	CY97	CY01	CY02	CY03	CY04	CY05	CY06
10 percent and above	28.0	49.1	58.8	48.2	44.5	60.5	86.7
8 to 10 percent	8.7	38.7	31.1	43.8	55.1	38.8	12.1
Below 8 percent	63.3	12.2	10.1	8.0	0.4	0.7	1.2

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
CY01	43	5	5	11	22
CY02	40	4	4	9	23
CY03	40	4	10	5	21
CY04	38	1	13	9	15
CY05	39	2	7	13	17
CY06	39	3	4	15	17

The strengthened financial performance, improved risk management frameworks and good governance have also been reflected in improved credit ratings of the banks (see **Box-5.1.1**).

Figure-5.1.6:- CAR of Banks as Per Their Market Share



*One specialized bank with market share of 0.2 percent has negative capital.

All this suggests that solvency profile of our banking system has so far been strengthening and expected to continue in near future as well. The major support is expected to come from meeting the requirement of enhanced MCR by the banks. This would certainly add to the resilience of the banking system towards plausible shocks. However, to further strengthen their solvency; the banks will have to be more vigilant about their risk exposures, especially before entering into the riskier ventures to explore higher returns, and further improve their risk management processes and framework to avoid threats from assets quality.

CREDIT RATINGS OF BANKS & DFIs

S. No.	Name of Bank/ DFI	Rating Agency	Short Term	Long Term	Date of Rating	Remarks
PUBLIC SECTOR COMMERCIAL BANKS						
1.	National Bank of Pakistan	JCR-VIS	A-1+	AAA	June 2006	
2.	First Women Bank Limited	PACRA	A-2	BBB+	August 2003	
3.	The Bank of Khyber	JCR-VIS	A-2	BBB+	February 2007	
4.	The Bank of Punjab	PACRA	A-1+	AA	June 2006	
LOCAL PRIVATE BANKS						
5.	Askari Commercial Bank Limited	PACRA	A-1+	AA+	June 2006	
6.	Bank Alfalah Limited	PACRA	A-1+	AA	June 2006	
7.	Bank AL Habib Limited	PACRA	A-1+	AA	June 2006	
8.	Mybank Limited	PACRA	A2	A-	June 2006	
		JCR-VIS	A-2	BBB	June 2006	
9.	Faysal Bank Limited	PACRA	A-1+	AA	June 2006	
		JCR-VIS	A-1+	AA	July 2006	
10.	Habib Metropolitan Bank Limited	PACRA	A1+	AA+	November 2006	
11.	KASB Bank Limited	PACRA	A2	BBB+	June 2006	
12.	Prime Commercial Bank Limited	PACRA	A1	A+	October 2006	Placed on Rating Watch - Positive
13.	Saudi Pak Commercial Bank Limited	JCR-VIS	A-2	A-	November 2006	
14.	PICIC Commercial Bank Limited	JCR-VIS	A-1	A+	December 2006	Placed on Rating Watch - Positive
15.	Soneri Bank Limited	PACRA	A1+	AA-	June 2006	
16.	Standard Chartered Bank (Pakistan) Ltd.	PACRA	A1+	AAA	January 2007	
17.	MCB Bank Limited	PACRA	A1+	AA+	May 2006	
18.	Allied Bank Limited	JCR-VIS	A-1	A+	August 2006	
19.	United Bank Limited	JCR-VIS	A-1+	AA	June 2006	
20.	Meezan Bank Limited	JCR-VIS	A-1	A+	June 2006	
21.	NIB Bank Limited	PACRA	A1	A+	December 2006	Placed on Rating Watch - Positive
22.	Crescent Commercial Bank Limited	JCR-VIS	A-2	BBB	December 2006	Placed on Rating Watch - Positive
23.	Habib Bank Limited	JCR-VIS	A-+	AA	June 2006	
24.	Atlas Bank Limited	PACRA	A-2	A-	October 2006	
25.	Arif Habib Rupali Bank Ltd.	JCR-VIS	A-2	A	February 2007	
26.	JS Bank Limited	PACRA	A2	A-	March 2007	
FOREIGN BANKS						
27.	ABN AMRO Bank N.V.	Standard & Poor's	A-1+	AA-	September 2006	
		Moody's	P-1	Aa1	September 2006	
		Fitch-IBCA	F1+	AA-	September 2006	
28.	Albaraka Islamic Bank B.S.C.	JCR-VIS	A-1	A	June 2006	
29.	The Bank of Tokyo Mitsubishi UFJ Ltd.	Standard & Poor's	A-1	A	March 2006	
		Moody's	P-1	A1	March 2006	
		Fitch-IBCA	F1	A-	March 2006	
30.	Citibank N.A.	Standard & Poor's	A-1+	AA+	December 2006	
		Moody's	P-1	Aaa	December 2006	
		Fitch-IBCA	F1+	AA+	December 2006	
31.	Deutsche Bank AG	Standard & Poor's	A-1+	AA-	September 2006	
		Moody's	P-1	Aa3	June 2006	
32.	Hongkong & Shanghai Banking Corp. Ltd.	Standard & Poor's	A-1+	AA	July 2006	
		Moody's	P-1	A1*	July 2006	*Represents Deposits Rating Only
		Fitch-IBCA	F1+	AA	July 2006	
33.	Oman International Bank S.A.O.G.	JCR-VIS	A-2	BBB	December 2006	Placed on Rating Watch - Developing
SPECILIZED BANKS						
34.	Zarai Taraqiati Bank Limited	JCR-VIS	A-1+	AAA	June 2006	
35.	Punjab Provincial Cooperative Bank Limited	JCR-VIS	B	BB+	January 2007	Placed on Rating Watch - Developing
36.	SME Bank Limited	JCR-VIS	A-2	BBB	February 2007	
DEVELOPMENT FINANCE INSTITUTIONS						
37.	Pak Kuwait Investment Company (Pvt.) Ltd.	PACRA	A-1+	AAA	June 2006	
		JCR-VIS	A-1+	AAA	June 2006	
38.	Pak Libya Holding Company Limited	PACRA	A1+	AA-	June 2006	
39.	Pak Oman Investment Company Limited	JCR-VIS	A-1+	AA+	June 2006	
40.	Pakistan Industrial Credit & Investment Corporation	PACRA	A1+	AA	December 2006	
41.	Saudi Pak Industrial & Agricultural Investment Company Limited	JCR-VIS	A-1+	AA+	June 2006	
42.	House Building Finance Corporation	PACRA	A1	A	June 2006	
MICRO FINANCE BANKS						
43.	Khushhali Bank Limited	JCR-VIS	A-1	A-	May 2006	
44.	First Micro Finance Bank Limited	JCR-VIS	A-1+	A+	April 2006	
45.	Network Microfinance Bank Limited	PACRA	A3	BBB	November 2006	
46.	Tameer Microfinance Bank Limited	JCR-VIS	A-2	A-	March 2007	

The above mentioned ratings represent the opinions of respective rating agencies and do not reflect the views of the State Bank of Pakistan. Besides, these also do not represent investment advice nor should be construed as such. Ratings are updated as of May 02, 2007

5.2 Profitability

In terms of profitability of the banking system, the year 2006 proved to be yet another milestone. The profits, before and after tax, kept their pace of growth on the back of growing levels of high yield earning assets coupled with the well supporting non-interest income. As a result, pre-tax profit of the banking system crossed the Rs100 billion mark and reached to Rs123.6 billion in CY06. Similarly, after-tax profit also increased to Rs84.1 billion compared to Rs63.3 billion in CY05 (see **Table-5.2.1**).

Table-5.2.1: Profitability of Banking System

(Billion Rs)	CY97	CY01	CY02	CY03	CY04	CY05	CY06
Profit before tax							
PSCBs	(22.9)	0.2	10.9	16.1	14.2	22.8	31.5
LPBs	4.9	5.0	11.9	23.8	31.0	60.5	85.6
FBs	7.4	5.0	6.6	7.1	7.2	11.6	6.3
CBs	(10.6)	10.3	29.4	47.0	52.4	94.9	123.5
SBs	(0.2)	(9.2)	(10.4)	(3.3)	(0.4)	(1.1)	0.1
All Banks	(10.8)	1.1	19.0	43.7	52.0	93.8	123.6
Profit after tax							
PSCBs	(21.4)	(4.6)	4.8	9.4	8.0	15.5	21.2
LPBs	1.8	2.0	6.4	14.8	21.8	41.1	59.1
FBs	3.4	2.4	4.2	4.2	5.8	8.0	4.3
CBs	(16.2)	(0.2)	15.3	28.4	35.6	64.6	84.6
SBs	(0.2)	(9.5)	(12.4)	(3.7)	(0.9)	(1.3)	(0.5)
All Banks	(16.4)	(9.8)	2.9	24.7	34.7	63.3	84.1

Group-wise, all of the banking groups including SBs contributed to this higher before tax profits. However, both the LPBs and PSCBs made a significant contribution and before tax profits of these two groups increased to Rs85.6 and Rs31.5 billion in CY06 from Rs60.7 and Rs22.6 billion respectively in CY05. The shift of one of the FBs to the LPBs category also helped to increase the profits of LPBs. Corollary to this, the FBs booked lower before tax profits i.e. Rs4.3 billion as compared to Rs8.0 billion in CY05.

Table-5.2.2: Profitability Indicators

(Percent)	CY97	CY01	CY02	CY03	CY04	CY05	CY06
Before Tax ROA							
PSCBs	(3.4)	-	1.3	1.8	2.4	3.3	4.0
LPBs	1.4	0.9	1.4	2.2	1.7	2.7	3.1
FBs	3.0	1.7	2.3	2.6	2.5	3.6	3.2
Comm. Banks	(0.8)	0.6	1.5	2.1	2.0	2.9	3.2
SBs	(0.2)	(8.4)	(10.2)	(3.3)	(0.4)	(1.0)	(1.3)
All Banks	(0.8)	0.1	0.9	1.8	1.9	2.8	3.1
Before Tax ROE *(based on Equity plus Surplus on Revaluation)*							
PSCBs	(272.7)	0.5	26.3	29.9	30.8	30.7	32.4
LPBs	29.0	25.4	32.3	41.5	28.8	39.8	36.2
FBs	37.7	19.3	24.2	25.0	26.7	38.9	30.0
Comm. Banks	(23.8)	12.2	27.5	33.7	29.0	36.9	34.7
SBs	(1.8)	-	-	-	0.0	0.0	0.0
All Banks	(20.2)	1.4	21.1	35.4	30.5	37.3	35.2
After Tax ROA							
PSCBs	(3.1)	(0.5)	0.6	1.0	1.3	2.2	2.7
LPBs	0.5	0.4	0.7	1.4	1.2	1.8	2.1
FBs	1.4	0.8	1.5	1.5	2.0	2.5	2.1
CBs	(1.3)	(0.0)	0.8	1.2	1.3	2.0	2.2
SBs	(0.2)	(8.8)	(12.1)	(3.7)	(0.8)	(1.2)	(1.8)
All Banks	(1.2)	(0.5)	0.1	1.0	1.2	1.8	2.1
After Tax ROE *(based on Equity plus Surplus on Revaluation)*							
PSCBs	(255.0)	(12.2)	11.5	17.3	17.2	20.6	21.7
LPBs	10.9	10.3	17.3	25.8	20.2	27.0	25.0
FBs	17.2	9.1	15.2	14.8	21.5	27.1	20.4
CBs	(36.2)	(0.3)	14.3	20.3	19.6	25.1	23.7
SBs	(2.0)	-	-	-	0.0	0.0	0.0
All Banks	(30.7)	(12.6)	3.2	20.0	20.3	25.0	23.8

The strengthening profitability can be assessed in almost all of the key profitability indicators. The return on assets (ROA), both pre-tax and after-tax, improved further. Group wise, all of the commercial banking groups except FBs have witnessed increase in ROA (see **Table-5.2.2**). The breakdown of total assets of the banking system on the basis of ROA shows some positive shift. As the number of banks with ROA in the range of '0.5 and over' has increased to 30 from 28 and their share in total assets has increased to 96.1 percent from 93.7 percent in CY05 (see **Table-5.2.3)**. Moreover, the number of banks with ROA in the range of 'zero and below' has reduced to 6 from 7 and their share in total assets of the banking system has also decreased to 2.1 percent from 3.5 percent in CY05.

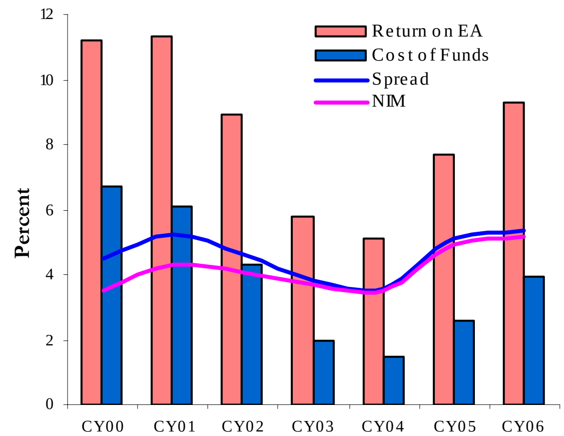
Table-5.2.3:- %age Breakdown of Banking System's Total Assets (TA) by ROA

	CY03		CY04		CY05		CY06	
ROA	No. of Banks	% Share in TA	No. of Banks	% Share in TA	No. of Banks	% Share in TA	No. of Banks	% Share in TA
O and below	7	1.7	6	3.9	7	3.5	6	2.1
0 to 0.5	4	5.5	2	5.2	4	2.8	3	1.8
0.5 to 1	5	48.7	11	21.3	2	7.0	6	9.9
1.0 to 1.5	9	23	12	45.3	5	4.0	5	9.6
1.5 and Over	15	21.1	7	24.3	21	82.7	19	76.6

However, return on equity (ROE) of the banking system experienced slight decline due to the increase in capital to meet MCR and the higher appropriation of profits by the banks.

The return on earning assets increased to 9.3 percent from 7.6 percent in CY05 (see **Figure-5.2.1**). Such an increase can be attributed to higher return on incremental earning assets in CY06. Although, the cost of funds also grew to 3.9 percent from 2.6 percent in CY05 due to slight surge in weighted average return on deposits, the greater increase in the yields on earning assets has added to the increased NIM in CY06.

Figure-5.2.1:- Interest Rate Spread NIM



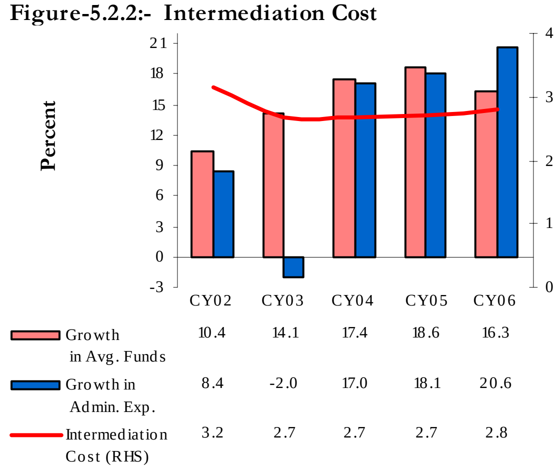
The disaggregated analysis shows that interest income on loans to customers increased by Rs69.0 billion to Rs218.1 billion in CY06. Both the change in interest rates and change in volume of business contributed almost equally to this increased interest income. In absolute terms, the increased business volume contributed about Rs34.1 billion in CY06 as against the Rs25.3 billion in CY05 (see **Table-5.2.4**). Whereas, contribution of rate variance on customers' loans declined to Rs34.9 billion in CY06 as compared to Rs46.7 billion in CY05.. This safely concludes that during CY06, the increased business volume lent almost an equal hand in the increased interest income as compared to the CY05 and the volume is growingly contributing towards the increased income.

Table-5.2.4: Sources of Change in Interest Income on Customers' Loans and Interest Expense on Deposits

(Billion Rs)	Balance of the Previous Year	Change Due to Rate Variation	Change Due to Volume Variance	Balance for the Year
Interest Income on Customers' Loans				
CY04	67.0	(11.6)	21.6	77.0
CY05	77.0	46.7	25.3	149.0
CY06	149.0	34.9	34.1	218.0
Interest Expense on Deposits				
CY04	33.4	(11.7)	6.5	28.2
CY05	28.2	26.2	5.6	59.9
CY06	59.9	39.4	9.3	108.6

Viewing the expense side on the same grounds, the level of interest expenses also experienced a significant increase of Rs58.7 billion during CY06, which in percentage terms remained around 78 percent, as compared to the increase of Rs38.0 billion in CY05. This increase in the interest expenses can be referred to the rising cost of deposits which stayed around 3.6 percent in CY06 as compared to 2.3 percent in CY05. Variance analysis of cost of deposits reveals that 81 percent of the increased cost of deposit came from the increase in deposit rates during CY06, which may be termed as due to the "rate variance". Whereas, the remaining 19 percent of this increased cost of deposits can be attributable to the increased deposit base, the "volume variance".

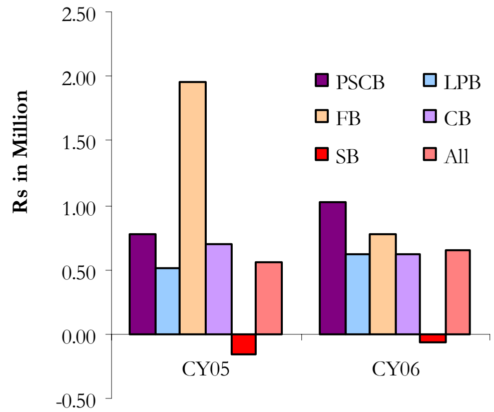
Figure-5.2.2:- Intermediation Cost



Comparing the rate variance and the volume variances of the two, i.e. interest income on customers loans and interest expense on deposits during the CY06, it is obvious that the impact of increase in interest rate was higher on deposits, which amounts to Rs39.4 billion as compared to the Rs34.9 billion in case of customers' loans.

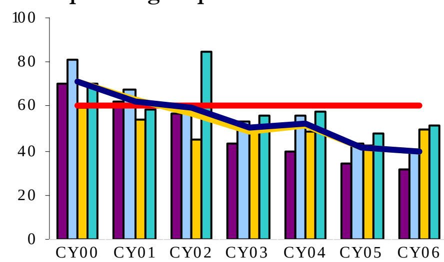
The administrative expenses, witnessed an increase of around 20.6 percent to Rs95.6 billion from Rs79.2 billion in CY05 (see **Figure-5.2.2**). Since, the average funds grew with relatively lower pace i.e. by only 16.3 percent in CY06, therefore, the intermediation cost ratio moved up to 2.8 percent from 2.7 percent in CY05. This increased intermediation cost can be traced into the expanded business operations of the banks in order to maximize the return on capital. The expansion has resulted into creation of more job opportunities in the banking system. During CY06, the CBs'[9] staff strength has increased by 17.2 percent, whereas all banks have witnessed a growth of 15.4 percent. Notwithstanding the increased staff strength of the banking system, after-tax profit per employee for all banks has surged to Rs0.65 million from Rs0.56 million in CY05 (see **Figure-5.2.3**).

Figure-5.2.3:- After Tax Profit Per Employee



Since gross income grew with much larger pace, operating expense to gross income ratio improved from 41.4 percent in CY05 to 39.8 percent in CY06 (see **Figure-5.2.4**). Group wise, the ratio for LPBs and PSCBs improved in CY06. The deterioration in the ratio for SBs was due to increased markup/interest expenses incurred by one large specialized bank. While in the case of FBs, deterioration was due to the shift of one large FB to the LPBs category. This shift resulted into decline in non- interest income of FBs by 28.8 percent in CY06.

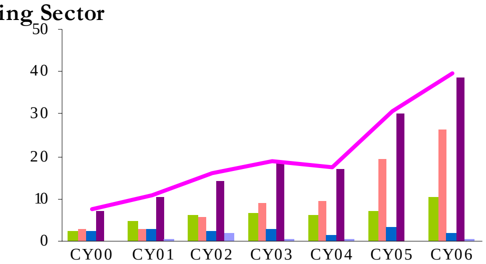
Figure-5.2.4:- Operating Expenses to Gross Income



	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	70.1	62.3	56.9	42.8	39.4	34.5	31.8
LPBs	80.9	67.3	60.0	53.2	56.2	42.9	40.7
FBs	59.4	54.5	45.4	48.2	49.0	42.2	49.8
SBs	70.5	59.0	84.7	55.6	57.8	47.8	51.1
Bench Mark	60.0	60.0	60.0	60.0	60.0	60.0	60.0
CBs	71.6	62.7	56.7	48.6	51.7	41.1	39.4

As for the tax expense, the reduction in the tax rate for the last few years has reduced the tax expense of the banking system in CY06. This lower taxation has also added to the net profits of the banking system. Though in terms of before tax profits, the tax charge in CY06 was lower when compared with that of CY05, however, since the profits were on higher side, the banking system made a higher contribution in tax revenue by the amount of Rs39.5 billion as compared to Rs30.5 billion in CY05 (see **Figure-5.2.5**).

Figure-5.2.5:- Annual Tax Contribution by Banking Sector

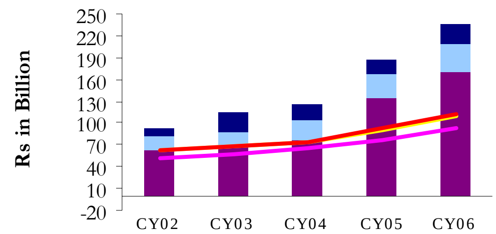


	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	2.2	4.8	6.1	6.8	6.3	7.3	10.4
LPBs	2.8	3.0	5.5	9.0	9.3	19.4	26.5
FBs	2.3	2.7	2.5	2.9	1.4	3.5	2.0
CBs	7.3	10.5	14.1	18.7	17.0	30.3	38.9
SBs	0.1	0.3	1.9	0.4	0.5	0.2	0.6
All	7.3	10.8	16.1	19.0	17.5	30.5	39.5

[9] The staff strength includes all permanent, contractual, outsourced and daily wage employees.

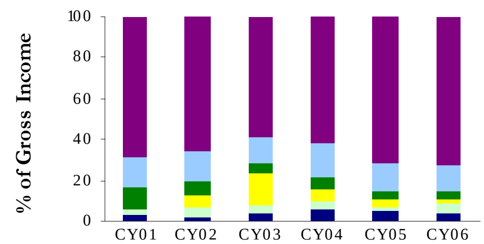
The growing business volume especially in riskier areas has started taking its toll in terms of higher provision charges. During CY06, the provision and direct write off charges against bad debts, increased to Rs22 billion, whereas this costed the banking system around Rs19 billion during CY05. Such a huge amount of charge against infected portfolio has eaten up significant portion of earnings of the banking system, and invites due concern since the trend is rising. This amount was around 13 percent of the net interest income. Had this cost not been there, the before tax profits would have been higher by around 18 percent. Further the analysis shows that around 1 percentage of the spread between the cost of funds and return on advances has covered the provision charges.

Figure-5.2.6:- CBs Profit &Loss Composition



	CY02	CY03	CY04	CY05	CY06
Other Non-Int. Inc.	11.8	27.7	19.9	19.5	26.3
Fee &Currency Dealing	19.7	19.8	27.7	34.5	39.5
Net Int. Inc.	61.4	68.2	77.3	133.3	170.1
All expenses	63.4	68.6	72.4	92.5	112.3

Figure-5.2.7:- Sources of CBs Gross Income



	CY01	CY02	CY03	CY04	CY05	CY06
Net Interest Income	68.9	66.1	59.0	61.9	71.2	72.1
Fee Based Income	14.6	14.2	12.7	16.8	14.0	12.7
Currency Dealing Income	10.2	7.0	4.3	5.4	4.4	4.0
Gain on Sale of Securities	0.7	6.2	16.4	6.2	3.2	2.1

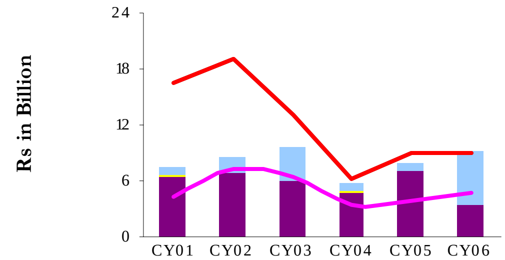
Group wise, the CBs' profit & loss composition shows that net interest income contribute major share in the overall total income of CBs. The net interest income increased to Rs170.1 billion in CY06 compared to Rs133.3 billion in CY05 (see **Figure-5.2.6**). The share of NII in the total income has increased to 72.1 percent in CY06 from 71.2 percent in CY05. The non-markup/interest income has also increased to Rs65.7 billion in CY06 thereby exhibiting a growth of 21.75 percent over a period of one year. The non-interest income of CBs has also shown increase over the year. The fee based income and income from dealing in foreign currencies have shown a growth of 14.5 percent and 14.3 percent respectively in CY06. Moreover, the dividend income has witnessed a growth of 133.8 percent in CY06 (see **Figure-5.2.7**). However, such a growth in non-interest income is accompanied by a corresponding increase in the operating expenses of CBs which grew by 20.7 percent to reach Rs92.9 billion in CY06. The administrative expenses, the major component of the operating expenses, have increased to Rs91.6 billion from Rs75.4 billion in CY05. The breakup of administrative expenses shows that salary and allowances etc. grew by 22 percent to increase to Rs47.6 billion from Rs39.0 billion in CY05 and constituted 52 percent of the total administrative expenses. The provision and bad debt expenses of the CBs increased to Rs17.6 billion from Rs13.9 billion in CY05.

The SBs' profit & loss composition shows that net markup/interest income has declined by 50 percent, from Rs7.0 billion to Rs3.5 billion in CY06 (see **Figure-5.2.8**). The reason for such a downfall in NII is the increased markup/interest expenses of Rs4.8 billion in CY06 compared to Rs1.5 billion in CY05. However, SBs have shown increase in the other non-interest income which has increased to Rs5.6 billion in CY06 compare to Rs1.0 billion in CY05. The provision and bad debt expenses of the SBs stayed at Rs4.4.

A comparative regional study of South Asian countries reveals that Pakistan has a quite comfortable position in respect of ROA and ROE. Further, the operating cost ratio and staff cost ratio are better than the other countries under study (see **Table-5.2.5**).

To conclude, the banking system has witnessed a remarkable improvement in all the key profitability indicators on the back of favorable economic condition in the country. The lucrative profits of the banking system have attracted many foreign banks to invest in the banking system of Pakistan. Further, the recent trend of mergers and acquisitions of local banks by the foreign banks is also intended to extend their outreach to maximize return on their capital. The growth in earning assets coupled with upward movement in interest rates suggests the continuity of the profitability trends in coming year too. However, since, banks have been increasing their exposures in high-return fast-growing business areas, which also carry higher credit risk; any deterioration in the asset quality portrays threat to profitability in future.

Figure-5.2.8:- Specialized Banks' P&L Composition



	CY01	CY02	CY03	CY04	CY05	CY06
Other Non-Int. Inc.	0.7	1.7	3.6	1.0	1.0	5.7
Fee-based & currency Dealing Inc.	0.2	0.2	0.0	0.0	0.0	0.0
Net Int. Inc.	6.4	6.8	6.0	4.8	7.0	3.5
All exp. +	16.6	19.1	13.0	6.2	9.1	9.1

Table-5.2.5:- South Asian Countries Performance and Efficiency Indicators-Ye

	Bangladesh	India	Nepal	Sri Lanka	Pakistan
Return on equity	28.6	16.9	(42.7)	7.2	25.4
Return on assets	1.3	1.3	2.8	1.6	2.0
Operating cost ratio	107.9	74.5	50.9	97.2	57.7
Staff cost ratio	65.0	59.0	77.3	39.5	50.7
Banks with computerized systems	95.8	100.0	40.3	90.0	100.0
ATMs per bank (number)	5.2	203.0	3.5	39.0	28.6

Source: "Getting Finance in South Asia" Report No.37295 The World Bank

5.3 Prudential Stability of the Recent Increase in Banks' Profits

Pakistani banks have been showing healthy profits for the last few years, and the year 2006 proved to be another year of excellence in terms of profitability. These profits have resulted in stronger ROA in year 2006. The level of ROE, though remained quite significant, experienced slight fall when compared with the one in CY05. The improved efficiency has no doubt been extending support to the ROE since long, there are other factors as well, which shape the trend of ROE.

This chapter discusses the contribution of the key factors in determining the current level of ROE. For the purpose of analysis, the following two possible sources of ROE have been discussed briefly.

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

A brief of this framework is given in **Box -5.3.1**.

Box -5.3.1

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 healthy 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 significantly from the negative in 2001 to a positive 23.7 percent in CY06. Looking into the in-depth analysis of the components of ROE, indexed to the year 2002 as base, the following came to surface.

Operating Efficiency

Net Margin of the commercial banks increased significantly since 2002. This increasing trend in net margin was mainly the function of relatively lower provisioning charge. After experiencing a slight dip in CY05, the net margin of commercial banks witnessed improvement during CY06. Since CY02 the net margin index increased by 55 to 155 in CY06.

Operating Efficiency of the commercial banks witnessed marked improvement since CY02. Operating profits before provision in terms of gross income have been increasing and when indexed to CY02 scale of 100, it rises to 140 in CY06 (see **Figure-5.3.1**). It were the controlled operating expenses which contributed to this increased operating efficiencies.

Productivity of Assets has also witnessed improvement when compared with the CY04 and onwards. Although there has been significant growth in the risk weighted assets over the past few years, the commercial banks were able to manage good returns by locking more and more in high yield assets.

Funding Structure Policy

Risk Profile of Assets of the commercial banks has been increasing significantly especially when compared with that of a few years back. It is due to the attractive returns, the banks are finding in high risk assets. The risk weighted assets of commercial banks have grown more than two folds in the last five years and considering the CY02 base as 100, it went to 216 in CY06 (see **Figure-5.3.2**).

Figure-5.3.1:- Operating Performane, CY02 to CY06

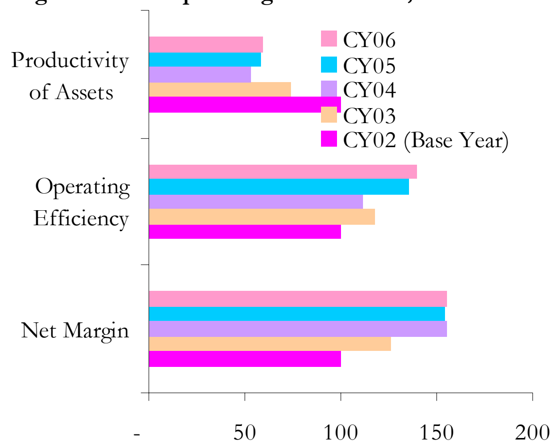
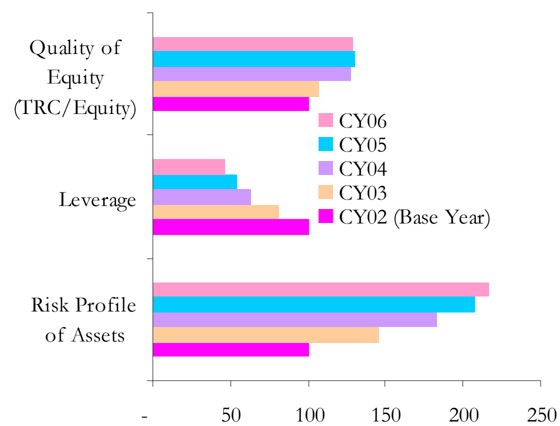


Figure-5.3.2:- Funding Structure, CY02 to CY06

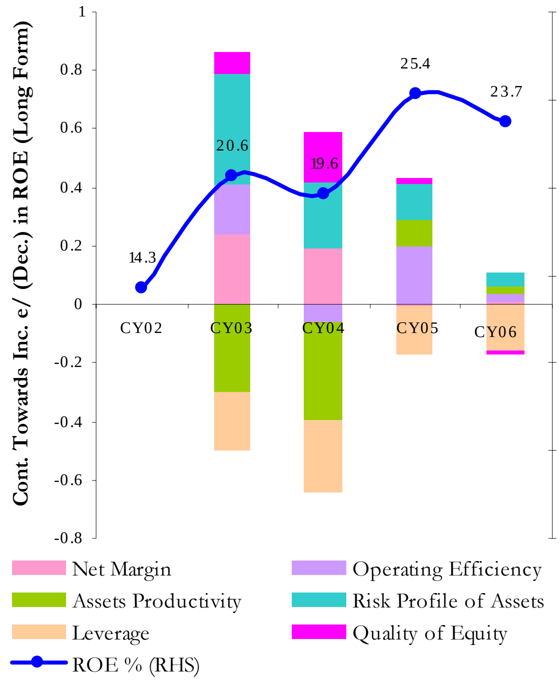


Leverage of the banking system witnessed further decline in CY06. It is happening due to the increasing equity base owing to higher profits and the fresh capital injections to meet the regulatory requirement of enhanced MCR. Mergers and consolidation of the banking system further supported this increasing equity base. Resultantly, for the commercial banks, the leverage has come significantly down to the level of 46 from the base of 100 in CY02. Although this reduction in leverage constrains ROE, however, it refers to the strengthening solvency profile of the banking system.

Quality of Capital: The core capital in terms of total regulatory capital has been increasing and is around 81 percent in CY06 as compared to the 79 percent in CY02. However, the dependence on non-core capital seems to be increasing when looked into the regulatory capital to equity ratio. When compared with the level of 100 of CY02 as base, it went up to 129 in CY06.

Summing up, the major support to equity came from the operating efficiencies whereby the operating expenses remained under check (see **Figure-5.3.3**). Increased risk profile due to gradual shift of asset mix to the high yield assets and hence the higher asset productivity lent further hand to the fortifying profits. The declining leverage and heavy reliance on the own funds, however, put some strain on the ROE, which experienced slight decline in CY06. Although the strengthening equity base may lower the ROE, it addresses the issue of moral hazard of excessive risk taking and also increases the resilience of the bank to the adverse shocks. Now, since the banks are locking more and more in the higher risk areas in search of healthy returns, they would need to have stronger equity base so as to serve as cushion against potential threats. Nevertheless, the banks should follow a prudent lending policy and focus on risk diversification to maintain higher returns.

Figure-5.3.3:- Contribution to Changes in ROE, CY02 to CY06



6 Risk Assessment of the Banking System

6.1 Credit Risk

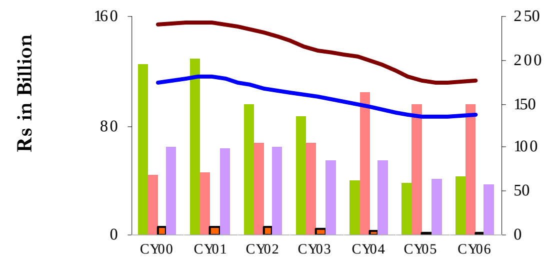
The credit portfolio of the banking system, though grew at relatively lower rate in CY06, continued the upward trend. Despite aggressive loan growth over the last few years, the banking system has so far been able to successfully manage to contain the credit risk within reasonable limits. It is relevant to mention that in contrast to the significant growth of loans portfolio by 148 percent over last six years, NPLs of the banking system have reduced by 27 percent in the same period.

Analysis reveals that during the CY06 the non-performing loan portfolio of the banking system has further reduced by Rs2 billion to Rs175 billion from Rs177 billion in CY05 (see **Figure-6.1.1**). However, the declining trend in NPLs has significantly slowed down. Group wise analysis shows that NPLs of CBs increased by Rs2.5 billion, while SBs have managed to reduced their NPLs by Rs4.5 billion.

The disaggregated analysis reveals that there has been considerable movement in NPLs of the banking system during CY06. Though there were significant inflows of fresh NPLs during the period under review, the extensive recoveries and write offs have managed to reduce the overall stock of NPLs.

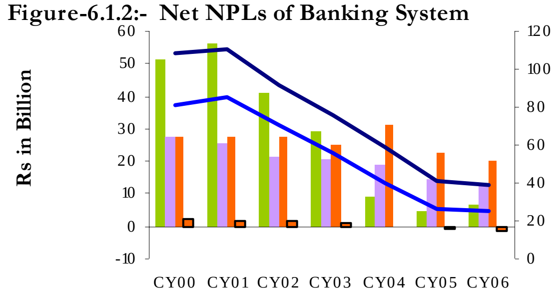
In line with the gross NPLs, Net NPLs of the banking system have also reduced by Rs2 billion to Rs39 billion in CY06 (see **Figure-6.1.2**). CBs also managed to reduced their NPLs by around Rs1 billion to Rs26 billion. Group wise, an increase in NPLs of PSCBs raised their net NPLs by Rs1 billion. However, FBs remained on their path to proactively manage their credit risk by making provisions more than their NPLs.

Figure-6.1.1:- NPLs of Banking System



	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	125	130	96	86	40	38	42
LPBs	43	46	67	67	103	96	95
FBs	7	6	5	4	3	2	1
SBs	65	63	64	54	54	42	37
CBs(RHS)	175	181	168	157	146	136	138
All(RHS)	240	244	232	211	200	177	175

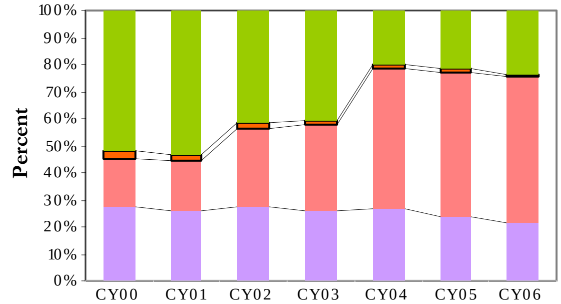
Figure-6.1.2:- Net NPLs of Banking System



	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	51	56	41	29	9	5	6
SBs	27	26	21	21	19	15	13
LPBs	27	27	28	25	31	22	20
FBs	2	2	1	1	(0)	(1)	(1)
CBs(RHS)	81	85	70	55	40	27	26
All(RHS)	108	111	91	76	59	41	39

With cross-group mergers and acquisitions during CY06, the group-wise composition and share in NPLs for all groups of banks has changed. Eventually, the share of LPBs has increased from 53.9 percent in CY05 to 54.2 percent in CY06 with the corresponding decline in the share of FBs from 1.2 percent in CY05 to 0.7 percent in CY06 **(**see **Figure-6.1.3)**. The addition in NPLs of PSCBs resulted in increase in their share from 21.4 percent in CY05 to 23.8 percent in CY06. Moreover, significant reduction in NPLs of on large specialized bank helped in overall reduction in NPLs of this group. Accordingly, NPLs of SBs reduced their share in NPLs from 23.5 percent in CY05 to 21.2 percent in CY06.

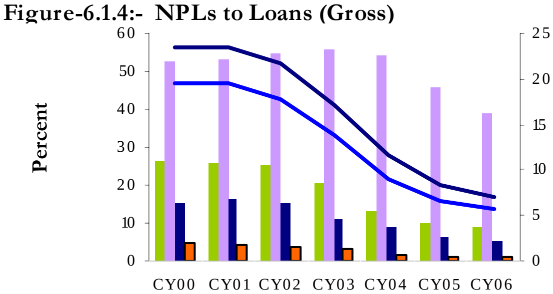
Figure-6.1.3:- Group-wise Share in NPLs



	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	52.1	53.1	41.3	40.6	20.1	21.4	23.8
FBs	2.7	2.5	2.2	1.9	1.3	1.2	0.7
LPBs	18.1	18.7	28.9	31.9	51.8	53.9	54.2
SBs	27.1	25.7	27.6	25.6	26.9	23.5	21.2

The key asset quality indicators also witnessed improvement. NPLs to Loans (Gross) ratio of the banking system improved to 6.9 percent from 8.3 percent in CY05 (see **Figure-6.1.4**). Likewise, the net NPLs to net loans ratio also dropped to 1.6 percent from 2.1 percent in CY05 due to the increased provisions against NPLs **(**see **Figure-6.1.5)**. Though net NPLs to net loans ratio of SBs declined to 18.7 percent from 23.1 percent in CY05, the ratio is still highest among all the groups.

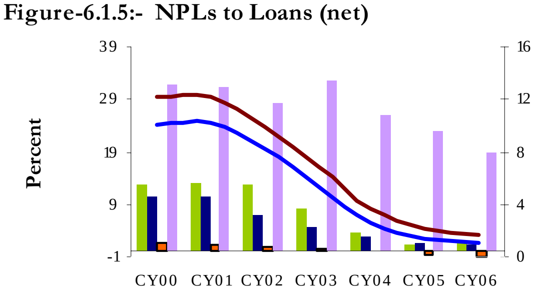
Figure-6.1.4:- NPLs to Loans (Gross)



	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	26	26	26	20	13	10	9
SBs	52	53	55	56	54	46	39
LPBs	15	16	15	11	9	6	5
FBs	5	4	4	3	2	1	1
CBs (RHS)	20	20	18	14	9	7	6
All (RHS)	24	23	22	17	12	8	7

On the back of stringent classification and provisioning criteria, introduced in CY06, the provisioning against NPLs increased to Rs137 billion from Rs136 billion in CY05 **(**see **Figure-6.1.6)**. Resultantly, the coverage ratio has also improved to 77.8 percent from 76.8 percent in CY05.

Figure-6.1.5:- NPLs to Loans (net)



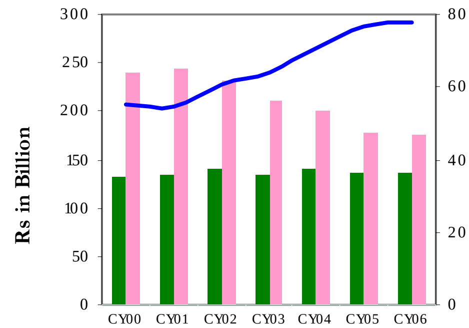
	CY00	CY01	CY02	CY03	CY04	CY05	CY06
PSCBs	13	13	13	8	3	1	2
LPBs	10	10	7	5	3	2	1
FBs	2	1	1	1	0	-1	-1
SBs	32	32	29	33	26	23	19
CBs(RHS)	10	10	8	5	3	1	1
All (RHS)	12	12	10	7	4	2	2

The percentage breakdown of the total assets by respective banks' NPLs to loans (net) ratio signifies that the number of banks having NPLs to loans (net) ratio in the range of zero and below increased to 15 from 14 in CY06. These banks were holding 25 percent of total assets of the banking system **(**see **Figure-6.1.7)**. The banks having NPLs to loans (net) ratio below 5 percent were holding 96 percent of total assets. The increase in NPLs of SBs lead to increase in the number of banks in the bracket of 15 and above. However, their share in the total assets of the banking sector remained 3 percent in CY06.

The analysis of sector-wise distribution of credit reveals that the flow of credit to different sectors was uneven. Since, the manufacturing sector covers a number of sub-sectors, the concentration of credit to manufacturing sector, excluding textile sector, was the highest at 30 percent (see **Figure-6.1.8)**. The second largest recipient of the bank credit was the textile sector with a share of 27 percent. The concentration of credit to any single sector may pose a credit risk in case of any adverse development within that sector. The pattern of credit concentration remains on the historical lines due to the size and contribution of each sector to exports and GDP. The banks' higher exposure to a single sector should be considered in line with their risk appetite for that particular sector.

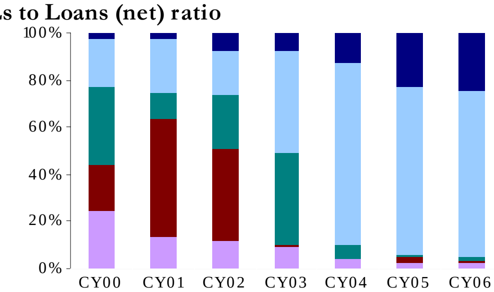
The segment-wise breakup shows that loans to the corporate sector registered an increase of 18.9 percent and correspondingly its share increased to 53.3 percent of total domestic loan portfolio (see **Table 6.1.1**). On the other hand, the share of NPLs of this sector has also increased significantly to 52.4 percent from 43.6 percent in CY05 due to both the rise in NPLs of this sector in absolute terms and decline in the overall NPLs of the banking sector. However, such a trend of growth in NPLs raises concerns over the banks' credit risk management policies and practices. The SME sector, the second largest consumer of banking loans, has also shown a growth of 13 percent during CY06. A promising trend in the quality of loans to SMEs has been seen whereby the NPLs of SMEs have dropped significantly from Rs42.1 billion in CY05 to Rs36.0 billion in CY06, exhibiting a decline of 14.4 percent. Resultantly, the NPLs to Loans ratio for SMEs improved from 11.6 percent in CY05 to 8.8 percent in CY06. Loans to the consumer sector has increased from Rs252.8 billion in CY05 to Rs325.2 billion in CY06, thereby raising its share from 12.4 percent in CY05 to 13.5 percent in CY06. The banks are lured towards this fast growing sector due to higher returns. However, given the riskier nature of this venture, there are certain concerns over the fast

Figure-6.1.6:- Provision Against NPLs



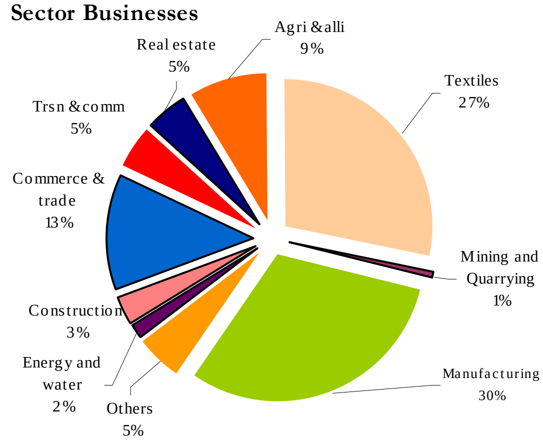
	CY00	CY01	CY02	CY03	CY04	CY05	CY06
Provision	132	134	140	135	141	136	137
NPLs	240	244	232	211	200	177	175
Provision to NPLs (RHS)	55	55	61	64	70	77	78

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



	CY00	CY01	CY02	CY03	CY04	CY05	CY06
0 and below	3	3	7	8	13	23	25
0 to 5	20	23	19	43	77	72	71
5 to 10	33	11	23	39	6	0	1
10 to 15	20	50	39	1	-	3	1
15 and above	24	14	12	9	4	3	3

Figure-6.1.8:- Concentration of Loans to Private Sector Businesses



growing NPLs of this business avenue since the NPLs of consumer finance have increased to Rs7.0 billion from Rs3.1 billion in CY05.

Table-6.1.1:- Segment-wise Infection of Loans Portfolio as of 31-12-2006
(Domestic Operations) (Rs In Billions)

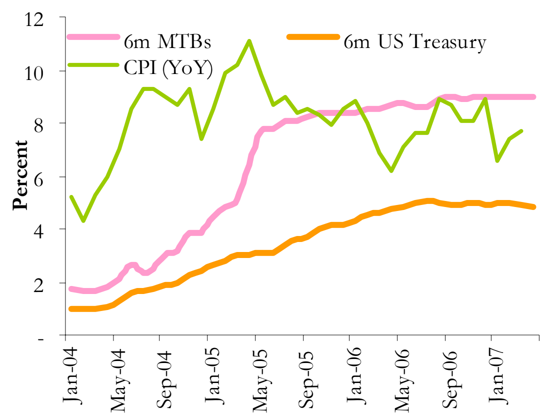
Sector	Amount Outstanding	Share %	NPLs	Share in overall NPLs	NPLs as % of Outstanding
Corporate	1279.1	53.3%	83.4	52.4%	6.5%
SMEs	408.3	17.0%	36.0	22.7%	8.8%
Agriculture	141.9	5.9%	29.5	18.5%	20.8%
Consumers	325.2	13.5%	7.0	4.4%	2.2%
Credit Cards	39.2	1.6%	0.5	0.3%	*1.4%*
Auto Loans	104.1	4.3%	1.9	1.2%	*1.9%*
Consumer Durables	1.3	0.1%	0.1	0.1%	*9.8%*
Mortgage Loans	49.2	2.1%	0.9	0.6%	*1.8%*
Others	131.3	5.5%	3.5	2.2%	*2.7%*
Commodity Finance	171.9	7.2%	1.0	0.6%	0.6%
Staff Loans	48.0	2.0%	0.5	0.3%	0.9%
Others	26.4	1.1%	1.6	1.0%	6.2%
Total	2,400.8	100%	159.0	100.0%	6.6%

The analysis reveals that the banking system so far has been able in keeping the credit risk well within the manageable limits in spite of the large expansion in the loan portfolio in last couple of years. However, the concern of the increase in NPLs holds because of the aggressive lending by the banks more into the riskier venture like consumer finance in search of higher yields. Although it is expected that the banks, in order to maintain the ROE and avail the leverage against the increasing capital base, would try to maintain the pace of loan growth, however, at the same time, they should not compromise on the quality of the asset since the bad loan carry greater risk for the bank. This poses the banks' management with the challenge of maintaining an optimum mix of the risk and return. There is a growing need that the banks should be extra vigilant and focus more on improving their risk management standards and internal controls to contain the rising credit risk.

6.2 Market Risk

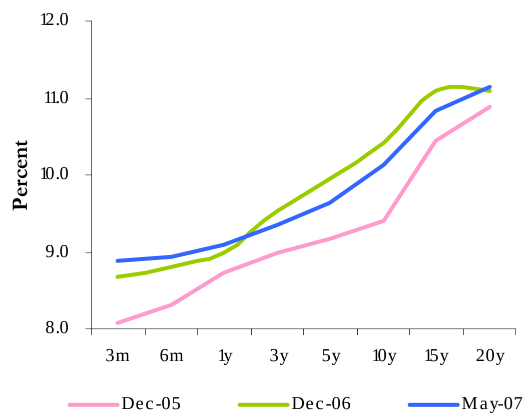
Among the three market risk factors, interest rate risk continued to remain the dominant one during CY06 as well. On the back of inflationary pressure, the interest rates both on national and international fronts increased gradually over the year (see **Figure-6.2.1**). SBP continued to pursue its tight monetary policy stance by increasing the benchmark rates, enhancing statutory liquidity requirements and mopping up the additional liquidity through frequent OMOs.

Figure-6.2.1:- CPI & 6M MTBs Vs US Treasuries



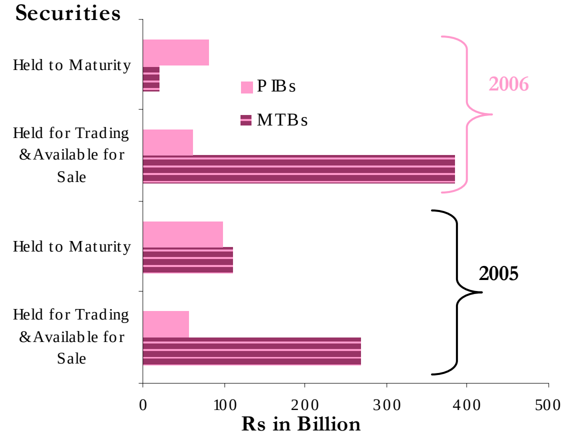
The rise in the benchmark rates has pushed the secondary market yield up, which can be seen in the shift in the yield curve (see **Figure-6.2.2**). Interest rates along all of the maturities have gone up since January 2005. This increase in interest rates may enhance the concerns of revaluation risk, as banks are running positive duration gap (the effective maturities of rate sensitive assets are longer than those of rate sensitive liabilities). The impact can be significant in the banks which hold significant amount of fixed income securities in the available for sale or trading portfolio.

Figure-6.2.2:- Shift in Yield Curve



The analysis revealed that though the level of investment in fixed income securities has increased by around 3 percent, the share of trading and available for sale categories has increased significantly to 81 percent from 61 percent in CY05 (see **Figure-6.2.3**). It indicates that banks are preferring to hold their major portion of securities in liquid form and do not want to lock the same in held-to maturity category. This can also be attributed to the policy instructions by SBP as per which the banks/DFIs were refrained from using their investments held under Held-to-Maturity category for meeting short term liquidity requirements. This policy instruction along with the increase in the liquidity requirement, in July 2006, put some strain on the short term interest rates, which remain quite volatile during that period (see Figure--6.2.4).

Figure-6.2.3:- Investments in Fixed Income Securities



Movements along the yield curve have also been witnessed during the year, giving rise to the yield curve risk, since the increase in the interest rates was not equal along all the maturities.

Volatility in the short term rates remained significant especially during the mid of the CY06 (see **Figure-6.2.4**). Year on year movements in the yields witness that up to the 1 year maturity, yield curve actually flattened and for the longer term it showed some steepening. This can be seen in the steeper rise in the yields of the 10 year yields when compared with that of the 3 year yields (see **Figure-6.2.5**). This is also evident in the increasing yield spread between the 10 year and 3 year PKRV rates (see **Figure-6.2.6**). However, with the higher increase in the 3-year yields, the yield spread again started declining since November 06, and by the May-07, the yield curve again started flattening. Nevertheless, the yields are still higher than what were in the beginning of CY06.

This increase in the yields may create re-pricing risk especially for the banks with the significant negative gaps between the maturities of rate sensitive assets and liabilities. The analysis shows that although the gaps in terms of total assets are within the manageable limits, the maturity of rate sensitive assets is shorter than rate sensitive liabilities in the one month bucket which signify interest rate risk for the banks in this time horizon. Since the trends in interest rates are on rise, such negative gaps may cost higher in terms of funding these mismatches (see **Figure-6.2.7**).

Of the commercial banking groups, PSCBs were more prone to this risk of repricing. The negative gap in the one month bucket was as high as 22 percent of total assets, whereas for the rest of the buckets the gaps were positive (see **Figure-6.2.8**). This largely positive duration gap signifies that the economic value of equity of the banks may fall with the increase in the interest rates.

Figure-6.2.4:- Volatility in the 7-Day Rate

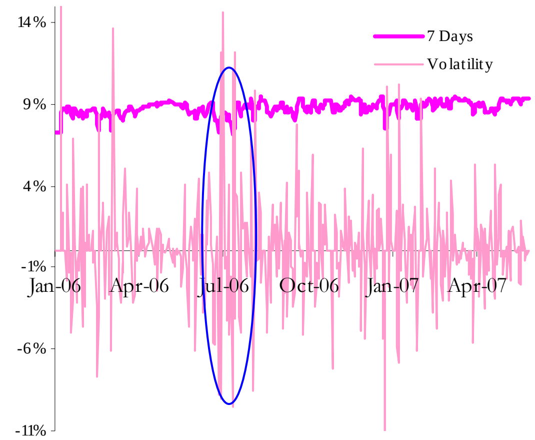


Figure-6.2.5:- 3M & 10Y PKRV Rates

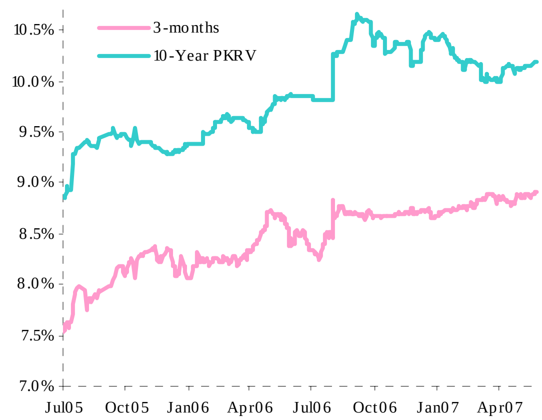
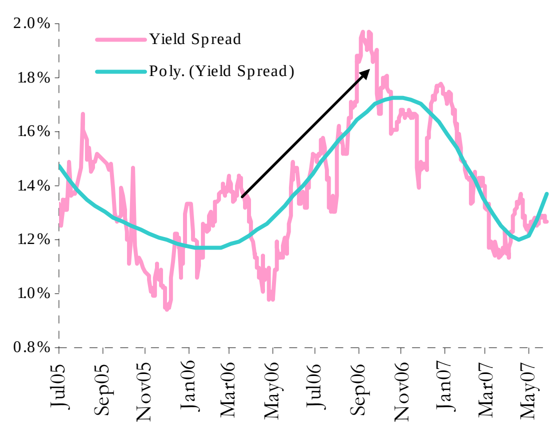


Figure-6.2.6:- Yield Spread b/w 10Y & 3M PKRV



Although the derivative products provide risk management solutions to square the positions or hedge the exposures, however, since such transactions require much sophistication on part of its players, the significant position taking may increase the risk exposures.

Figure-6.2.7:- GAP (RSA-RSL) to TA of All Banks

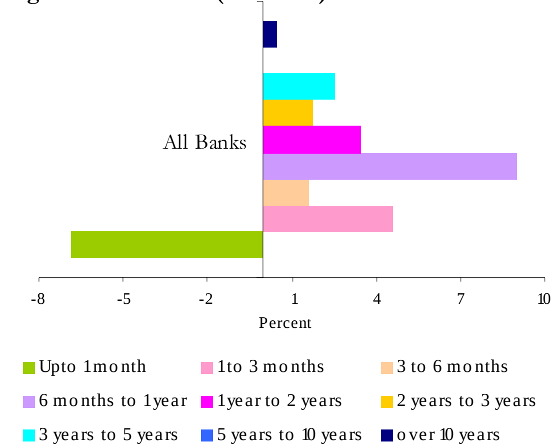
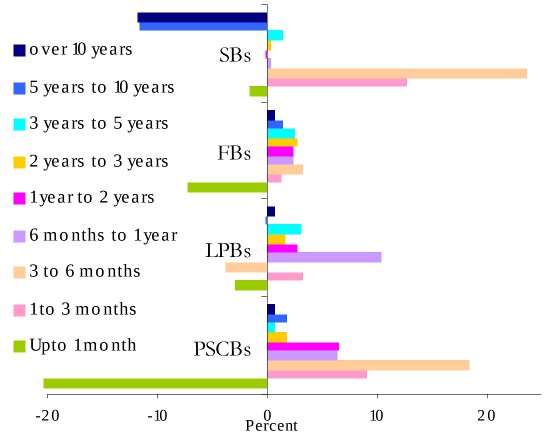


Figure-6.2.8:- GAP (RSA-RSL) to TA



Currency risk arises with the change in the exchange rate. Rupee shed some value against dollar during CY06. In the beginning of the year CY06, the rupee dollar exchange rate was Rs59.8, which crossed the psychological barrier of 60 by the mid March 2006 and by the end of December 2006 increased to Rs60.9 (see **Figure-6.2.9**).

Swap points remained positive during CY06 and hovered around Rs1.0, which signify some pressure on rupee, may be due to the heavy import payments and hence the rising trade deficit. However, inflows of foreign exchange in terms of both the workers remittance and foreign direct investment may extend a short term support to the value of our local currency. Kerb market premiums were actually positive till October 2006 and in July 2006, the same reached to the highest at Rs0.67 (see **Figure-6.2.10**). However, for onwards, rupee gained some strength and the exchange rate hovered around Rs60.7.

Figure-6.2.9:- Exchange Rate and Swap Points

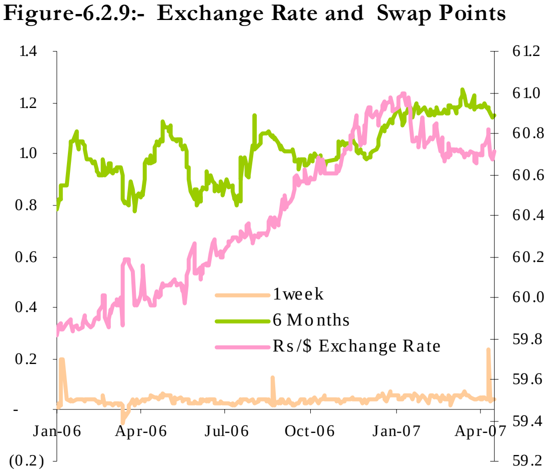
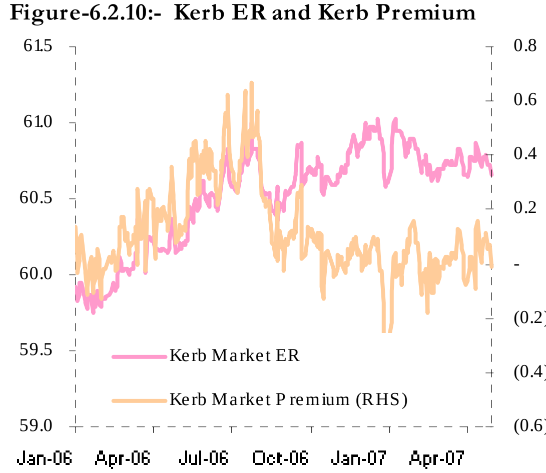


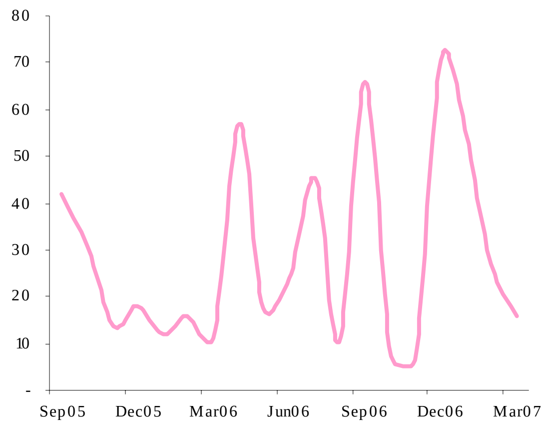
Figure-6.2.10:- Kerb ER and Kerb Premium



NOP of the banks, another measure of currency exposure of banks, remained positive, which signified that banks generally remained long in currency (see **Figure-6.2.11**). When compared in terms of capital, generally the level is well with in the acceptable limit.

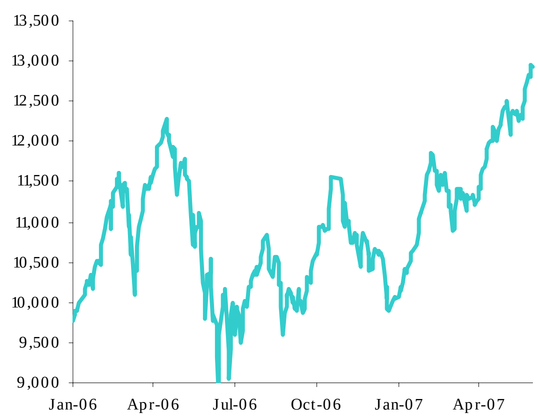
As for the direct currency risk, which arises when there is change in the value of foreign currency denominated assets and liabilities, the banks would actually gain with this depreciation in the local currency. This was because they had foreign currency assets in excess of foreign currency liabilities. Rather, the banks would actually gain from any depreciation of rupee. However, the indirect currency risk, which deals with the inability of the borrower to pay the foreign currency denominated loan due to significant exchange rate depreciation, may become a source of concern.

Figure-6.2.11:- NOP of All Banks (in Million $)



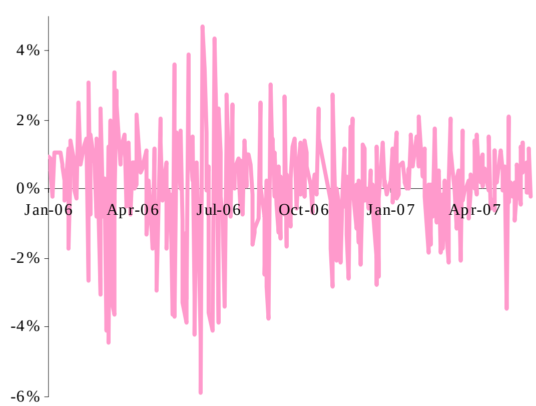
Equity price risk emanates from the volatile nature of the stock prices, which may depend upon both the internal and external factors, hence attracts the attention of the regulators. The movements in the KSE 100 index remained volatile (see **Figures 6.2.12 & 6.2.13**).

Figure-6.2.12:- Movements in KSE 100 Index



The overall direct equity exposures (including quoted and unquoted) of the banks has increased by 27 percent during the CY06, and in absolute terms stand at Rs43.4 billion as compared to Rs34.0 billion in CY05. However, in terms of capital, the investment in shares has actually declined due to the higher increase in the capital of the banks. As for the all banks, total investment in ordinary shares was 10.8 percent of the total capital (see **Figure-6.2.14**). Group wise position shows that LPBs carry the highest exposure, which in percentage terms is around 70 percent of the total exposure. For all the banking groups, the investment in equities in terms of total capital remained less than 12 percent. Bank wise position showed that these were the large banks which held the significant share of investment in equities (see **Figure-6.2.15**).

Figure-6.2.13:- Volatility in KSE 100 Index



When compared with the capital, a few banks also witnessed their significant equity exposures (see **Figure-6.2.16**). Since such investments are prone to the equity price risk, the total surplus booked against the investment in quoted shares actually declined to Rs4.8 billion from Rs7.4 billion in CY05. Bank wise, quite a few banks have booked revaluation deficits against their equity portfolio (see **Figure-6.2.17**).

Figure-6.2.14:- Exposure of Banks in Equities-CY06

	PSCBs	LPBs	FBs	CBs	SBs	All Banks
Actual Exposure	11.9	30.3	0.2	42.5	0.9	43.4
Exposure to Capital (RHS)	11.7	10.6	1.0	10.3	-9.3	10.8

Figure-6.2.15:- Investment in Fully Paid up Ordinary Shares

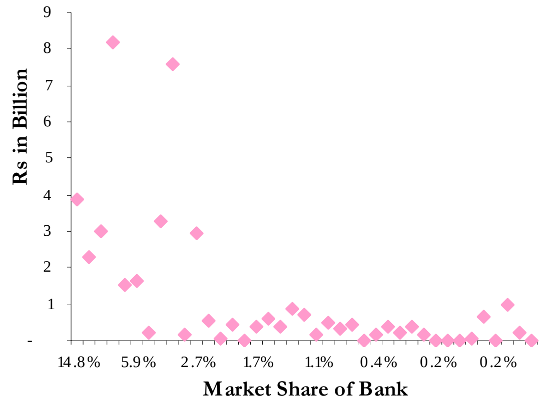


Figure-6.2.16:- Investment in Shares as Percent of Capital

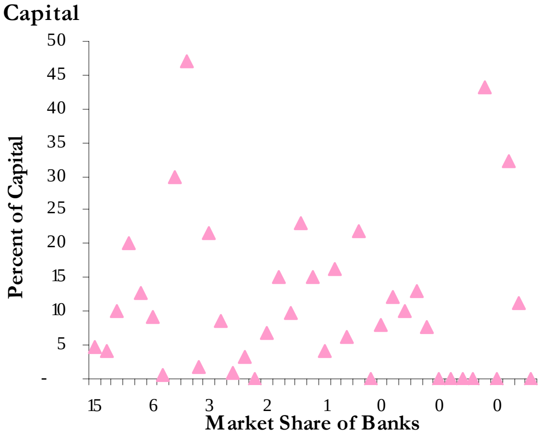
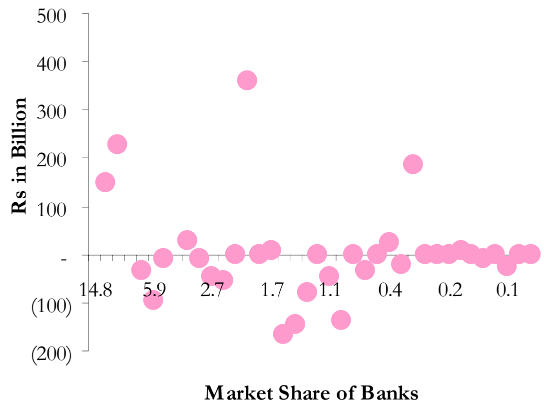


Figure-6.2.17:- Surplus/(Deficit) on Revaluation of Shares



A sensitivity analysis reveals that, on consolidated basis, the banks can sustain the shock of a 20 percent fall in the value of the investment in shares held by them since they actually have sufficient cushion available in the form of surplus booked against such shares (see **Figure-6.2.18**). The bank wise, surplus of 6 more banks in addition to the existing 16 banks, which were facing the deficit on revaluation of equities, might turn into negative under this scenario (see **Figure-6.2.19**).

Figure-6.2.18: Impact of Surplus/(Deficit) on Revaluation of Shares with 20% Fall in Prices

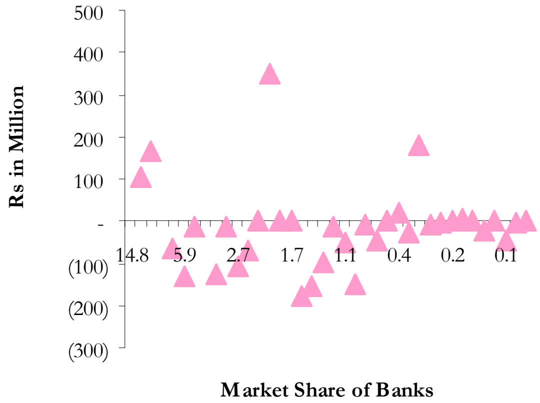
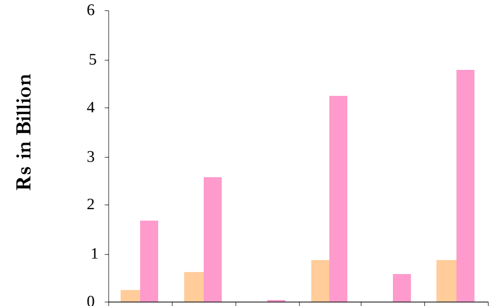


Figure-6.2.19:- Impact of a 20 Percent Fall in the Value of Shares



	PSCB	LPB	FB	CB	SB	All
Fall in the Value of Shares	0.24	0.61	0.00	0.85	0.02	0.87
Surplus on Shares	1.7	2.6	0.0	4.2	0.6	4.8

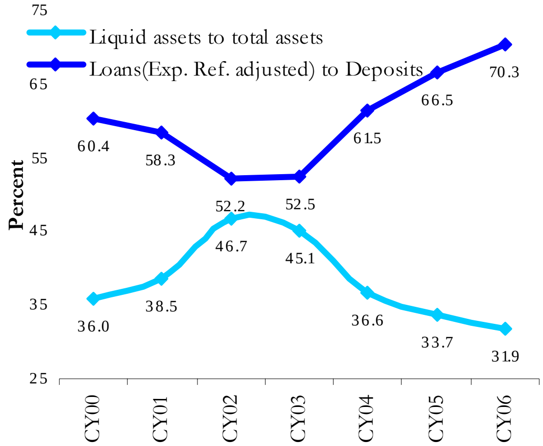
Summing up, it is the interest rate risk that mainly drives the market risk in our scenario. The changes in the yield curve during the year have increased the interest rate risk for the banks which have been carrying adverse gap between the maturities of their rate sensitive asset and liabilities. Further the upward shift in the yield curve has put some pressure on the value of the fixed income securities. On currency side, depreciation of rupee did not create direct exchange rate risk for our banking system, since the banks have foreign currency denominated assets exceeding the liabilities. On equities, although the equity exposure in absolute terms has increased over the year, however, given that the exposure in terms of capital has declined and in terms of total assets was negligible; it might not pose significant risk to the solvency of the banking system.

6.3 Liquidity Risk

Liquidity of the banking system portrays a mixed picture. The monetary signals continue to remain tight in CY06, as a result, interest rates witnessed a gradual increase over CY05. Frequent liquidity mop-ups by SBP and also the banks' aggressive lending trends has drained much of the excess liquidity available with the banks. However, steady foreign inflows continue to provide liquidity support to the banking system.

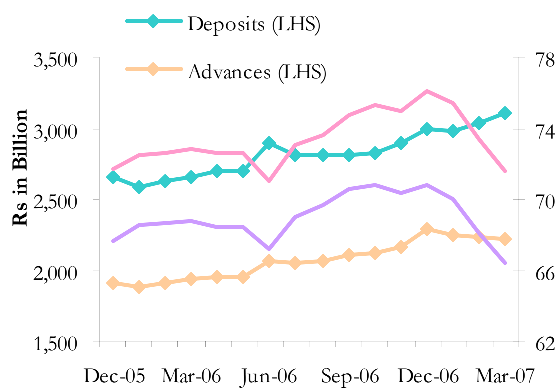
Of the key liquidity indicators, generally advances in terms of deposits followed a gradually increasing trend. Though deposits of the banking system continued to grow steadily over the period on the back of significant inflows in the form of remittances and FDI, advances registered relatively higher pace of growth. This has resulted into rise in advances to deposit ratio (ADR). Accordingly, ADR increased to 74.6 percent (excluding ERF: 70.3 percent) in December 2006 (see **Figure-6.3.1**).

Figure-6.3.1:- Liquidity Indicators



This rising ADR signified lesser liquidity left with the banking system. This was also evident from the decreasing liquid assets to total assets ratio which reduced to 31.9 percent in Dec-06 from 33.7 percent in CY05. However, quite recently-post December 2006, though deposits continued to maintain the growth movement, loans started slow down (see **Figure-6.3.2**). As a result, ADR has declined to 70.5 percent (Excluding ERF: 66.0 percent) in Mar-07 from 74.6 percent in Dec-06, which indicates the easing market liquidity position.

Figure-6.3.2:- Trends in Advances and Deposits of the Banking System



With regard to liquidity, one of the significant developments during the year was the increase in the liquidity requirement by SBP. In July 2006, SBP raised the liquidity requirement by actually withdrawing some of the exemptions previously given and increasing the statutory liquidity requirement (SLR) to 18 percent from the previous 15 percent on both the time and demand liabilities. Further, the cash reserve requirements has also been changed as 7 percent of the demand liabilities and 3 percent of the time liabilities as against the previous 5 percent for both the time and demand liabilities. Although the objective of setting a higher cash reserve requirement for demand liabilities was to encourage the time deposits, nevertheless, it increased the overall liquidity requirement of the banks because of the relatively significant share of demand deposits in the overall deposits of the banks.

As a result of this, the excess liquidity reserves declined significantly (see **Figure-6.3.3**). However, post December 06 trend indicates an increase in the total excess reserves maintained by the banks indicating increased level of liquidity in this period.

Figure-6.3.3:- Excess Reserves Held by the Banking System

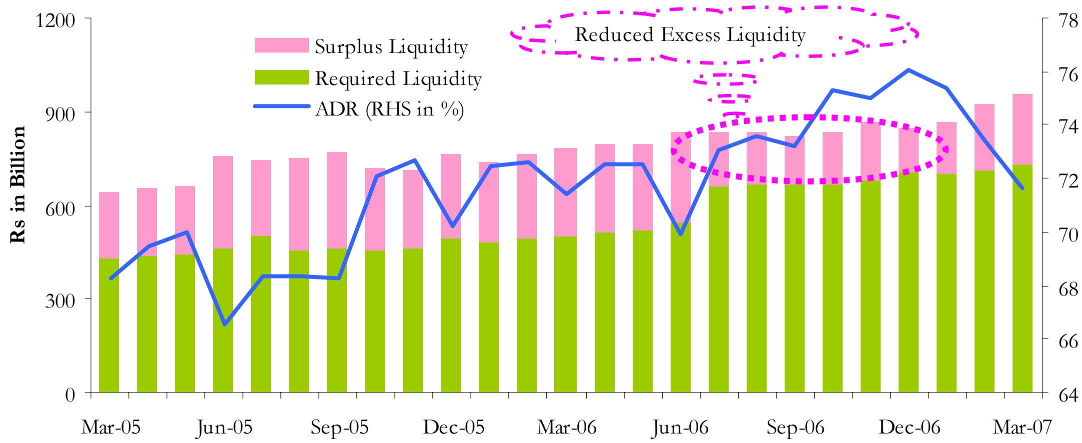
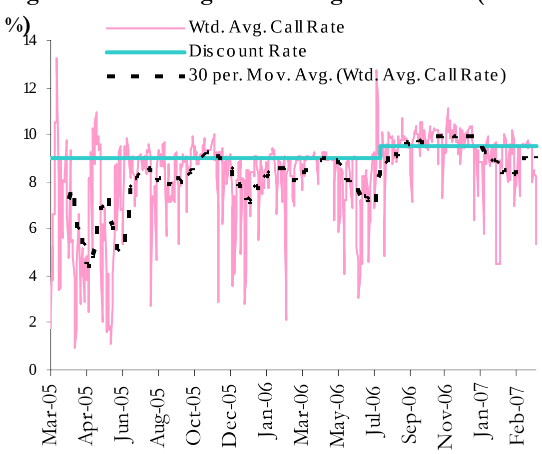


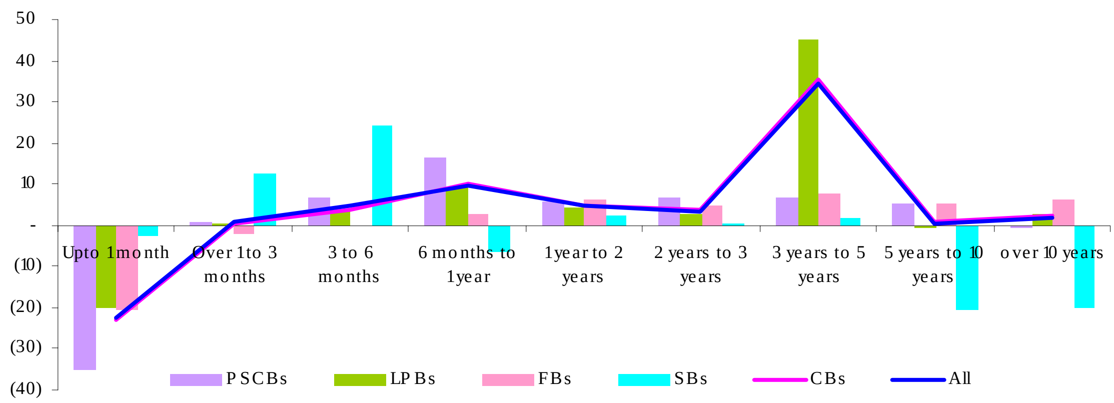
Figure-6.3.4:- Weighted Average Call Rates (in %)



The overnight interest rate (ONIR)—that is primarily a decreasing function of excess reserves, with very low excess reserves associated with very high (close to discount rate) ONIR rates and vise versa—shows a considerable decline in volatility with a steady rise in average level. The higher ONIR with lower volatility shows steady tightening of overnight money market. Nonetheless, the daily trend in ONIR (see **Figure-6.3.4**) Weighted Average Call Rates) shows more volatility since January 2007 which may hints towards some liquidity ease.

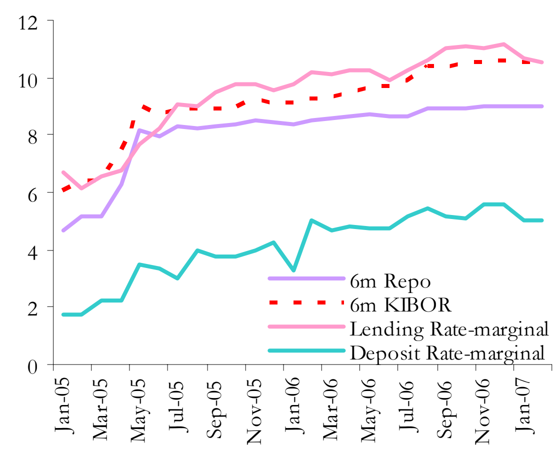
Maturity gaps, a measue of funding liquidity, were high in couple of time buckets. As for the one month time bucket, the negative gap of all banks was quite high at 22 percent of assets (see **Figure-6.3.5**). This significant negative gap has been reflected by all of the banking groups. Whereas, the gaps in 3 years to 5 years time bucket was exceptionally positive. In this case it were only LPBs which reflect so high positive GAP. This implies that, especially the LPBs were running positive duration gap since they have locked their assets in longer term buckets which did not commensurate with the maturity of liabilities. Since, in the short term bucket, the banks are running negative gap, a disruption in the steady inflows may create a liquidity concern for the system.

Figure-6.3.5:- Maturity GAP (Assets - Liabilities) to Total Assets (in %)



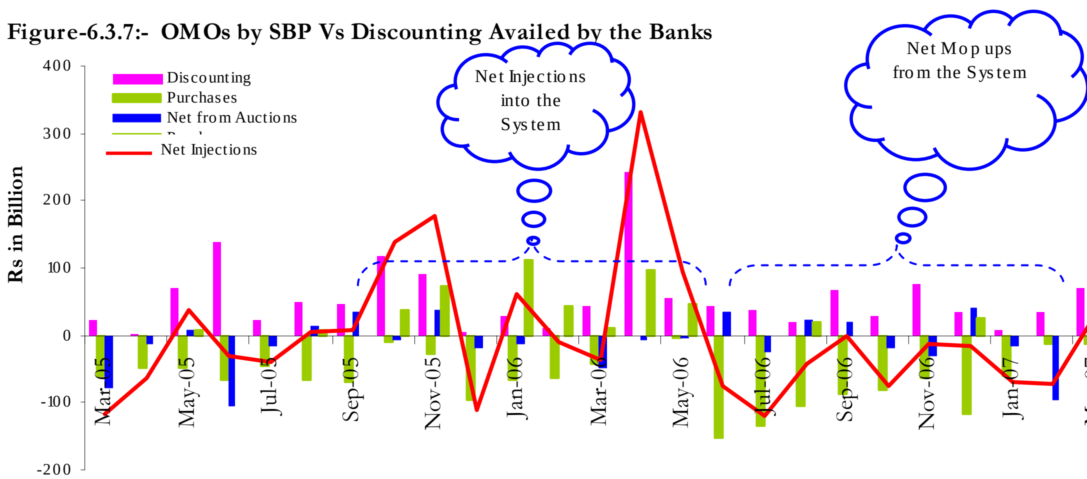
In theory, monetary policy should transmit in key market inertest rates; the movements in key market interest rates (see **Figure-6.3.6**) showed a steady rise in past couple of years with a slight decline since January 2007.

Figure-6.3.6:- Key Interest Rates (in %)



All the above mentioned indicators support that liquidity of the banking system has squeezed especially when compared with the scenario of a couple of years back when there was flush of liquidity available in the system and the management of excess liquidity was a challenge. Now the excess liquidity from the system has drained to a greater extent since the tight monetary policy stance of SBP worked well (see **Figure-6.3.7**). SBP in lieu of its monetary policy stance, took a number of measures that included the gradual increase in the benchmark rates in the auctions, the increase in the discount rate and liquidity requirements and the frequent OMOs to manage the liquidity of the system.

Figure-6.3.7:- OMOs by SBP Vs Discounting Availed by the Banks



Though the excess liquidity reserves maintained by the banking system have declined when compared with the couple of years back, especially due to the increase in statutory liquidity requirement, the increasing advances to deposit ratio, mainly due to the significant loan growth during the same period, also shows that the banks had the liquidity available to support this increased growth in loans. Hence this decrease in the excess liquidity reserves may be attributable to the preference of the banks locking in more in the high yield assets.

The increasing advances to deposit ratio indicate liquidity tightening especially when the banks also need to keep around 24 percent with SBP on account of liquidity requirements. However, considering the other sources of the funds available with the banks, the advances in terms of total assets are at 56 percent in CY06, which does not seem very high. This is because of the steady increase in other sources of funds for example; strengthening. equity base on account of meeting the MCR and the increasing flow of Export Refinance Borrowing from SBP.

Suming up, the liquidity of the banking system though has marginally declined when compared with the scenario in 2005, however, the banks are available with adequate inflows to fund their liquity needs and also to support growth momentum in the economy. Nevertheless, banks should remain vigilant about their maturity mismatches while managing their assets and liabilities structure, to cope with any adverse liquidity condition, if any.

6.4 Operational Risk

Operational risk is intrinsic to financial institutions and constitutes an important component of their enterprise-wide risk management systems. It is becoming increasingly central to the fundamental health of the individual banks and stability of the system as a whole. Operational risk management improves the quality and stability of earnings, thereby enhancing the competitive position of the institutions and facilitating their long term survival. However, the increasing rate of change and the level of sophistication have resulted in the need for more responsive approaches to operational risk management. The contributory factors to enhanced operational risk exposure generally originate from new automated technologies, more complex products, e-banking and acquisitions/ mergers in the banking system.

Besides its endeavors to implement the best practices in operational risk management within banks; State Bank of Pakistan, assesses the gravity of threats emanating from lapses in control environment. For this purpose, it keeps track of frequency and volume of frauds and forgeries committed in the banking system. During CY06, the number of fraud and forgeries cases increased from 2758 to 2949 whereas the amount recoverable against those cases increased from Rs4.5 billion to Rs4.8 billion **(see Figure-6.4.1)**. Resultantly, the amounts outstanding at the year-end as a percentage of last three years moving average kept on the rising trend of last year **(see Figure-6.4.2).**

By gravity of the incidents, data collected from the banks reveals that the Serious Fraud cases (involving an amount of Rs10 million and above) constituted 4.6 percent of total incidents reported; whereas, the amount involved there against was around 67 percent of total amount outstanding **(see Table-6.4.1).**

On the institutions side; for other financial risk dimensions, such as credit and market risk, the banks have in place an array of more sophisticated economic models for quantifying risk exposures. Quantification of operational risk, however, is a relatively new arena, so the banks have made less progress in developing formal models in this regard. Therefore, the supervisors, worldwide, are emphasizing standards for robust systems for operational risk management amongst the banking institutions.

Figure-6.4.1:- Frauds & Forgeries in Banks

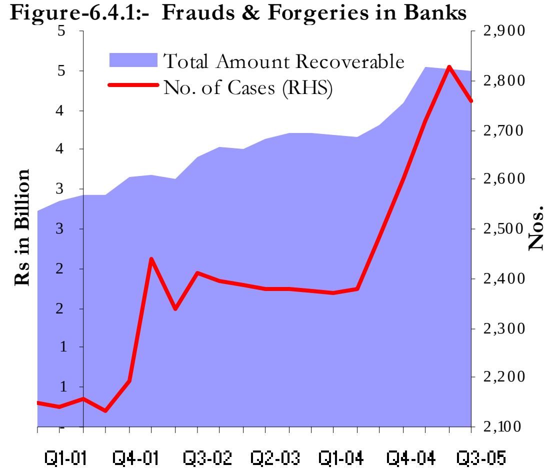


Figure-6.4.2:- Trends in Operational Risk

Table-6.4.1:- Break up of Frauds and Forgeries-CY06

(Rs in Billion)

Category	No. of Cases	Amount Outstanding
Serious Frauds	135	3
Medium Severity Cases	465	1
Low Severity Cases	2,349	1

The operational risk has unlimited downside and can expose an institution to serious financial and reputation losses which need to be accounted for. That's why the Basel-II framework folds the treatment of operational risk into risk-based capital requirements. The framework calls for banking institutions to hold capital to absorb possible losses from their exposure to operational risk. While recognizing that the risks of loss from banking operations are not as obliged to statistical modeling as are other risks, Basel-II capital framework has set new criteria for implementing risk-based capital requirements for operational risk and prescribed three methods for calculating operational risk capital charges in a range of increasing sophistication and risk sensitivity. These are, in the order of their increasing complexity.

- Basic Indicator Approach
- Standardized Approach
- Advance Measurement Approach

Under these approaches, the regulatory capital requirement for operational risk would be determined primarily by a bank's own internal risk measurement system, subject to certain qualitative and quantitative criteria.

State Bank of Pakistan, further to the roadmap issued in 2005 for implementation of Basel-II framework, has issued detailed instructions for adoption of various approaches for calculating capital adequacy requirements for credit, market and operational risks under Pillar I of Basel-II Capital Accord. For Operational Risk, the banks are free to adopt either Basic Indicator Approach or Standardized Approach from 1st January, 2008. However, the Advance Measurement Approach has not being offered at present.

As part of its implementation roadmap, a parallel run of Basel-II framework is underway and impact studies are being conducted on various aspects of the framework. The assessment of capital requirement on the basis of returns submitted under Basel-II framework reveals that, while adopting 'Basic Indicator Approach', the banking system is required to allocate an additional capital charge of around Rs29 billion for operational risk during CY06.

6.5 Resilience of the Banking System towards Stress Tests

To assess the resilience of the Pakistani Banking System, stress tests have been performed using simple sensitivity analysis. Employing the top-down approach to stress testing, the exercise discusses the impact of various stress scenarios on banks, both individually as well as all the three commercial banking groups viz. Public Sector Commercial Banks (PSCBs), Local Private Banks (LPBs) and Foreign Banks (FBs). This exercise assumes the stress scenarios along three risk factors i.e. credit, market and liquidity (see **Box 6.5.1**). The scenarios have been devised based on both the historical and hypothetical moves in the risk factors.

Box 6.5.1
Reference Scenarios

Credit Risk

Scenario C-1 assumes a 10 percent increase in NPLs (with a provisioning rate of 100 percent).

Scenario C-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 C-3 assumes a cumulative impact of the two shocks under Scenarios C-1and C-2.

Scenario C-4 assumes an increase in NPLs upto 10%age points rise in NPLs to Loans ratio of consumer finance (with 100% provisioning against increased NPLs)

Scenario C-5 refers to the NPLs to total loans ratio, which would wipe out capital (with a 50 percent provisioning rate for additional NPLs).

Market Risk: Interest Rate Risk

Scenario IR-1 assumes an increase in interest rates by 200 basis points.

Scenario IR-2 assumes a shift and steepening in the yield curve by increasing interest rates of all the three maturities (by 50, 100, and 150 basis points)

Scenario IR-3 assumes a shift coupled with flattening of the yield curve by increasing 150,120 and 100 basis points in the three maturities respectively.

Market Risk: Exchange Rate Risk

Scenario ER-1 assumes a depreciation of ER by 13 percent (closer to the highest change in the monthly average PRS/US$ exchange rate (12.83) over the period from Jan 1994, in September 2000).

Scenario ER-2 is based on the hypothetical assumption of appreciation of rupee by 20 percent.

Scenario ER-3 assumes a 10 percent depreciation of the rupee and deterioration in the quality of 10 percent of unhedged foreign currency loans with 50 percent provisioning requirement.

Market Risk: Equity Price Risk

Scenario E-1 assumes the impact of a 20 percent fall in the equity prices.

Scenario E-2 assumes the impact with a 40 percent decline in the equity prices

Liquidity Risk

Scenario L-1 assumes a 5 percent decline in the liquid liabilities and its impact on liquidity coverage ratio calculated after excluding Govt. securities under Held to Maturity category from liquid assets.

Scenario L-2 assumes a 10 percent decline in the liquid liabilities and its impact on liquidity coverage ratio calculated after excluding Govt. securities under Held to Maturity category from liquid assets.

Calibration of Shocks

The impact for credit and market shock scenarios has been gauged both in terms of earnings as well as capital. The revised capital adequacy ratio has also been calculated after applying the shocks. As for liquidity, the impact of the shocks has been gauged in terms of liquidity coverage ratio[10]. The results of the stress tests have been summarized in the **Box 6.5.2.**

Box 6.5.2

Results of "Stress Tests" of Pakistani Banking System

Reference Scenarios			Dec-05			Dec-06		
			Impact of Shock as %age of Before Tax Profit	*%age Point Change in CAR due to Shock*	*Revised CAR-After Shock*	*Impact of Shock as %age of Before Tax Profit*	*%age Point Change in CAR due to Shock*	*Revised CAR-After Shock*
Credit Shocks								
Scenario	C-1	Deterioration in the qualityof loan	-14.4	-0.5	11.7	-11.2	-0.4	12.9
Scenario	C-2	Shift in categories of classified loans	-8.0	-0.3	11.9	-7.8	-0.3	13.0
Scenario	C-3	Cumulative impact of all shocks in 1and 2	-22.4	-0.8	11.4	-19.0	-0.7	12.6
Scenario	C-4	Deterioration in NPLs ratio of consumer finance	-26.7	-1.0	11.2	-26.3	-1.0	12.3
Scenario	C-5	Level of NPLs to loans ratio where capital wipes out (i.e. 33.52% in Dec-05 and 36.3% in Dec-06)	-288.1	-12.2	0.0	-295.2	-13.3	0.0
Market Shocks; Interest Rate Shocks								
Scenario	IR-1	Shift in the yield curve	-30.3	-1.1	11.1	-16.9	-0.7	12.7
Scenario	IR-2	Shift and steepening of the yield curve (large shock)	-22.2	-0.8	11.4	-12.1	-0.5	12.9
Scenario	IR-3	Shift & flattenining of the yield curve	-15.3	-0.6	11.6	-8.7	-0.3	13.0
Market Shocks; Exchange Rate Shocks								
Scenario	ER-1	Depreciation of Rs/US$ exchnage rate (the historical high)	7.1	0.3	12.5	28.6	1.1	14.4
Scenario	ER-2	Appreciation of Rs/US$ exchnage rate (hypothetical)	-5.5	-0.2	12.0	-22.3	-0.9	12.5
Scenario	ER-3	Depreciation in ER along with deterioration of quality of FX Loans (50 % Provisioning)	-0.2	0.0	12.2	0.0	0.0	13.3
Market Shocks; Equity Price Shocks								
Scenario	E-1	Fall in the KSE index (historical high)	-0.6	0.0	12.2	-4.1	-0.2	13.2
Scenario	E-2	Fall in the KSE index (hypothetical scenario)	-8.6	-0.3	11.9	-11.7	-0.5	12.9
Liquidity Shocks								
Liquidity Coverage Ratio				*Actual*	*After Shock*	*Actual*	*Actual*	*After Shock*
Scenario	L-1	5 Percent Fall in the Liquid Liabilities		36.3	32.9		35.5	32.1
Scenario	L-2	10 Percent Fall in the Liquid Liabilities		36.3	29.2		35.5	28.3

Note: The results have not been adjusted for deferred tax benefits accruing on these losses.

Summary of Results

Below is the brief description of the results of the stress tests under all the three credit, market and liquidity shocks.

Credit Shocks

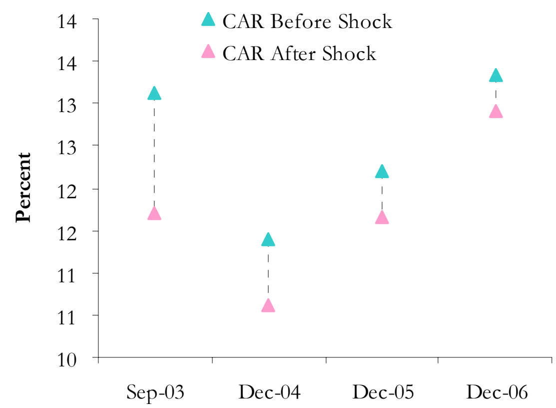
Strengthening solvency position added to the resilience of the Pakistani banking system towards the plausible shocks. On the credit front, the improved asset quality reflected in the declining infection ratios has lent a hand to this resilience. Five scenarios (C1 – C5) have been assumed to gauge the sensitivity of the banks towards deterioration in credit quality. The results of these have been summarized as follows:

Credit Scenario C-1 refers to the impact of 10 percent increase in NPLs assuming a 100 percent provisioning against the increased NPLs. The results show that banks are generally resilient toward this level of shock (see **Figure-6.5.1**). Such a shock may eat up 11.2 percent of the before tax profit of CY06 of the commercial banks. Resultantly, the CAR may experience a decline of around 0.4 percentage points to 12.9 percent. Bank wise, the CAR of none of the banks would fall to below 8 percent with this shock.

[10] Ratio of liquid assets to liquid liabilities

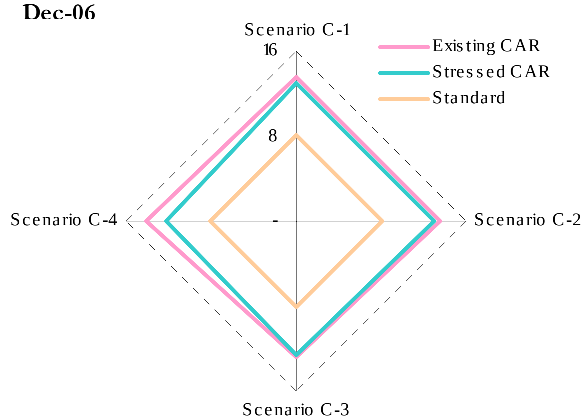
Since more than 75 percent of the total NPLs lie in loss category, the impact of shock assumed in **Scenario C-2** remained somewhat on lower side, when measured in terms of profits (see **Figure-6.5.2**). This shock may toll the commercial banks profits by around 8 percent and the CAR by a fraction of percentage point. The group wise CAR remains comfortable. With this shock, the CAR of none of the banks falls to below the required standard.

Figure-6.5.1:- Impact of 10% Rise in NPLs on CAR-Scenario-C1



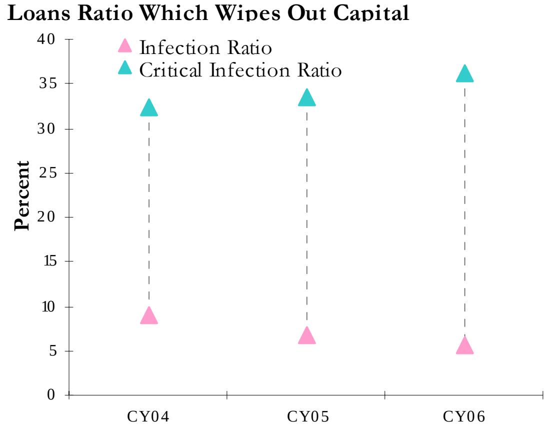
Scenario C-3 gauges the combined impact of the above two credit scenarios. Combining both the increase in NPLs and shift in the categories of NPLs CAR of commercial banks may not decline to below 12 percent. Group wise, all the groups would comfortably stay at more than 8 percent. Individually, one bank, carrying a market share of less than 2 percent, may experience a fall in CAR to slightly below the 8 percent.

Figure-6.5.2:- Impact of Credit Shocks on CAR-Dec-06



Credit Scenario C-4 assumes a shock to the credit quality of consumer sector. It takes into account an increase in NPLs of consumer finance equivalent to 10 percent of consumer portfolio. The results show that all groups of commercial banks would remain compliant with the 8 percent requirement. Group wise, highest decline is experienced by FBs, the CAR of this group would experience a fall of 2 percentage points to 13 percent. Individually, three banks, having a market share of around 14 percent may experience a fall in their CAR to below 8 percent but not less than 7 percent.

Figure:-6.5.3 NPLs to Loans Ratio Vs the NPLs to Loans Ratio Which Wipes Out Capital



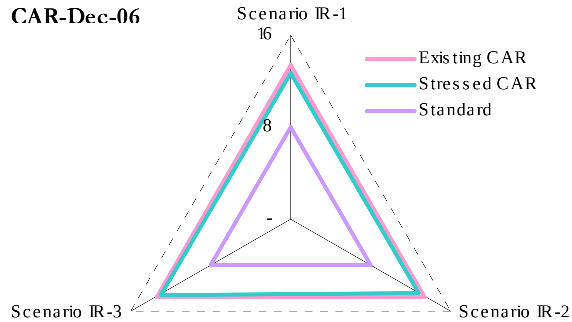
Credit Scenario C-5 assumes an extreme value shock. It gauges the level of NPLs to loans ratio which would wipe out capital of the banks assuming a 50 percent provisioning against the additional NPLs. NPLs to loan ratio of all commercial banks as of CY06 stayed at 5.7 percent. The critical loan infection ratio that can eat up whole of the capital base of the banks hovers around 36.3 percent (see **Figure-6.5.3**). Now, the healthy margin between the present level of this ratio and critical infection ratio, suggests that banks are operating with the safe cushions

Market Risk

Interest Rate Shocks

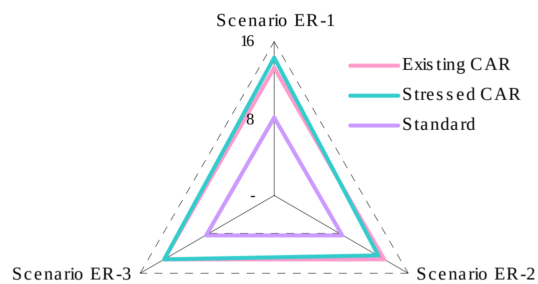
To gauge the interest rate sensitivity of CBs, three stress scenarios (IR-1 to IR-3) have been envisaged. A 200bps rise in interest rates across all the maturities along the yield curve, a shock assumed in **Scenario IR-1,** would lower the CAR of CBs to 12.7 percent from the 13.3 percent (see **Figure-6.5.4**). Bank wise, no additional bank becomes non compliant to the 8 percent CAR after applying this shock.

Figure-6.5.4:- Impact of Interest Rate Shocks on CAR-Dec-06



The impact of shock in **Scenario IR-2**, that assumes an upward shift of 50bps as well as steepening of the yield curve, is lesser than what was under Scenario IR-1. The CBs experience a fall of 0.47 percentage points in their existing CAR of 13.3 percent and would remain safely above the required level. Group wise CAR, for all commercial banking groups, also remains comfortably above required level. Bank wise, no additional bank becomes non compliant to the 8 percent CAR after applying this shock.

Figure-6.5.5:- Impact of Exchange Rate Shocks on CAR-Dec-06



The overall impact of shock assumed in **Scenario IR-3,** a shift and flattening of the yield curve remained on lower side and the CAR of CBs, after the shock, declined to 13.0 percent. Group wise, the fall in CAR for none of the commercial banking groups exceeds 0.7 percentage points. As for the individual banks, the CAR of none of the banks falls to below 8 percent with this shock.

Exchange Rate Shocks

Three different scenarios (ER-1 to ER-3) have been envisaged to assess the exchange rate risk of the banks (see **Figure-6.5.5**). **Scenario ER-1** assumes depreciation in the rupee by 13 percent. The impact of the shock is rather positive on the CAR of the banks as the FCY assets are more than FCY liabilities and any depreciation of exchange rate would actually benefit the banks also evident by the overall CAR of CBs.

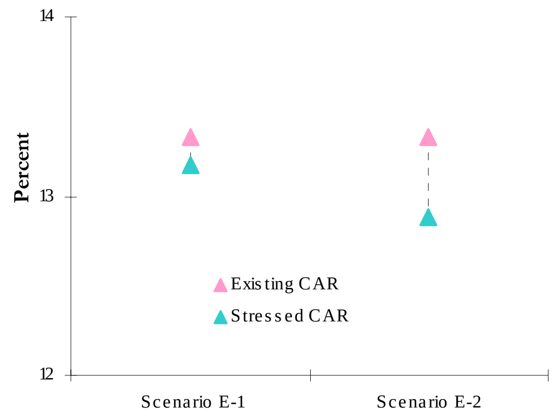
Under **Scenario ER-2**, as opposed to Scenario ER-1, an increase in value of rupee by 10 percent has been assumed. The impact of this appreciation in rupee on the banks positions would be negative and CBs would experience a 0.86 percentage points decline in their CAR. Amongst all the groups, PSCBs experience the greatest fall in their CAR. On individual basis, CAR of none of the banks falls below 8 percent benchmark.

Scenario ER-3 assumes the direct as well as indirect impact of exchange rate changes on the banks. In addition to the direct impact of exchange rate, which is obvious in the change in the value of assets/liabilities, the indirect impact captures the impact of this change in the exchange rate on the foreign currency loans by affecting the credit repayment capacity of the borrower. This scenario assumes a 10 percent depreciation of the rupee which may result in deterioration in the quality of 10 percent of un-hedged foreign currency loans with 50 percent provisioning requirement. The results witness that since FCY loans are not significant, the deterioration in its quality may not be significant in value terms especially when it is compared with the depreciation gain under this scenario, hence the net impact may be nil.

Equity Price Shocks

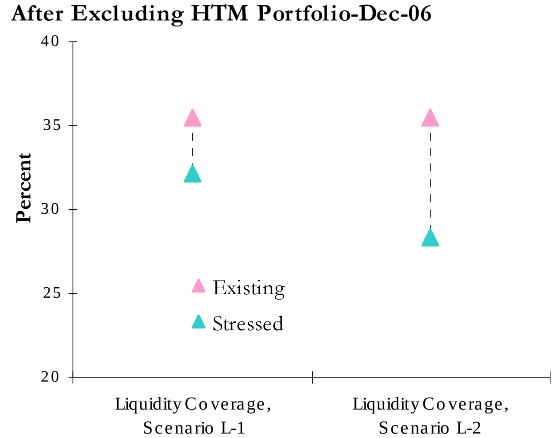
Two scenarios (E1 & E2) have been assumed to gauge the sensitivity of the banks towards equity price movements (see **Figure-6.5.6**). The impact of a 20 percent fall in the equity value, under **Scenario E-1,** is not significant as the direct equity exposures of the banks are not a significant portion of their total investments. The CAR of CBs falls merely by a few basis points. On individual basis, no bank has its adjusted CAR to fall below 8 percent.

Figure-6.5.6:- Impact of Equity Price Shocks on CAR- Dec-06



In **Scenario E-2**, since the LPBs carry the highest share in such investments among all the groups, the fall in their CAR, is greatest at 40 basis points. However, the after shock CAR would still be comfortably high. As for CBs, their CAR falls from 13.3 percent to 12.9 percent. Individually, the CAR of none of the banks would fall to below 8 percent with this shock.

Figure-6.5.7:- Liquidity Coverage Ratio Calculated After Excluding HTM Portfolio-Dec-06



Liquidity Risk

Since liquidity risk relates to the inability of a bank to meet its short term liquidity demands, two scenarios (L-1 to L-2) seek to measure the liquidity risk of the banks through liquidity coverage ratio. As the statutory liquidity requirement is about 24 percent of time and demand liabilities (inclusive of cash reserve requirement), considering the other sources of funds as well, a minimum 25 percent level is of this liquidity ratio has been considered minimum and a 30 percent and above as comfortable. Under these scenarios liquid assets have been taken exclusive of investments in Held to Maturity category.The result in **Scenario L-1** shows that the liquidity coverage ratio (calculated after excluding HTM securities from liquid assets) of CBs declined from 33.5 percent to 30.0 percent after shock (see **Figure-6.5.7**). Amongst commercial banking groups, LPBs experience greatest decline in liquidity coverage ratio, which falls from 32.4 percent to 28.9 percent.

Scenario L-2 considers a 10 percent decline in liquid liabilities. Group wise, the liquidity coverage ratio of all the groups, except those of FBs, would fall to below 30 percent with this 10 percent decline in liquid liabilities.

Summing up

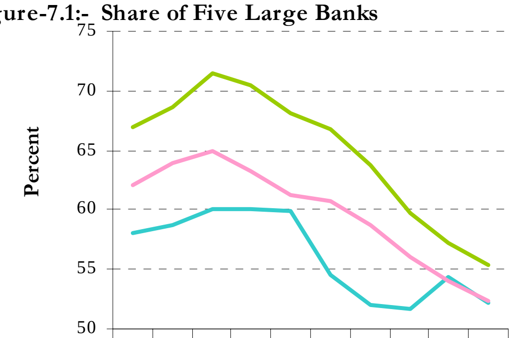
The fortifying capital base and the solvency position of the banks have significantly improved the resilience of Pakistani banking system towards different credit and market related shocks. From credit side, the shock assuming a significant deterioration in the loans to consumer sector may erode the profits of a few banks. Such banks should cautiously monitor their consumer sector exposures to avoid any adverse situation. Movements in the interest rates may not show a major impact on the values of the banks portfolio. Exchange rate risk also seemed to be benign. Equity exposures, though are not that significant, may raise a concern if there is a large downward moves of the capital market, which can erode the capital of a few banks. On liquidity front, in the absence of liquidity inflows, a 10 percent fall in the liquid liabilities may affect the liquidity of the banking system.

7 Trend in Selective Efficiency Indicators of the Banking System

Over the years, banking system of Pakistan has transformed into a robust, resilient and stable banking system. All of the performance and stability indicators witnessed significant improvement during the last ten years. High profitability and strengthened solvency remained the hallmark of our banking system in recent years. In regional perspective[11], the Pakistani banking system has been placed among the top ten of the emerging market economies in terms of profits, whereas the capital position has been ranked among the first half of these economies. On qualitative front, the steps taken by Pakistan to implement effective corporate governance framework have been recognized by The World Bank[12] and rated the best in the South Asian Region.

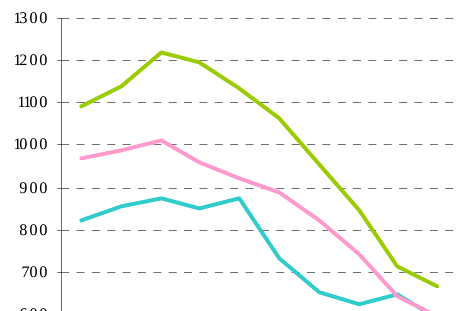
Over the last ten years, the banking system of Pakistan has gone through significant changes, on the back of financial sector reforms which include privatization, liberalization, deregulation, strengthened prudential measures, enhanced role of IT, products diversification etc. Such structural changes in the banking system desire in depth analysis of the trends. Ensuing paragraphs discuss the trends of the selective efficiency indicators of the banking system in terms of industry concentration, increasing competition, rationalizing cost structure and promoting efficiencies in the banking system.

Figure-7.1:- Share of Five Large Banks



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05	CY06
Advances	58.1	58.8	60	60	59.9	54.6	52	51.6	54.3	52.2
Total Assets	62	63.9	65	63.2	61.2	60.7	58.7	56	54.1	52.3
Deposits	67	68.6	71.5	70.4	68.1	66.7	63.8	59.7	57.2	55.4

Figure-7.2:- Herfindahl Index for Five Large Banks



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05	CY06
Advances	820.62	853.18	872.86	850.46	874.42	733.26	653	624.2	645.1	588.27
Total Assets	969.1	989.58	1009.9	960.2	920.21	887.43	820	742.9	643.24	595.79
Deposits	1089.9	1140.5	1221.9	1197	1135.1	1063.3	954	844.88	714.8	664.38

Industry Concentration:

During 90s, the banking system of Pakistan was primarily dominated by the large five banks which were holding around 62 percent of the total market share in terms of assets. During 2003, the share of these large five banks reduced to below 60 and in CY06 it further diluted to 52 percent (sees **Figure-7.1**). This is also obvious in the declining levels of Herfindahl Index[1], which is a measure of concentration. The value of Herf-

[11] IMF Country Report No. 06/426 of December 2006-Pakistan: 2006 Article IV Consultation – Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Pakistan.

[12] Financial Performance and Soundness Indicators Phase II -Getting Finance in south Asia- The World Bank Report on South Asia Region.

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

assets of these five banks, which was greater than 900 before CY00, declined to 596 in CY06 (see **Figure-7.2**).

As for the industry, the Herf-assets were more than 1000 in CY97, which reduced to about 745 in CY06 (see **Figure-7.3**). By comparing the concentration in deposits and advances separately, it comes to the surface that the concentration in deposits is relatively higher. The values of Herf-deposits and Herf-advances in CY97 were 1149 and 906, whereas in CY06 these came down to 810 and 746 respectively. This endorses the view that still the big five banks hold relatively greater share of deposits. This may be attributed to the greater outreach of these banks and greater confidence of the general depositor due to their long presence in the market.

With this decreasing Herfindahl index, the number of equivalent size banks, a measure based on Herfindahl index value, has increased from 9 to 13 since 1997. With consolidation of the banking system, which is obvious in the growing number of mergers and acquisitions, the number of banks has come down from 46 in CY97 to 39 in CY06.

This coupled with the growing capital and asset base of the banks talks well about comparatively competitive market structure.

This bodes that actually the concentration in our banking system has reduced from the levels in 90s. Further, the present level of Herf-asset, Herf-advances and Herf-deposits show that the concentration in terms of assets, advances and deposits is decreasing. Such scenario is promoting competition which would enhance the efficiency of the banking system as whole. However, relatively higher deposits concentration in the larger banks is affecting the overall cost structures of the system.

Figure-7.3:- Herfindahl Index for Industry

	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05	CY06
Advances	906	941	967	942	965	850	780	764.32	772.53	745.96
Total Assets	1045	1055	1069	1023	993	971.7	913	850.08	762.16	744.88
Deposits	1149	1190	1259	1238	1185	1128	1032	946.03	832.28	809.75

Figure-7.4:- Trends in Intermediation Cost (Admin. Expense)

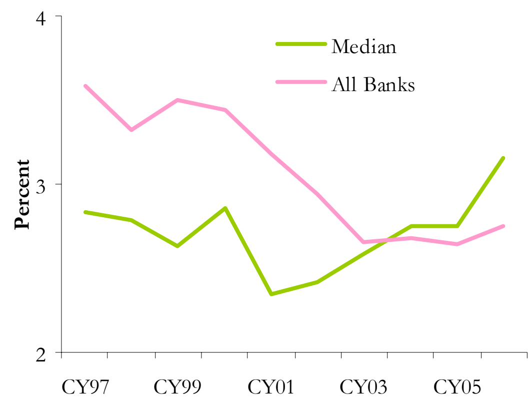
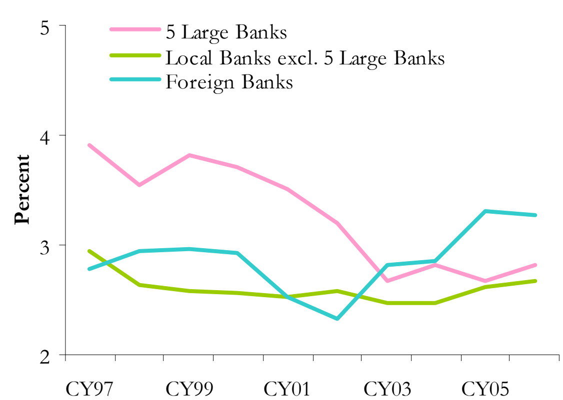


Figure-7.5:- Category-wise Intermediation Cost, Admin. Expense



Intermediation Costs[2]**,** a measure of operating efficiency, has also witnessed improvement since 90s. Administrative expenses in

[2] To ensure comparability, forthcoming discussion focuses on commercial banks only and excludes the spcialized bank whose nature of business differ significantly.

absolute terms experienced a consistent decline till CY03, after which these slightly inched up (see **Figure-7.4**). However, the level is still lower than that of in late 90s. More importantly, these administrative expenses when looked in terms of gross income are actually declining considerably over the period.

Category wise behavior shows that large 5 banks experienced a steeper decline in the intermediation costs whereas the local banks were able to show a marginal decline (see **Figure-7.5**). Foreign banks which were cutting their costs till 2003, witnessed a reversal in their trend and their administrative expenses actually increased in last couple of years

A X -sectional analysis reveals that the difference in the intermediation cost of the bank at 25th percentile and the one on 75th percentile actually reduced till CY03, and for onwards it increased (see **Figure-7.6**). This behavior is also reflected in its median values. Resultantly, the inter quartile range of this ratio, after CY03, has inched up, which signifies that the difference between the intermediation costs of different banks has been widening since CY03.

This widening inter quartile range and the increase in the administrative expenses especially in the big banks and foreign banks during the last few years may be attributed to the fact that the banks have been spending relatively higher to gain market share and increase penetration. The administration cost has been increasing due to the growing technological improvement, institutionalizing the risk based IT systems, improvement in infrastructure, increasing investments by the banks in the areas of human resource skill enhancement and capacity building etc. The benefit of this increased spending by the banks in the form of administrative expenses can be seen in the higher business and profit volumes.

Figure-7.6:- Trend and X-Sectional Dynamics of Intermediation Cost

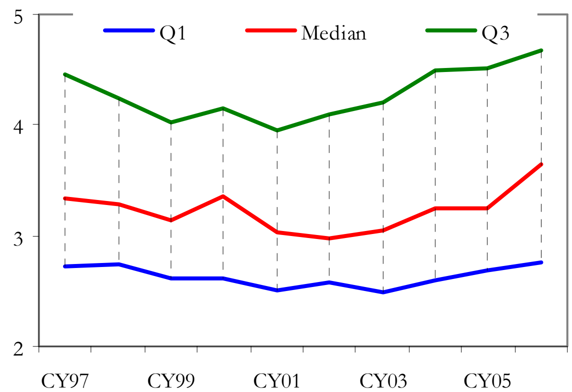
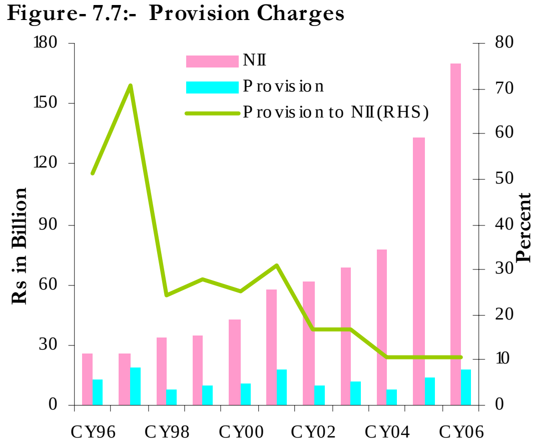


Figure- 7.7:- Provision Charges



Provision charges witnessed a downward trend till CY04, when it again started to inch up (see **Figure-7.7**). However, when looked in terms of net interest income, these provisions have been consistently declining. As compared to the level of more than 70 percent in late 90s, its level has reduced to about 10 percent in CY06. The higher level of infection ratios and the strict enforcement of Prudential Regulations have caused this charge to be quite higher in late 90s. However, with the gradual cleaning of infected portfolio and the adoption of prudent lending practices, these charges have reduced significantly. In the recent years, the marginal increase in the amount of provisioning may imply that banks are now taking greater risks by focusing more on relatively high risk assets in search of better yields. As a result, the level of NII has witnessed much higher growth as compared to provisioning.

Interest Margins[13]: When compared with the intermediation cost, the cost of funds and the return on earning assets also experienced a similar trend over the last 10 years. A steeper decline has been witnessed in both the cost of funds and the return on earnings till CY04 due to overall declining trends in interest rates in this period (see **Figure-7.8**). Declining intermediation costs supported the rationale of lower margins, which can be seen in the marginally declining interest margins till CY03-04. By that time, interest rates had touched historic low due to excessive liquidity available in the banking system. Hence, in declining interest scenario, the banks were locking more and more in fixed term investments to book large capital gains. Resultantly, the share of investments in total assets inched up to 31 percent in CY03 (CY00: 17 percent, CY06:-19 percent). This led to compositional shift in earning structure of the banking system in that period, as significant portion of banks' earnings came through capital gains which eventually affected the overall share of interest income. As a result, the interest margins reduced during this period.

Figure- 7.8:- Interest Margins and Intermediation Costs (in %)

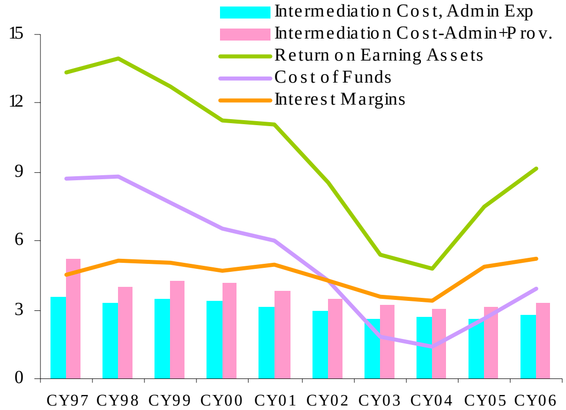
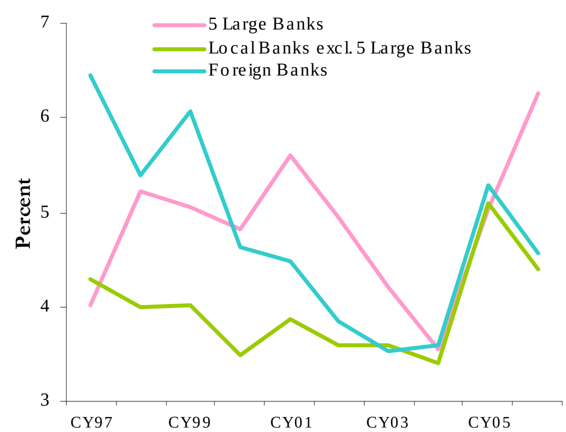


Figure-7.9:- Category-wise Interest Margins



However, since CY04 the interest rates started to increase and were more pronounced in case of assets due to the facts 1) the real interest rates on loans were negative and there was greater room to increase, 2) the shifting of portfolio mix from fixed income securities to the advances due to the depletion of revaluation gains on the back of rising interest rates 3) the surplus liquidity encouraged banks to penetrate into new business ventures which carry higher yields. This has resulted into significant rise in yields on asset side. Whereas, on cost side the factors, like 1) the steady inflows 2) relatively lesser interest rate sensitivity of the depositor, 3) the liquidity preference of the depositors for maintaining checking/transactional accounts (saving and current) caused a relatively less increase in the cost of funds of the banks. Under this scenario, interest rate on assets relatively increased sharply as compared to deposits. Consequently, the gap between the yields on assets and cost of deposits widened during this period.

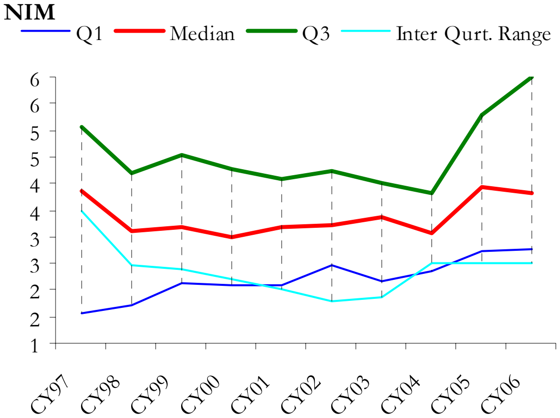
Category wise breakup shows that the interest margins of large 5 banks have been on rise since CY04 (see **Figure-7.9**), while in case of foreign banks and local private banks excluding big five banks, it has actually declined in CY06 due to higher increase in cost of funds of these groups. This suggests that the large 5 banks continue to enjoy the cheaper funds available to

[13] A percent calculated as follows: (rupees of interest earned divided by the rupee amount of interest earning assets) minus (rupees of interest paid divided by the rupee amount of overall interest costing liabilities).

them. As they still hold over 50 percent of industry deposits, they actually pushed down the overall cost of deposits of the industry which widen the margins.

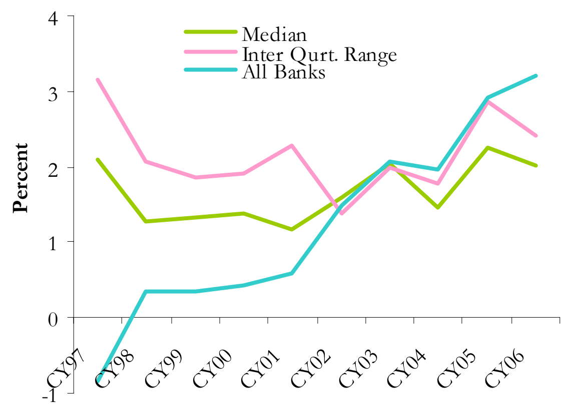
Interest margins of the industry showed that inter quartile ranges initially declined since late 90s to CY03-04 i.e. actually converging, however from CY04 onwards, it again started increasing (see **Figure-7.10**). This shows that margins across the industry vary widely.

Figure-7.11:- Trend and X-Sectional Dynamics of NIM



This dispersion in the margins has also been reflected in the trends of NIM (see **Figure-7.11**). The inter quartile range of the NIM initially decreased till CY04, then onward it started increasing steeply. This signifies that a few banks, which generally are the large banks, are enjoying very high NIM while there are other banks which are operating with lower NIM.

Figure-7.12:- Trend and X-sectional Dynamics of Pre-Tax ROA



All the above mentioned indicators, somehow, were the key contributors in the increasing profits. The pre tax ROA turned positive in CY98 and for onwards as well maintained a steep increase (see **Figure-7.12**). The cross sectional analysis of pretax returns show that dispersion of pre tax profits among the individual banks, though reduced when compared with the late 90s, however, the trend reversed in CY04 when it again increased noticeably.

The above discussion summarizes that although the performance of the banking system remained well in terms of profitability during the last 10 years, the key efficiency indicators witnessed a mixed trend. The concentration of the banking system has reduced. The stake of private sector in the overall banking system has increased significantly. Provisioning charges have also come down which can rationally be attributed to the prudent lending policies and monitoring standards. Interest margins, however, have been widening.

It is heartening to note that the interest rates on incremental/fresh deposits have been increasing, thus lowering the pace of increase in the margins in future. Further, growing competition and the depositors' awareness towards rate sensitivity would also help in squeezing the margins.

For onwards, the concentration is expected to further decline as far as the medium sized and small banks opt for mergers/acquisitions. Increasing competition and the regulatory requirements to institutionalize risk based systems may leave no room for the banks but to focus on upgrading the systems, introducing IT based customer friendly solutions, institutionalizing the risk based systems and of course higher focus on human resource development, which is expected to increase the intermediation costs in short run.

8 Overseas Operations of Pakistani Banks[14]

The overall share of overseas operations of Pakistani banks continued to remain at 7 percent of total banking system assets. With the increased number of banks with overseas operations, the share of smaller banks in total overseas assets has increased to 8.6 percent from 6.7 in 2005. However, dominance of the three large banks continued in CY06 as well, with their share at 91.4 percent of total overseas assets (See **Figure-8.1**). Pakistani banks have presence in almost all the regions of the world barring Latin America; however, 63.5 percent of the overseas assets of Pakistani banks are concentrated in Middle East (see **Figure-8.2**).

Figure-8.1:- Bank-wise Share in Overseas Assets-CY06

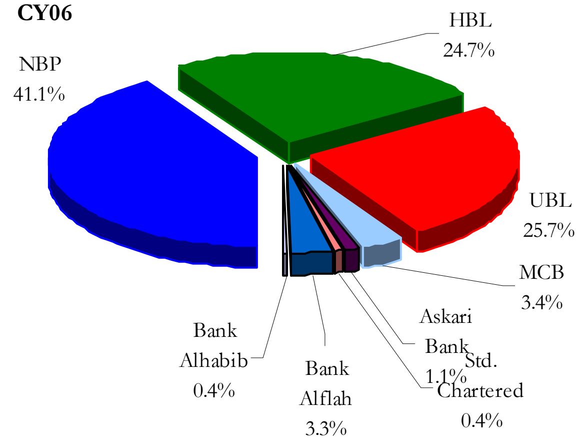
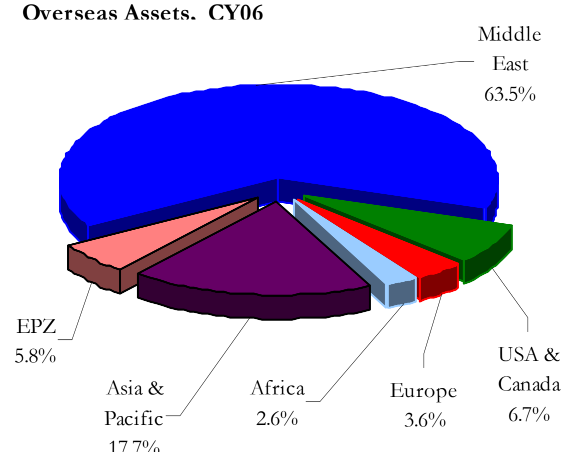


Figure-8.2:- Geographical Distribution of Banks' Overseas Assets. CY06



Pakistani banks in overseas markets appear to have been facing constraints like lack of capacity, constrained market penetration and lack of competitiveness. Resultantly, a large chunk of their assets was deployed in bank balances and interbank placements (see **Table-8.1**). This is in sharp contrast to the commercial banks' global ratio of only 13.7 percent in bank balances and interbank placements and more than 55 percent in advances. As a corollary to this, the overseas operations have earned modest pre-tax ROA of 2.0 percent as compared to commercial banks' overall pre-tax ROA of 3.2 percent. Notwithstanding a smaller loans portfolio, the asset quality indicators remained a concern. NPLs to loans ratio, though showing an improving trend, was still high at 11.9 percent as compared with commercial banks' global ratio of 5.7 percent. These NPLs are, however, adequately covered, as evident from Net NPLs to Net loans ratio at 2.5 percent. The situation has the peculiarities with regard to specific banks and countries of operations. The operations in UAE and Export Processing Zone (EPZ) Pakistan account for more than 85 percent of the total overseas NPLs, while these contribute around 35 percent of total loans portfolio.

Table-8.1: Composition of Overeas Assets & Liabilities

(Percent of Total Assets)	CY01	CY02	CY03	CY04	CY05	CY06
Cash and Bank Balances	48	39	38	45	41	42
Lending to Financial Institutions	1	1	0	0	1	2
Investment	11	15	16	15	18	13
Loans	28	30	34	32	35	37
Other Assets	12	15	11	6	5	6
Total Assets (Billion Rs)	255	230	216	261	252	312
Deposits	63	61	67	69	70	67
Borrowings	8	8	7	4	1	5
Other Liabilities	23	23	15	17	17	16
Capital	7	8	11	10	12	12

[14] Branch Operations

Owing to the fact that banking regulations, scope of operations, business strategies and the resultant performance indicators vary from country to country, the forthcoming paragraphs focus upon the overseas operations of Pakistani banks in developing and developed markets.

Developing Markets

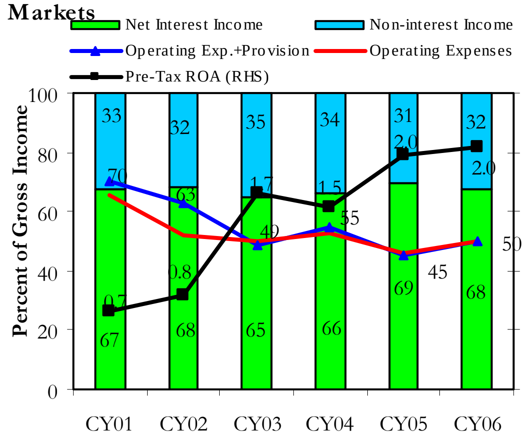
More than 80 percent of total assets of the overseas operations of Pakistani banks reside in the developing markets. The developing markets being in the growth phase present ample potential to explore untapped sectors. Given the fact that a sizable Pakistani community resides in these developing countries, especially in Middle East, the operating environment in those countries is akin to that available to Pakistani banks at home. This allows competitive advantage to Pakistani banks operating in these markets.

Table-8.2: Composition of Overeas Assets & Liabilities in Developing Markets

(Percent of Total Assets)	CY01	CY02	CY03	CY04	CY05	CY06
Cash and Bank Balances	48	37	38	39	38	39
Lending to Financial Institutions	1	1	0	1	1	2
Investment	13	17	18	17	18	13
Loans	31	32	37	39	39	39
Other Assets	6	12	8	5	4	7
Total Assets (Billion Rs)	208	185	176	195	208	263
Deposits	66	64	69	71	73	71
Borrowings	10	10	9	5	1	4
Other Liabilities	19	18	12	14	14	14
Capital	6	8	10	10	12	11

Pakistani banks have been adopting conventional business strategies and their operations remained focused mainly towards loans and advances which constituted 39 percent of their total assets. However, due to bad loans experience of some of the banks, the banks resorted to deploy 54 percent of their assets in interbank placements, balances with banks and investments (see **Table-8.2**). The individual banks, however, followed diverse strategies ranging from focusing on Pakistani blue chips to selective targeting of mid-segment customers and consumer banking.

Figure-8.3:- P&L Composition in Developing Markets



The analysis of income structure reflects a stable outlook and dominance of net interest income, which signifies the business approach focused on lending operations. The net interest income is also supported by a stable non interest income. On the expense side, operating expenses and loan loss charges increased during the year to 50 percent of gross income. Both these expenses account for half of the total gross income, leaving an ample profit margin. Pre-tax ROA at 2.0 percent remained stable and higher as compared to 1.7 percent for developed markets (see **Figure-8.3**).

Developed Markets

Corollary to the assets concentration in developing markets, less than 20 percent of the overseas assets of Pakistani banks were in developed countries' markets. Pakistani banks operating in these countries, besides relatively more stringent regulatory requirements, have been facing tough competition from an array of financial institutions offering wide range of financial products. Resultantly, the scope of their conventional lending operations remained restricted and their focus remained mainly interbank placements. The overall

Table 8.3: Composition of Overeas Assets & Liabilities in Developed Markets

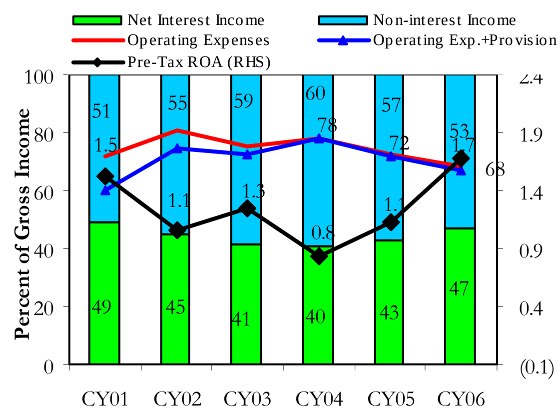
(Percent of Total Assets)	CY01	CY02	CY03	CY04	CY05	CY06
Cash and Bank Balances	46	43	40	66	55	55
Lending to Financial Institutions	-	-	-	-	-	2
Investment	2	6	9	11	17	14
Loans	14	22	23	13	19	23
Other Assets	37	28	28	10	9	6
Total Assets (Billion Rs)	47	45	40	66	44	49
Deposits	49	45	60	65	54	47
Borrowings	1	1	1	2	3	8
Other Liabilities	40	44	25	23	28	28
Capital	10	10	14	9	15	17

asset base also reflects a stagnant position. The restrained operational base has an impact on asset growth, which remained around 11.4 percent during the year as against 26.4 percent in developing countries (see-**Table-8.3**).

The analysis of income statement of Pakistani banks operating in developed markets reflects their conservative business strategies. The main source of income accrued from non interest sources, while the contribution of net interest income remained low. However, the banks have witnessed improvement in operating efficiency by gradually reducing their cost-income ratio to 68 percent from 72 percent in CY05. However, it is still high as compared to 50 percent for operations in the developing markets (see **Figure-8.4**). Further, on the back of stronger asset quality, the low profit margins remained unaffected from loan loss charges, Hence, leaving ROA in a reasonable range.

To conclude, the scope of Pakistani banks' operations in overseas markets has remained restricted to fewer areas and narrow client base; and as such their ability to generate diversified income streams and establish a noticeable presence in the global market was significantly impacted. Contrarily, the Pakistani banks operating in domestic market have been successful in diverting their business strategy from conservative approaches to more competitive market based visions. The experience at home market may prove helpful for the banks to apply in the overseas markets.

Figure-8.4:- P&L Composition in Developed Markets



9 Performance of Other Financial Institutions

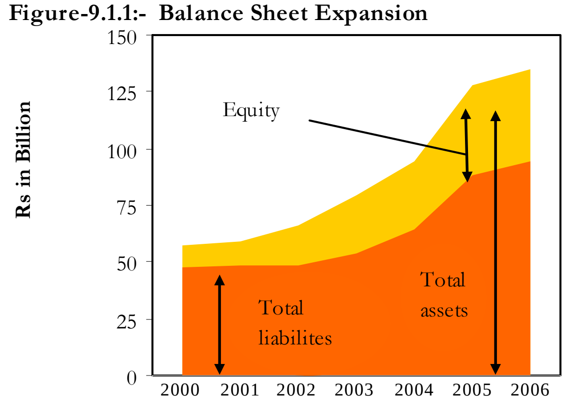
9.1 Development Finance Institutions

During CY06, DFIs witnessed a moderate growth pattern. Solvency profile of the DFIs further strengthened on the back of significant increase in the equity base. ROA of the DFIs, though remained significant, experienced some decline during the year. Asset quality also experienced some deterioration.

Total assets of the DFIs registered a growth of 6.0 percent after experiencing an increase of Rs7.7 billion during CY06 (see **Figure 9.1.1)**. Assets of the DFIs constitute only 3 percent of total assets of the banking system and DFIs taken together. Composition of assets reveals that although loans continue to enjoy predominant position, their share in total assets declined to 39.5 percent from 42.2 percent in CY05 (See **Figure 9.1.2).** Likewise, investment also declined to 31.1 percent of total assets from 37.7 percent in CY05. However, the share of other assets increased to 20 percent from 12.1 percent in CY05. Lending to financial institutions, major component of other assets, has almost doubled its share in CY06. In absolute terms, this component increased by Rs.8.8 billion.

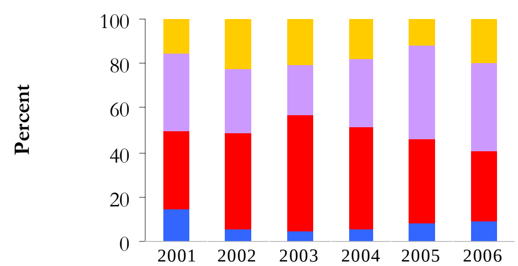
Deposits mobilization efforts that had picked up last year appear to have receded with the share of deposits declining to 22 percent of total sources of funds from 30 percent in CY05. In absolute terms, the deposits declined by Rs.8.6 billion in CY06 (see **Figure-9.1.3)**. Reduction in low cost deposits compelled the institutions to turn toward high cost borrowings. Resultantly, the share of borrowings increased to 43 percent from 34 percent in CY05. In absolute terms, the increase translated into an addition of Rs.14.8 billion in borrowings. DFIs' inability to mobilize deposits has already started to affect the profitability of the DFIs adversely.

Figure-9.1.1:- Balance Sheet Expansion



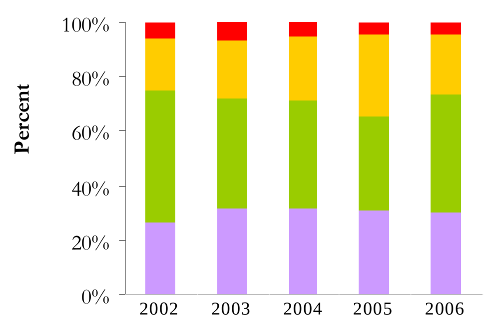
	2000	2001	2002	2003	2004	2005	2006
Total Assets	58	59	66	79	95	128	135
Total liabilites	48	48	49	54	65	88	94

Figure-9.1.2:- Composition of Assets



	2001	2002	2003	2004	2005	2006
Other Assets	15.1	22.8	20.5	17.9	12.1	20.0
Loans	35.7	29.0	22.3	31.1	42.2	39.5
Investments	34.5	43.0	52.8	45.8	37.7	31.1
Cash & Bank Balances	14.7	5.2	4.4	5.2	8.0	9.3

Figure-9.1.3:- Share of Sources of Funds



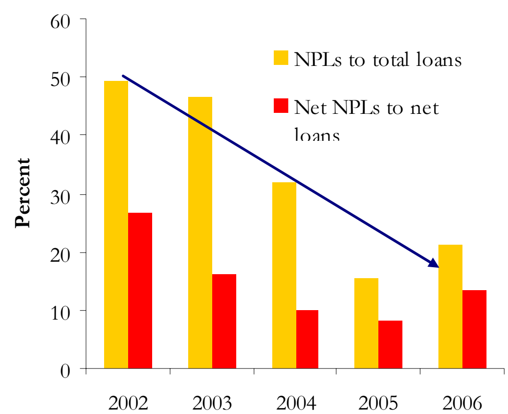
	2002	2003	2004	2005	2006
Other Liabilities	6	6	5	5	5
Deposits	19	21	24	30	22
Borrowings	49	41	39	34	43
Total Equity	26	32	32	31	30

Loans portfolio of DFIs, in absolute terms, remained at the same level as that of last year, while loans as percentage of earning assets declined to 43 percent from 45 percent in CY05.

The loans portfolio of DFIs stood at Rs.53 billion. When seen in the context of growth of around 19 percent in advances of the banking system, the sector exhibits its inability to capitalize on the increased demand for loans.

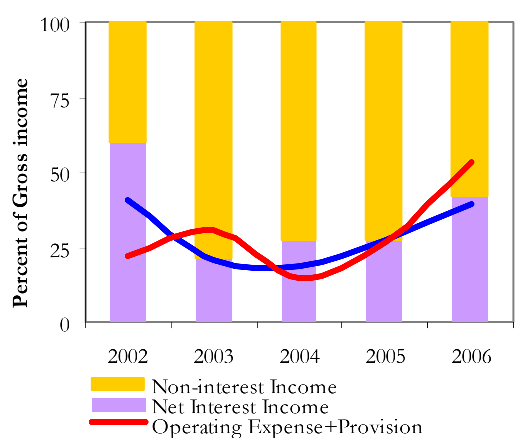
Asset quality of the DFIs also reflected deterioration due to increase in NPLs. Their NPLs increased to Rs.12.4 billion from Rs8.9 billion in CY05. Resultantly NPLs to loans ratio surged to 21.1 percent from 15.4 percent in CY05. Similarly, net NPLs to net loans ratio also deteriorated to 13.2 percent from 8.4 percent in CY05. In a rising interest rates scenario, the asset quality may further deteriorate if appropriate corrective measures are not taken by the DFIs **(**See **Figure-9.1.4)**.

Figure-9.1.4:- Quality of Loans



During CY06, the solvency position of DFIs improved significantly due to 89 percent increase in their paid up capital. In absolute terms it increased by Rs10.5 billion, and was mainly achieved through capitalizing the reserves and un-appropriated profits. The increased paid up capital beefed up their CAR to 36.7 percent and tier-I capital to RWAs ratio to 34.2 percent. Total equity of DFIs increased marginally to Rs40.9 billion from Rs39.7 billion in CY05. However, as percentage of total sources of funds, it increased to 30 percent from 26 percent in CY02. The strong capital position of the DFIs allows ample space for the sector to expand their operations.

Figure-9.1.5:- P & L Structure of DFIs



Liquidity position of DFIs, as evident from liquid assets to total assets ratio at 53 percent in CY06, presents comfortable position. Further, the loans to deposits plus borrowing ratio declined to 61 percent from 66 percent in CY05.

After-tax profits of DFIs declined to Rs.2.9 billion from Rs.5.5 billion in CY05. The decline in profitability was largely driven by fall in non-interest income from Rs.6.3 billion in CY05 to Rs.4 billion in CY06. Since, bulk of non-interest income accrues from capital market operations; it is susceptible to volatility in the market. Income from stock market operations experienced some deterioration. Resultantly, the after-tax ROA declined to 2.3 percent from 5.3 percent in CY05 (see **Figure 9.1.5**). However, net interest income increased to Rs2.9 billion from Rs2.3 billion in CY05.

To conclude, over reliance on capital gains, high equity exposures and costly borrowings tend to remain the problems needed to be sorted out. With rising interest rates, DFIs may find it difficult to expand their lending operations and simultaneously keep their asset quality good in stiffen competitive market. Moreover the returns from capital gains hinge upon stock market behavior, which is quite volatile and cannot be relied upon for regular streams of income.

Hence, the DFIs need to look out for more economical sources of funds, while broad basing their deposit mobilization efforts so as to ease out their cost structure. This will help improve the sector's flexibility to innovate products and services at competitive price.

9.2 Micro Finance Banks

On the back of rapid growth in CY06, regulated MFBs have increased their market share in the sector. This growth of Microfinance as a specialized banking industry has been exhibited in all the areas including enabling policy environment; supporting infrastructure; institutional development through developing alternate delivery channels, human resource, use of technology and outreach enhancement in the form of number of microfinance banks, service outlets and client base.

The pace of outreach of microfinance industry in Pakistan has been fairly satisfactory. Currently four nation-wide and two district-wide Micro Finance Banks (MFBs)[15] are providing financial services to the poor segment of the society in Pakistan. During the CY06, the combined outreach of the micro finance banks saw a satisfactory growth. The branch network continued to expand, also bringing geographical diversification to the sector. The number of branches stood at 145 in CY06 as compared to 91 in CY05 (see **Table 9.2.1**). The growth was largely attributable to the expansion of newly-licensed MFBs, as the pioneer and largest MFB slowed down its branch expansion and pursued the consolidation of its operations during the period under review.

Table-9.2.1:- Micro Finance Outreach

	2002	2003	2004	2005	2006
Institution Age (Yrs)	2	3	4	5	6
No. of Branches	39	56	75	91	145
Total No. of Borrowers	56,939	95,090	177,648	248,091	326,498
No. of New Borrowers	56,939	38,151	82,558	70,443	78,407
Total No. of Depositors	2,773	10,150	18,589	32,577	70,891
No. of New Depositors	2,773	7,377	8,439	13,988	38,134
Average Loan Size (Rs)	6,232	7,969	7,340	9,450	8,721
Average Deposit Size (Rs)	23,231	38,625	25,229	20,867	20,731

During CY06, the number of borrowers increased by 32 percent. This growth in the sector was largely urban based as many of the new branches/service centre opened during CY06 were in big urban cities like Karachi, Lahore, Rawalpindi, and Peshawar. To keep the focus of MF market on poverty-ridden areas, the existing Regulatory framework defines eligibility criteria for borrowers' selection based on their annual income. The average loan size stood at Rs. 8,721, indicating the depth of outreach. As the permissible maximum loan size is Rs. 150,000/-, MFBs still have plenty of space to enhance their loan size.

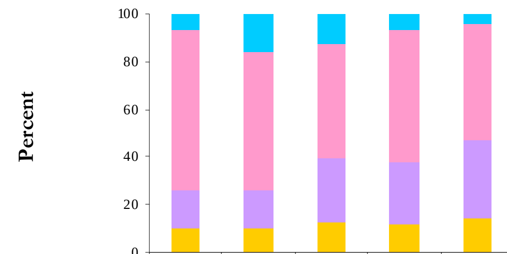
During CY06, the number of depositors increased by 117 percent. This high growth in number of depositors was largely benefited owing to thin-base advantage. In absolute terms, deposit base of MFBs is far behind the loan portfolio. The sector's weakness in this area can be assessed by the fact that the largest MFB has not yet started deposit operations. At present, none of the MFB has positioned itself to be a 'deposit' oriented institution. However, the recent interest of Microfinance Banks in exploring products other than credit e.g. deposit, insurance and remittance services may bring healthy change for the stability of the sector and convenience of the clients.

As sector continued to expand, the overall balance sheet footing of MFBs also recorded an expansion of 24 percent to Rs10.514 billion from Rs8.458 billion in CY05 (see **Figure-9.2.1**). This year, growth momentum was somewhat diluted as the largest MFB could not pursue the previous growth pattern. A critical factor to the bank's conservative strategy was not to start generation of internal fund through deposit-mobilization even in the wake of drying up of credit lines.

[15] Khushhali Bank, First Micro Finance Bank, Tameer Micro Finance Bank, Pak Oman Microfinance Bank, Network Micro Finance Bank and Rozgar Micro Finance Bank

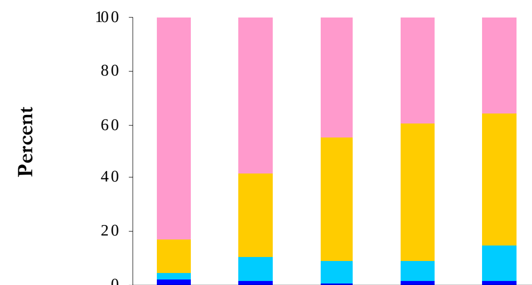
The asset composition of the MFBs shows that most of the funds are still placed in treasury assets. This is mainly because of the fact that the pioneer MFB endowed with large capital base and funding-surplus from credit lines has a considerable portfolio in treasury assets. However, the share of investment in total assets declined to 48.5 percent from 55 percent in previous year with a corresponding enhancement in the share of loan portfolio from 26.7 percent to 32.8 percent. Despite this marginal improvement in share of advances, the ratio is still unfavorable to meet the sustainability objectives of MFBs as micro-credit has to be the prime source of revenue for any successful MFB. As regards the quality of loan portfolio, it was encouraging to see that the portfolio quality remained satisfactory as NPL to Assets Ratio saw a decline from 4.4 percent to 1.8 percent. The major reasons for such decline were the revised stringent criteria for loan classification, better management of loan quality, and fresh disbursements for which the quality test will take some time.

Figure-9.2.1:- Asset Structure of MFBs



	2002	2003	2004	2005	2006
Cash and Balances	6.8	15.9	12.6	6.5	4.2
Investment	67.2	57.6	47.5	55.4	48.5
Advances	16.0	16.6	27.1	26.7	32.8
Other Assets	9.9	9.8	12.8	11.4	14.5

Figure-9.2.2:- Funding Structure of MFBs



	2002	2003	2004	2005	2006
Equity	82.7	57.9	45.0	39.6	36.1
Borrowings	13.0	31.7	45.8	51.2	48.9
Deposits	2.1	8.9	8.3	8.0	13.5
Other Liabilities	2.1	1.6	0.9	1.2	1.5

The funding structure of the sector continues to be dominated by owners' equity and borrowings. The funding structure in last three years saw only minor adjustments (See **Figure-9.2.2**). The borrowings continued as major funding component at 48.9 percent followed by shareholders' equity at 36.1 percent. The capital to asset ratio stood at 36 percent, which indicates that MFBs are still underleveraged. Their deposit mobilization has remained weak as deposits to total funding ratio recorded only a marginal improvement in last two years to 13.5 percent from 8.3 percent. The major factor contributing to the failure in deposit mobilization has been the fact that the pioneer MFB (also the largest) has not yet started taking deposits. During CY06, the two district MFBs registered a negative trend in deposit mobilization. With exception of two, rest of MFBs have not yet institutionalize effective strategies and sound systems in place for mobilizing the public deposits.

On asset quality front, the NPLs ratios improved during CY06 and NPLs to advances ratio stayed at less than 2 percent and net NPLs ratio stayed negative (see **Table 9.2.2**). However, the operating performance of MFBs has so far remained weak since these suffered from negative returns on assets. The adverse returns have largely been attributed to the fact that the

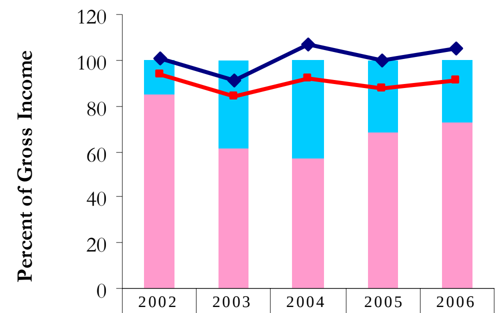
Table-9.2.2:- Key Performance Indicators

Percent	2002	2003	2004	2005	2006
NPLs to Advances	1.6	7.6	7.2	4.4	1.8
Net NPLs to Net Advances	(2.9)	2.7	1.3	0.7	(0.9)
Provisions to NPLs	356.8	65.0	78.3	84.1	147.9
Net NPLs to Capital	(0.6)	0.8	0.8	0.5	(0.8)
Growth in Advances	346.8	49.3	108.8	46.9	50.9
Net Interest Margin	8.4	6.9	6.8	7.8	8.8
Non Interest Income to Avg Assets	1.2	3.5	3.8	3.2	3.3
Non Interest Exp to Avg Assets	7.7	7.5	8.1	8.8	11.1
Operating Exp to Gross Income	94.2	84.4	91.7	87.6	100.2
ROA	0.0	0.6	(0.5)	(0.2)	(0.4)
Operating Sufficiency	91.4	75.8	71.9	84.1	76.3
Financial Sustainability	45.4	39.3	42.3	51.5	61.9

sector remained in a phase of market and institutional development.

The share of interest-based income to gross income has been increasing continuously. During CY06, the share rose to 72.7 percent as compared to 68.3 percent in last year (see **Figure-9.2.3**). The interest from loan portfolio continued to contribute higher towards the interest income of MFBs. Although the interest income remained as core income, its share still needs to be enhanced significantly. During CY06, the Net Interest Margin (NIM) improved from 7.5 percent to 9.8 percent despite increase in interest expenses which are now rationalizing with the increasing share of interest-bearing borrowings in the funding. The share of non-interest income in gross income has registered continuous decline over last 3 years. The operating expenses of MFBs in terms of gross income also rose to 100.2 percent as compared to 87.6 percent in last year. As a result of above, the operational sufficiency of the sector declined from 84 percent to 76 percent whereas financial sufficiency ratio improved from 51.5 percent to 61.9 percent.

Figure-9.2.3:- P & L Composition



	2002	2003	2004	2005	2006
Non Interest Inc	14.6	38.9	42.9	31.7	27.3
Net Interest Inc	85.4	61.1	57.1	68.3	72.7
Operating Exp + Prov	101.1	91.2	106.5	100.2	104.9
Operating Exp	94.2	84.4	91.7	87.6	91.1

Bringing sustainability to the operations of MFBs is a big challenge for their boards and management. This requires a high degree of responsibility and use of professional expertise. MFBs need to monitor their performance against the pre-defined performance benchmarks. As also MFBs should focus on scaling up their core business, rationalize loan yields, improve operational and productive efficiencies, and build deposit base to finance their loan growth, which would certainly add to their performance and stability.

9.3 Exchange Companies

With the implementation of Foreign Exchange Regulation (Amendment) Ordinance 2002 and transformation of Authorized Money Changers into Exchange Companies, the un-regularized sector has come under the enhanced regulatory framework of State Bank of Pakistan which helped in creating financial discipline and corporate culture in the business. Besides, various risks associated with this business have properly been addressed and mitigated. The scope of the exchange companies business has been further broaden and, now, they are authorized to deal in foreign currency notes, coins, postal notes, money order, bank drafts, traveler's cheques and transfers.

With the discontinuation of authorized moneychangers, 470 in numbers, the number of exchange companies **"A"** in 2004 was 25 which increased to 28 in 2005 and by the end of December 2006, declined to 26 However, the branches of exchange companies have increased from 102 in 2005 to 132 in 2006. The number of franchise arrangements and payment booths for sale and purchase of foreign currency have slightly dropped (see **Table 9.3.1**).

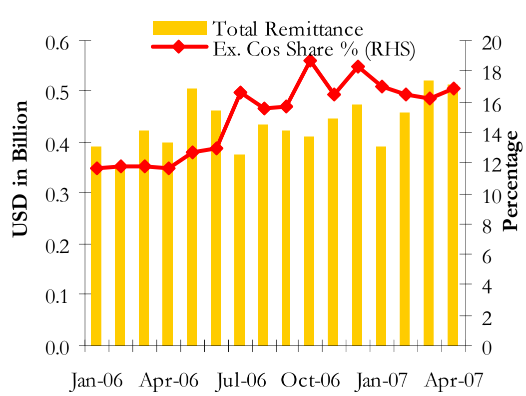
Table-9.3.1:- No.of Operational Exchange Companies	2004	2005	2006
Exchange Companies-"A"	25	28	26
Branches of Exchange Companies-"A"	79	102	132
Franchise Arrangement with Exchnage Companies-"A"	218	218	208
Payment Booth-"A" Exchange Companies	-	294	289
Currency Booths-"A" Exchange Companies		8	8
Exchage Companies-B	33	31	31
Branches of Exchange Companies-B	249	223	230

Table-9.3.2:- Financial Highlights of Exchange Companies "A" (Rs in Million)	2003	2004	2005	2006
Total Assets	1,775.6	2,395.8	4,433.1	4968.4
Total Liabilities	438.7	248.4	976.8	1122.1
Capital	1,336.9	2,147.4	3,456.3	3846.3
Profit Befor Tax	17.1	70.0	(53.7)	55.9
Profit After Tax	7.8	39.6	(81.7)	21.8

With the increase in regulatory requirement of minimum paid-up capital of Rs100 million, which requires to be further increased to Rs200 million within three years from the date of incorporation, the assets base of exchange companies is also growing. The assets base of exchange companies has grown up by 12 percent and is currently at Rs5.0 billion (see **Table 9.3.2**). Since Authorized Money Changers with small financial means were facilitated and encouraged to form Exchange Company of "B" category with a paid-up capital of Rs20 million and the same was required to be raised to Rs 25 million.

In sharp contrast to the year CY05 when exchange companies faced losses due to higher operational costs, year CY06 proved to be a profitable year. The exchange companies were able to book a net profit of Rs21.8 million in CY06 as against a net loss of Rs82 million in CY05.

Figure-9.3.1:- Share of Exchange Companies in Home Remittances-CY06-07



The exchange companies' performance in terms of mobilization of home remittances has further improved. The home remittances through exchange companies witnessed 36 percent growth and increased to USD 743 million in CY06 from USD 548 in CY05 **(**see **Figure 9.3.1)**. The share of home remittances through exchange companies, in the total remittances, also increased. The month-wise share of exchange companies in total remittances shows that the remittances were low, almost 11-12 percent, in the 1st half of CY06 and the same moved up to 18 percent in the 2nd half. This may be attributed to the fall of Eid-ul-Azha and Eid-ul-Fitr moons in the 2nd half of CY06. Further, the 1st quarter of CY07 has also witnessed a growing trend as compared to the corresponding period of CY06.

The institutionalized mode of foreign exchange transfer backed by the regulatory requirement of minimum capital, within and outside the country, has helped in maintaining the exchange rate stable in the kerb market.

Box – 9.3.1

Regulatory Development for Exchange Companies

In view of the difficulties at the initial stage in opening Nostro Accounts with the banks abroad, the exchange companies were allowed to open Nostro Accounts with the exchange companies abroad for related purposes. Later it was decided to close down such accounts latest by 25th July 2006. Accordingly, FCYs on account of home remittances or against export of foreign currencies (other than US$) should either be received in Exchange Company's Nostro Accounts with the Banks abroad or in FCY Accounts maintained with the Banks in Pakistan. Exchange Companies were required to report, on transaction-to-transaction basis, with relevant dates of export of foreign currencies (other than US $) and date of receipt of credit, the name of branch and the bank. Further, it is reiterated that funds against all individual inward remittances must be received in Exchange Company's accounts as above and all outward remittances must also be separately accounted for. Under no circumstances, should an exchange company resort to netting off inflows and outflows. All exchange companies are advised to review all their agency arrangements with foreign entities abroad and confirm in writing that to SBP within 15 days hereof that all such agreements are in conformity with the prescribed instructions alongwith up-to-date list of all such agreements. Furthermore, details of all exchange companies Nostro Accounts & FCY accounts with banks in Pakistan should also be provided to SBP within 15 days.

It has also been decided that as from 10th of July 2006 (inclusive), all Exchange Companies shall ensure that a minimum of 10 percent of foreign currencies exported by them and a minimum of 10 percent of foreign currencies received by them on account of inward home remittances, in equivalent US $ must invariably be sold in the interbank market on an ongoing basis. A report as of last day of the month must be submitted to SBP by every exchange company, giving aggregate FCYs amounts mobilized under the above two categories and amounts sold in the interbank market.

10 Islamic Banking in Pakistan-A Perspective on its Performance & Major Developments

Islamic Finance industry has made considerable progress at both the global and national front. Especially, during the last decade the Islamic Financial Sector (IFS) has registered a robust growth (between 15 to 20 percent per annum); making it one of the fastest growing segments of the overall financial system of the world. As a result, today the Islamic financial industry is comprised of across-the-board financial institutions / markets including onshore and offshore commercial banks, non-bank financial companies, housing cooperatives, microfinance institutions, venture capitals, mutual funds, Takaful companies, capital markets etc. Moreover, there are dedicated regulatory, legal and academic institutions at the international level that are providing support in establishing and developing the IFS.

In Pakistan, the Islamic banking system has witnessed a very healthy growth during the last couple of years and is steadily proving its potential to work as a compatible and parallel alternative system for providing financial services. It is growing in terms of size and structure (see **Table 10.1**). Growing at a rate of 114 percent, total number of branches increased to 150 in CY06 from 70 in CY05.

Table-10.1:- Islamic Banking Players

	Dec-02	Dec-03	Dec-04	Dec-05	Dec-06
No. of Islamic Banks (IBs)	1	1	2	2	4
No. of Branches	6	10	23	37	93
No. of conventional banks operating Islamic Banking Branches	-	3	9	9	12
No. of Islamic Banking Branches (IBBs)	-	7	25	33	57

The growing interest in Islamic banking in the year under review is also evident by the entry of three new conventional banks having Islamic banking branches. These include Askari Bank Limited, United Bank Limited, and National Bank of Pakistan. Moreover ABN Amro has also started operations in second quarter of the CY07, making the tally of conventional banks having Islamic Banking Branches to thirteen. 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 based on business considerations in addition to religious considerations.

In addition to existing full-fledged Islamic banks namely Meezan Bank, AlBaraka Bank, two new Islamic banks namely Bank Islami Pakistan Limited and Dubai Islamic Bank Pakistan Limited started their operations in the CY06. Moreover another two full fledge Islamic banks namely Emirates Global Islamic Bank Limited and First Dawood Islamic Bank Limited have since started their operations by the start of second quarter of the CY07. As on April 17, 2007, the 6 full-fledged Islamic and 13 conventional banks have a total of 108 and 58 branches respectively. They have presence in **25** cities & towns cover all the four provinces of the country.

The balance sheet footing of the Islamic banking industry kept on increasing. The total assets growing at a very healthy rate of 66.9 percent reached to Rs119.2 billion in CY06 from Rs71.5 billion in CY05 (see **Table 10.2**). The deposits remained the main source of finance. In absolute terms, deposits grew by Rs33.8 billion to Rs83.7 billion during CY06 and its share in overall sources remained around 70 percent. On the asset side, financing continued to remain the main activity, however its share in overall assets experienced a decline

Table-10.2:- Sources and Uses of Funds (Million rupees)

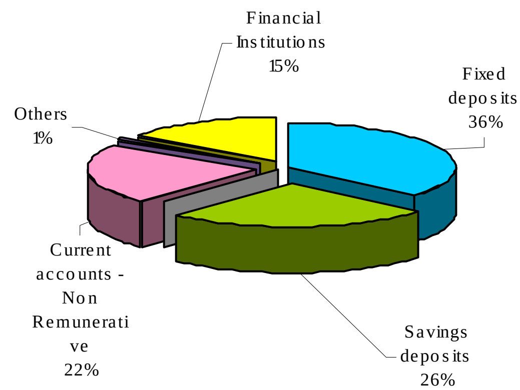
	2003		2004		2005		2006	
SOURCES:	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Deposits	8,397	65	30,185	68	49,932	70	83,740	70
Borrowings	1,899	15	6,559	15	9,006	13	10,843	9
Capital & other funds	1,994	15	5,123	12	7,811	11	16,348	14
Other liabilities	625	5	2,276	5	4,745	7	8,363	7
	12,915	**100**	**44,143**	**100**	**71,493**	**100**	**119,294**	**100**
USES:								
Financing	8,652	67	27,535	62	45,786	64	65,613	55
Investments	1,242	10	2,007	5	1,854	3	7,328	6
Cash, bank balance, placements	1,978	15	11,900	27	19,314	27	31,358	26
Other assets	1,042	8	2,701	6	4,539	6	14,996	13
	12,915	**100**	**44,143**	**100**	**71,493**	**100**	**119,294**	**100**

from 64.0 percent to 55.0 percent. The assets seem to experience some shift away from financing to the investments and other assets since the share of these two has increased over the year.

As the growth in assets base of Islamic banking outpaced the growth in the assets of the country's banking industry as a whole, the share of Islamic banking assets as percentage of overall banking assets increased to 2.86 percent from 2.0 percent last year. Likewise, deposits and financing as percent of overall deposits and financing of the banking system also increased to 2.75 percent and 2.62 percent in CY06 from 1.8 percent and 2.3 percent respectively in CY05.

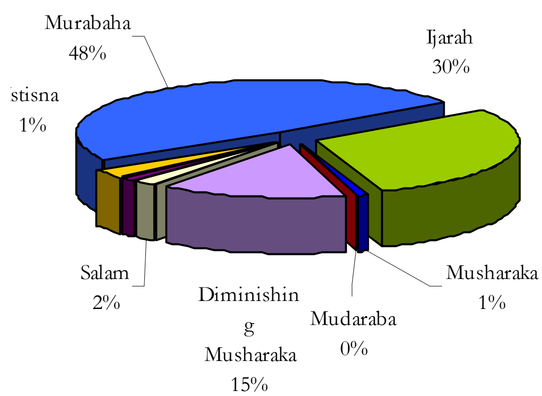
Because of the slower growth of financing, the finance to deposit ratio dropped to around 78 percent from 92 percent in CY 05.

Figure- 10.1:- Composition of Deposits



During the under review, the deposit structure depicts some changes; wherein the share of fixed deposits and financial institutions deposits increased from 31.4 percent and 12.0 percent last year to 36.4 percent and 15.2 percent respectively (see **Figure-10.1**). Corollary to this, the share of saving and current-non remunerative deposits have decreased from 31.0 percent and 24.7 percent in CY05 to 25.6 percent and 21.9 percent respectively in CY06. The shifting deposits mix is indicative of customers' continued growing trust in the Islamic banking products as they are becoming more eager to engage in long-term relationship with Islamic banks.

Figure-10.2:- Modes of Financing



The break-up of financing as per various Islamic modes shows the continuous predominance of Murabaha and Ijara financing, having their share of 48 percent and 30 percent respectively (see **Figure-10.2**). When compared with the last year, the share of Murabaha has increased by 4 percentage points and that of Ijara has remained at the same level. Diminishing Musharaka has also started to increase its share, which shows the eagerness on the part of Islamic Banking Institutions (IBIs) to diversify their financing portfolio.

The peculiar trends in the funding and financing structures also had their impact on the key performance indicators. Since the capital of the Islamic banking system grew at a higher rate of 109 percent as compared to the assets growth, the capital to total assets ratio increased to 13.7 percent from 10.9 percent. The ratio is comfortably more than double the generally accepted benchmark of 5 percent. Net NPFs to capital ratio remained contained at 1.4 percent and the capital coverage ratio improved to 13.5 percent from 10.8 percent. Capital adequacy ratios for the Islamic banking branches (IBBs) and Islamic banks at 12.8 percent and 20.9 percent respectively are also well above the regulatory benchmark of 8 percent.

With the growing operations and fast expanding financing portfolio, the occurrence of nonperforming financing is inevitable. During the year, NPFs increased from Rs480.3 million to Rs846 million resulting into an increase in ratios of NPFs to total financing and net NPFs to net financing to 1.3 percent and 0.40 percent in CY06 (see **Table 10.3**) from 1.0 percent and 0.2 percent respectively in CY05. These ratios are still very low and do not carry significant threat to the financial soundness of IBIs. However, IBIs have to exercise extra safety measures for the financing portfolio, keeping in view the fact that Shariah-based modes of financing require that any late payment fee recovered from clients could only be used for charitable purposes.

Table-10.3:- Key Performance Indicators

Indicator	2003	2004	2005	2006
NPFs to total financing	0.7%	0.9%	1.0%	1.3%
Net NPFs to net financing	0.0%	0.2%	0.2%	0.4%
Provision to NPFs	100.0%	82.3%	80.6%	72.0%
Net Markup Income to total assets	1.7%	1.4%	2.3%	2.4%
Non Markup Income to total assets	2.2%	1.4%	1.7%	0.9%
Operating Expense to Gross Income	54.6%	65.3%	49.9%	72.8%
ROA (average assets)	2.2%	1.2%	1.7%	0.9%
Growth in Assets	84.5%	241.8%	62.0%	66.9%
Growth in Deposits	64.6%	259.5%	65.4%	67.7%
Growth in Financing	147.0%	218.2%	66.3%	43.3%

Table-10.4:- Income Statement (Million rupees)

	2003		2004		2005		2006	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Markup Income	406.4	100.0	1,081.0	100.0	3,164.3	100.0	6,383.1	100.0
Markup Expense	188.5	46.4	483.7	44.8	1,542.3	48.7	3,515.3	55.1
Net Markup Income	217.9	53.6	597.2	55.2	1,622.0	51.3	2,867.9	44.9
Provision Expense	(15.8)	(3.9)	36.0	3.3	175.6	5.5	238.7	3.7
Non Markup Income	287.4	70.7	596.0	55.1	1,206.6	38.1	1,067.4	16.7
Operating Expense	276.0	67.9	779.0	72.1	1,410.5	44.6	2,864.5	44.9
Profit Before Tax	245.0	60.3	378.2	35.0	1,242.6	39.3	832.2	13.0
Tax	27.0	6.6	36.2	3.4	265.2	8.4	(34.4)	(0.5)
Profit After Tax	218.0	53.6	342.0	31.6	977.4	30.9	866.6	13.6

On the performance side, markup income experienced a strong growth of more than 100 percent during CY06 (see **Table 10.4**). Net markup income also witnessed healthy growth of 77 percent. Since non-markup income experienced some decline, gross income could manage to grow by 39 percent. However, significant increase in the operating expenses have actually reduced the before tax profits to Rs832 million from Rs1,243 million in CY05. Resultantly ROA also decreased from 1.7 percent in CY 05 to 0.9 percent in CY06.

The overall performance of the Islamic banking industry remained encouraging and the key indicators depicted healthy trends in CY06, auguring well for the future growth prospects. However, the industry will have to manage its growing expenses is addition to following the stringent appraisal and monitoring standards. This along with the strengthening systems and building capacities of the human capital will add to the efficiencies of this system and thus proving it a comparable alternate financial system.

Box: 10.1

Initiatives Taken by SBP to Promote Islamic Banking

Islamic banking industry in Pakistan is facing a number of challenges, key challenges include huge demand due to growing economy and the high potential mainstream market of large prospective customer base outside the conventional banking industry, expectation to see a more active role of Islamic banking players in developmental sectors (SME, Microfinance, Agri business, etc.), development of required pool of specialized, competent and high-caliber human capital and last but not the least, bringing in foreign investment in Pakistan through Islamic banking Institutions.

To cope with these challenges SBP took a number of steps for the promotion of Islamic Banking. The salient features of which are:

- SBP has put in place a comprehensive Shariah compliance framework for Islamic banking institutions the main features of which include, Shariah Board at SBP, Shariah Advisor for each IBI as per Fit and Proper Criteria approved by the SBP, Guidelines on Islamic banking in the form of Shariah Essentials and Model Agreements of various Islamic modes of financing, Shariah Compliance Inspection and Segregation of funds made compulsory for conventional banks offering Islamic banking products and services through dedicated branches.
- To cater to development needs of potential and existing workforce of Islamic banking, SBP has launched a three weeks Islamic Banking Certification Course at the National Institute of Banking and Finance. The course is aimed at building the capacity of bankers to deliver Islamic banking products and services.
- A Memorandum of Understanding has been signed between State Bank and **International Centre for Education in Islamic Finance (INCEIF), Malaysia** which envisages creating a strategic alliance between the two for promoting educational excellence in this field in the respective countries.
- Task Force on **"Research and Development"** has been established by SBP to undertake research and development in areas of Islamic Banking and Finance.
- SBP is one of the founding members of the **Islamic Financial Services Board** (IFSB). In the 9th meeting of the Council of the Islamic Financial Services Board (IFSB) held on 29th November, 2006 in Jeddah, the Council approved appointment of **Dr. Shamshad Akhtar, Governor, State Bank** of Pakistan as the Deputy Chairperson of the IFSB for the year 2007. Furthermore, Dr. Shamshad Akhtar will be appointed as Chairperson of the IFSB for the year 2008.
- To enhance investment opportunities and strengthen linkages with the global Islamic financial market, the SBP is also a member of the **International Islamic Financial Market.** SBP has been actively participating in its meetings of Board of Directors, Working Groups etc. SBP has now been given the status of a permanent member of IIFM. SBP has also been actively collaborating with **central banks** of other countries like Malaysia, Bahrain and Indonesia for the promotion of Islamic banking and finance. SBP has signed MOUs with Malaysia and Bahrain for the promotion of Islamic banking on a host of issues including supervision, technical expertise and training assistance.
- A Task Force has been formed at SBP to map out a plan for introducing short term and medium term **liquidity management products** based on innovative Islamic Structures. It has already prepared a structure for short term Shariah compliant government instrument which has been sent for Government approval.
- For development of **Accounting Standards for Islamic Modes of Financing** a Committee is constituted at Institute of Chartered Accountants Pakistan (ICAP) in which SBP is also represented. The Committee is reviewing the accounting standards prepared by Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain (AAOIFI) with a view to adapt them to Pakistani circumstances and if considered necessary to propose new accounting standards. The Committee has prepared the standards on Murabaha and Ijara and is now working on Diminishing Musharaka Standard.
- Pakistan has started work on adopting/adapting IFSB standards/guidelines in its Islamic banking sector. Keeping in view current risk management guidelines (RMG) of State Bank of Pakistan for conventional banking, the State Bank has initiated the necessary process of adopting/adapting IFSB Guiding Principles on Risk Management for Islamic Banking Institutions.
- SBP has issued Draft Guidelines for provision of Islamic microfinance services and products by financial institutions

It is expected that the active role of SBP in promoting this sector would help in reaping the benefits of Islamic banking.

Box: 10.2

Islamic Financial Services- Global Scenario

The international Islamic financial market is becoming increasingly dynamic and diversified. Once looked at as a patchwork of niches in the Arabian Gulf region and Malaysia, the market is evolving into a global one. In this milieu, the stakeholders are implementing important market harmonization measures as proposed by the international standard setting bodies like AAOIFI and IFSB. These in turn are providing the Islamic markets a stronger base to participate not only in global securities, but also to expand into important Muslim minority markets including China, Thailand, India U.K, U.S.A. and the Philippines. Once spearheaded by investors, the market is gradually becoming more informed by consumer demand.

It is to mention here that none of the retail developments or new product innovations would have been possible without the involvement of conventional banks. Foremost, the great **global banks**—HSBC, Citibank, Deutsche Bank, Standard Chartered, and more—all have either Islamic banking windows or subsidiaries.

At the **regional** level banks like RHB and Hong Leong in Malaysia or National Commercial Bank and its traditional banking peers in Saudi Arabia all have robust Islamic windows. In the case of RHB and Hong Leong, these windows have evolved into Islamic banking subsidiaries. Even in the U.S., regional banks like University Bank in Michigan and Devon Bank in Chicago have Islamic windows, with the former now turning their window into a full-fledged Islamic subsidiary. These windows and subsidiaries are expanding market capacity, encouraging innovation, and generally training a wider universe of bankers, clients and regulators in the methods of Islamic finance. GCC has also seen a number of conventional banks transformed into Shariah compliant institutions over the recent years. The conventional banks have in fact proved to be growth enablers for this market.

On the Human Resources Development front at the international level an important development has been the establishment of the International Centre for Education in Islamic Finance (INCEIF) by Bank Negara Malaysia in March 2006. Its basic aim is to nurture Islamic finance professionals and expertise in order to address the human capital needs of a rapidly expanding industry. Its main focus and objective is to produce high caliber professionals for the global Islamic financial services industry through certification programs as well as research and development of innovative Islamic financial products.

Global Growth trends & Size of Islamic Finance Market

In the last thirty years, Islamic Finance industry has made considerable progress at the global front. Especially, during the last decade the Islamic Financial Sector (IFS) has registered a robust growth (between 15 to 20 percent per annum); making it one of the fastest growing segments of the overall financial system. As a result, today the Islamic financial industry is comprised of across-the-board financial institutions / markets including onshore and offshore commercial banks, non-bank financial companies, housing cooperatives, microfinance institutions, venture capitals, mutual funds, Takaful companies, capital markets etc. Moreover, there are dedicated regulatory, legal and academic institutions at the international level that are providing support in establishing and developing the IFS.

Quantifying the size of the global Islamic finance market remains a difficult task. The frequent assertions of 15-20 percent growth per annum are, in some markets, outstripped by measurable facts on the ground. According to estimates, in the Arabian Gulf region alone, the number of Islamic financial institutions has increased by 70 percent between 2001 and 2006. In some countries, like Saudi Arabia, consumer demand for Shariah compliant services reaches 76 percent according to some surveys. And in the U.S. the volume of Islamic mortgage alternative transactions has grown to approximately $250 million per annum in 2006 from less than $20 million per annum in 2000. Whether home finance, or consumer goods acquisition, the global Islamic financial market has been pressed by the retail consumer into offering attractive new products that compete well with traditional banking services. Concerning Institutions Offering Islamic Financial Services (IIFS), Council for Islamic Banks and Financial Instiutions (CIBAFI) is the only official source of information at present. According to information released by CIBAFI, the IFSI includes 284 IIFS operating in 38 countries and managing US$250 billion. However, this does not include Islamic window operations of conventional banks, which CIBAFI estimates to manage some US$200 billion. Besides, the above information does not cover non-banking IIFS, Takaful and capital market activities.

11 Access to Financial Services

The traditional role of the financial system has been mobilization and subsequent transfer of resources to the productive channels of the economy. Through enabling saving mobilization a financial system allows household to accumulate financial assets which are much more liquid and also give a return. Moreover, financial system through availability of credit allows both the firms as well as the households to leverage their equity which in turn allows for greater productive activities to take place. For the households an additional benefit is smoothing of the consumption pattern, greater shock absorbing capacity and freeing up of the equity.

However, for the optimal extraction of these benefits, a financial system needs to have outreach and penetration across geographical and income segments. Thus a financial system needs to be financially inclusive in order to exert broad based impact on economic development. There is ample international empirical evidence to suggest that increase in financial sector access through increasing financial depth has a causal impact on growth which in turn has a positive relationship with poverty reduction[16] and income inequality.[17]

For the past few years Pakistan has witnessed a period of substantial improvement in various aspects of its financial sector performance. As a result, the banking sector performance has been one of the best in region.

Though the financial sector reforms have achieved their broad objectives, Pakistan still exhibits a rather low level of financial deepening and outreach.

Credit/GDP ratio at 27 percent is low judged by cross country comparison (see **Table-11.1**). Likewise only 30-35 percent of the adult population has bank accounts. Agriculture and SME credit reaches only 1.5 and 0.17 million borrowers[18], respectively and financing to those sectors despite increases in recent times still accounts for merely 5.9 percent and 17.4 percent of the total private sector credit. Though the quantum of disbursement may have increased, the percentage share has actually decreased in these sectors. Furthermore, outreach of documented microfinance sector is 1.1 million against a potential target market of 10-30 million[19]. In Pakistan financial exclusion manifests itself in different forms:

Table-11.1:- Private Sector Debt to GDP Ratio

Country	2000	2001	2002	2003	2004	2005
China	112	111	119	127	120	115
Hong Kong,	156	155	151	152	150	146
India	29	29	33	32	37	41
Indonesia	20	18	19	21	24	25
Korea	91	95	101	103	98	98
Malaysia	140	149	146	141	130	127
Pakistan	**18.1**	**18**	**18.2**	**20.1**	**22.6**	**26**
Philippines	44	40	37	36	35	31
Singapore	111	130	114	115	107	102
Thailand	108	97	103	103	97	97

[16] DFID paper "The Importance of Financial Sector Development for Growth and Poverty Reduction, 2004."

[17] Lately the following studies have concluded that:
- financial depth contributes to lower inequality (Li, Squire and Zou, 1998; Clarke, Xu and Zou, 2003);
- financial depth contributes to lower poverty (Honahan, 2004a);
- financial development has a positive impact on changes in inequality and changes in poverty; it is a causal factor in pro-poor growth (Beck,Demirgüç-Kunt and Levine, 2004);

[18] December 2006

[19] Microfinance strategy paper

(i) Exclusion because of geographical constraints: Pakistan exhibits a disproportionate financial sector penetration as urban areas despite having only 1/3rd of the population have more than 2/3rd of the bank branches and more than 70 percent of the deposit accounts (see **Table-11.2**). This rural financial underdevelopment assumes more significance in the wake of higher headcount poverty incidence (28.13 percent compared to merely 14.94 percent in urban areas). Moreover in r ural areas the percentage of adult population having bank accounts is far less than urban areas.

Table-11.2:- Penetration of Financial Services (%)

	Rural	Urban	Total
Percentage of Bank Branches	33	67	100
Percentage of Population	67	33	100
Headcount Poverty (as estimated by GOP)	28	15	24

(ii) Exclusion because of banking behavior and practices either because they are not servicing a large segment of population or they rely on traditional modes of lending which require collateral or documentary requirements or they impose prohibitive transaction costs etc.

(iii) Exclusion because of lack suitability of products like current accounts, which do not offer an overdraft and an easy route to borrowings.

(iv) Exclusion because of some regulatory barriers, such as the money laundering guidelines requiring proof of identification which many poor and vulnerable poor find difficult to provide.

Financial inclusiveness is critical as 42 percent of Pakistan's population is under 15 years of age and about 24 percent of the population lives below poverty line, both these segments can benefit from economic empowerment. Apart from the price and lack of easy availability, financial institutions are reluctant to venturing into new areas as they do not have the capacity to assess the demand and deliver their financial services. The lack of availability of the faith based system of financial services, lack of alternate delivery channels and financial innovation, inadequate database and information on borrowers, and weak enforcement of contract etc. are some of the main stumbling blocks that prevent inclusiveness of financial sector.

Recognizing the overwhelming size and intensity of financial exclusion in Pakistan, SBP in designing the second generation reforms for financial services industry is placing high priority on developing and implementing an effective strategy for financial inclusion.

A key objective of the financial inclusion strategy of Pakistan is to support the Government's target for halving the income poverty headcount by 2015 and to reduce eventually poverty to a single digit. To realize this objective, the Government and the SBP has for sometime been creating conducive policy, legal and regulatory framework across the board, while adopting multiple approaches and modalities to extend its net of financial services to larger segment of population.

Keeping these perspectives in mind, Pakistan has adopted a holistic strategy for empowering and enhancing the capacity of poor to contribute and participate in economic growth. On one hand, the Government is focusing on enhancing public investment in education and health and a wide variety of poverty alleviation programs. On the other hand, the central bank has been steering a broad-based policy framework for promoting inclusive financial development.

Broadly speaking for increasing financial access SBP has targeted the following areas:

i) Increasing the geographical outreach of the banking services and target the underserved regions.

ii) Besides increasing institutional and branch outreach stress is also on provision of products which meet the unique requirements of the local populace. Thus increasing focus on previously underserved sectors such as Microfinance, agriculture credit and SME has assumed significance. Increase in credit flow to these sectors will have a positive impact on these growth of these segments and will also affect the general poverty.

iii) The strategy also has acknowledges the potential role of Islamic banking due to its faith based appeal in increasing the over all penetration of financial services.

SBP's Annual Branch Licensing and Basic Accounts Policy. At present the branch network in rural areas is pretty low. In order to address the problem, SBP has introduced the Annual Branch Licensing Policy with a road map for 2008 and beyond. This policy requires commercial banks with 100 branches or more to open at least 20 percent of their branches outside big cities and set up branches in Tehsil Headquarters where no branch of any bank exists. In addition SBP is considering about allowing banks to establish sub branches, booth and service centre of commercial banks in inner regions where it is costly to maintain a full fledged branch. These sub branches can be managed by skeleton staff and can act as an extended arm of the nearby branch for performing limited banking functions such as deposits, withdrawals, issuance of demand draft, telegraphic transfer etc. and also facilitate payment of home remittances to their beneficiaries.

Basic Banking Account. Moreover since November 2005 all commercial banks operating in Pakistan are required to offer Basic Banking Accounts (BBA) to facilitate and provide basic banking facilities to the low income people in Pakistan. A typical BBA can be opened with a minimum deposit of Rs1000 carrying no fee, no limit of minimum balance and full ATM facility. As of March 2007, there were about 120,000 BBAs opened.

Promotion of Post Office Network. SBP and Post Office (PO) are exploring the ways to provide financial services by encouraging alliances between MFBs/MFIs and PO through their wide network of field offices. So far, PO manages 3.6 million saving accounts with 70 percent of such accounts holding saving below Rs10, 000 (or $165). PO is now working with a few MFBs/MFIs to develop viable arrangements for PO to sublet premises to MF providers or to partner with them to launch wide range of financial services. PO recognizes that it would have to rely on MFIs for financial intermediation, though local POs have over the years developed an understanding of local communities that they service.

Focus on Agriculture Sector: In order to promote the agriculture financing SBP is working on the strategy aiming at the followings:

i) Increasing the outreach level to about 3.3 million farmers from the existing 1.6 million, in the next 3-4 years (up to 2011)

ii) Removal of existing regulatory hurdles and ensuring enabling policy environment

iii) Conducting research and focusing on areas such as development of Islamic products for agri finance, mobile banking for increasing outreach and disbursement, dealing with collateral issues by introducing group based lending, corporate farming and collateral free products, etc.

iv) Capacity building of commercial banks

v) Coordination between stakeholders SBP, MINFAL, banks, Provincial Agricultural Departments, PARC, Farmers Associations and Research & Extension Departments

vi) Performance monitoring & evaluation

Microfinance Banking: Though in Pakistan the potential market size is huge (around 30 million) however, the penetration still remains very low despite substantial increase in number of borrowers (from 60,000 in 1999 to around a million in December 2006). Consequently a huge portion of this potential market remain under served.

Hence in order to further increase the outreach of microfinance SBP has developed a strategy paper. Under this strategy paper it is envisaged to increase the number of microfinance borrowers to 3 million within 2-3 years' time. In order to go beyond 3 million borrowers, certain new initiatives have also been discussed in the position paper that may help strengthen the industry further and eventually achieve accelerated growth beyond 3 million borrowers after 2010. The strategy to achieve this target includes: commercialization of microfinance sector; competition; launching innovative solutions; enhancing technological base; and establishment of Credit Unions in Pakistan as a fourth tier regulated microfinance institutions.

Small and Medium Enterprises (SME) Financing: In order to create awareness about the SME products available through banks and DFIs, SBP in collaboration with SMEDA has conducted a series of seminars on "SME Products and Delivery Channels of FIs". Last year five seminars were held in major SME cluster cities under this initiative. For this calendar year also we have planned, again in collaboration with SMEDA a series of seminars titled as "Hassle Free Business Environment for SMEs".

For the capacity building of banks in SME finance, SBP is also negotiating a capacity building project with the World Bank and DFID, UK. Under this proposal, capacity building support shall be available to a select few banks in Pakistan, through an international consultancy firm, in the implementation of "downscaling approach". The downscaling approach is designed to provide existing commercial banks with the technical know-how they need in order to be able to disburse loans to very small, small and medium enterprises. Under this approach a whole spectrum of SME lending infrastructure is established within a bank ranging from establishment of SME lending units, IT, product development to training of staff.

SBP, in collaboration with ADB, has also commissioned a feasibility study to strengthen secured transaction regime which will help develop a system that makes it efficacious for financial institutions to accept movable property as collateral. This is particularly important for improving SMEs' access to credit as they are more likely to be able to post movable property as collateral. Robust secured transaction regime will help improve the enforcement of repossession and sale of movable property. The objective of this reform must be to design methods that shift the bulk of repossessing and selling of collateral away from the courts.

In order to gauge the depth and breadth of products offered by the financial institutions in Pakistan, SBP in collaboration with EU is also conducting a survey on "Analysis of SME Portfolios of Banking and Non-Banking Financial Institutions".

iii) Promotion of Islamic Banking: Islamic banking is another area, which is coming to the forefront in Pakistan's financial sector. Due to religious belief of the general populace it is often felt that one of the major reasons behind low financial penetration is lack of Shariah compliant alternatives. Realizing that development of Islamic finance would invariably increase the financial depth and improve the penetration of financial services, SBP has taken a number of steps which besides promoting Islamic banking would also strengthen Islamic securities market. As a first step, SBP has adopted a policy of giving licenses only to Islamic banks which would also increase the number of potential buyers. At present there are 6 Islamic banks operating in Pakistan with a branch network of 108. Moreover SBP has also allowed conventional banks to open stand alone Islamic bank branches (IBBs). At present there are 58 stand alone branches of 13 banks. In addition, SBP has allowed banks to open Islamic subsidiaries for performing functions such as asset management, equity market activities etc. At present several commercial banks have shareholdings in Modaraba companies.

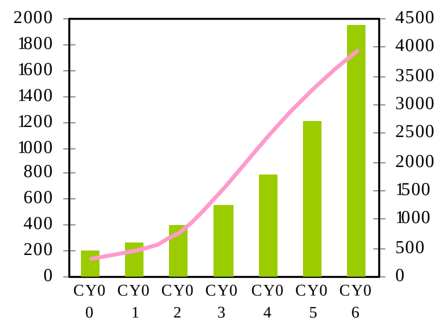
Growth in assets has been high enabling the Islamic banks to raise their share from merely 0.5 percent in December 2003 to 3.3 percent in April 2007. However in terms of scale, the size of the Islamic financial sector is still very small compared to its conventional counterpart. As discussed earlier, that developing Islamic banking would invariably increase financial penetration as more people would be willing to place their deposits and use various financial modes.

12 E-Banking Developments in Pakistan

The rapid development in computer and telecommunication technologies is transforming the present branch banking into highly integrated next generation multi-channel online banking. The e-banking technology has enabled the institutions to offer their services 24/7, cross border and in any currency. Banks in Pakistan have started offering their services through alternate delivery channels of e-banking such as Automated Teller Machines (ATM), Point of Sale (POS), Internet, Call Center, Interactive Voice Recognition (IVR), Mobile telephone, and Real Time Online Banking. The growth in e-banking witnessed in last 6 years both in terms of numbers and value is phenomenal and this has made the banking sector more attractive for market.

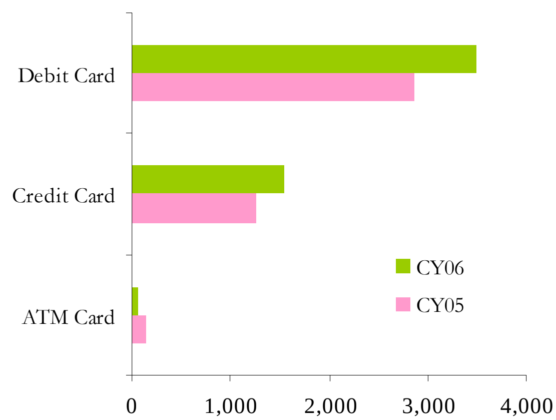
CY06 proved to be another good year in terms of growth in e-banking activities thus increasing the number of banks and online branches offering e-banking solution. Out of 39 banks, 30 banks are offering ATM service, 26 banks provide online banking facility, 16 have POS terminals, 10 are offering call center banking and 12 banks have internet banking programs. Number of on-line branches have increased significantly to around 4 thousand in CY06 (see **Figure-12.1**) after experiencing a growth of 21 percent. This adds to the e-banking coverage available to the market. Automated teller machines (ATMs) also witnessed a strong growth of 60 percent. e-banking infrastructure has exhibited a healthy growth during the last 6 years in all respect.

Figure-12.1:- E-banking Infrastructure



	CY00	CY01	CY02	CY03	CY04	CY05	CY06
No. of ATMs	206	259	399	552	786	1217	1,948
No. of Online Branches (RHS)	322	450	777	1581	2475	3265	3,947

Figure-12.2:- Volume of Plastic Cards (in '000')



The acceptability of e-banking products is also obvious in the growing use of plastic money. With the growing preference of plastic money the credit cards, debit & ATM cards also witnessed impressive increase over the last year. Total number of cards grew by around 20 percent during CY06 and in terms of volume these stand around 5.1 million. Debit cards carry the highest weight among all the cards and are about 68 percent of total cards in circulation. These debit cards, after experiencing a growth of 22 percent increased to around 3.5 million (see **Figure-12.2**) . Credit cards grew at much faster pace at 23 percent and its volume increased to around 1.5 million from around 1.3 million in CY05. Since most of the ATM cards were converted into debit cards, ATM cards actually declined to 71 thousand from 137 thousand in CY05. Smart cards, offering more security and safety, also showed a growth to 0.3 million from 0.1 million in CY05.

Such retail transactions are gaining popularity among the users due to their security, easy accessibility and of-course the customized solutions they are offering to the users. This is also reflected in the significant increase in the retail transactions through e-Banking during CY-06. The number of transactions grew by around 53 percent, which is really an impressive growth, to 84 million in CY06. The volume of such transactions even increased rapidly i.e. by about 2.4 times to around 9.5 million (see **Figure-12.3**).

Going by the e-banking channels, the ATMs transactions grew by much larger pace (see **Figure-12.4**). The value of such transactions is also on rise. When compared with the other e-banking channels, the ATM transactions are about 50 percent of the total e-banking transactions (see **Figure-12.5**). Whereas the share of Online Banking, POS, Call Centre and Internet Banking in the total E-Banking business was 31 percent, 17 percent, 1 percent and 1 percent respectively. However, in terms of rupee amount, the share of ATM transactions is quite small i.e. 3 percent of the total value of e-banking transactions (see **Figure-12.6**). This is due to the low per-transaction-value of ATMs.

Figure-12.3:- Volume of On-Line Transactions

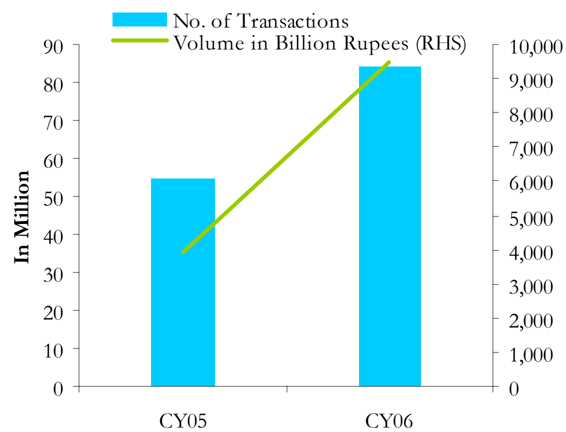


Figure-12.4:- ATM Transactions

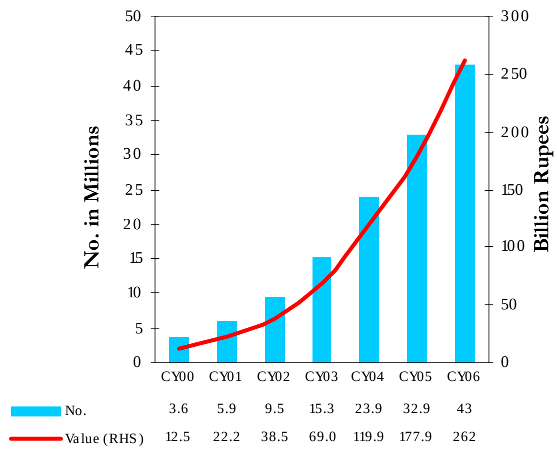


Figure-12.5:- Share in Transactions on E-Banking Channels

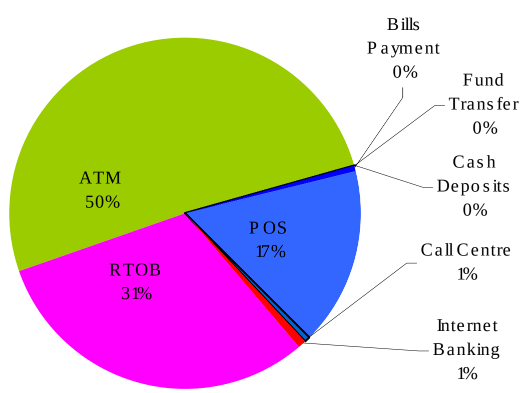
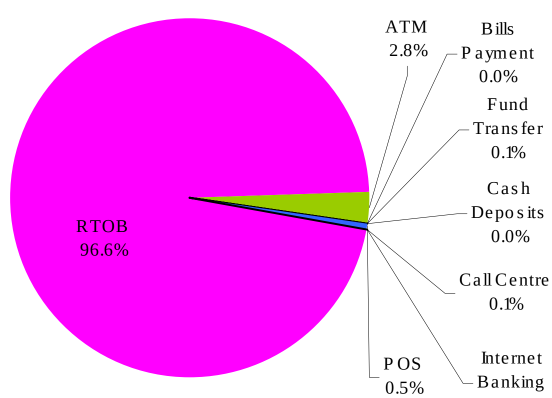


Figure-12.6:- Share in Value of Transactions on E-Banking Channels



Online banking holds about 97 percent share of in rupee terms of rupee value of all the e-banking transactions which by all means is quite significant. This may be attributed to the B2B transactions, which involves large volumes. Transactions of other e-banking channels like, call centre banking, internet banking, funds transfer, utility bill payment and cash deposits are, though growing, hold insignificant share at present. However, since the e-banking in Pakistan is in growing phase, the increasing awareness, competition and technological advancement in the years to come, are expected to add to the e-banking activities.

Box-12.1

Steps Taken by SBP for Smooth Functioning and Risk Mitigation of E-Banking

SBP in its efforts towards streamlining the state of the art and customized solutions offered by the e-banking channels, and also to mitigate the risks associated with such transactions took a number of steps, of which a few are summarized as follows:

- The use of e-banking channels is growing at a very high rate. However, the number of suspect transactions was also growing and causing inconvenience to customers. In order to enhance customer confidence, SBP developed standardized guidelines for banks' ATM Operations. With the issuance of those guidelines resolution of suspect ATM transactions improved, refund of un-disbursed cash became automatic, time-lines for refund were set, settlement by the Switches /Banks became automatic, sending of confirmation of refund to customers became mandatory for the banks, and installation of external camera/cameras in ATM cabins/rooms became compulsory within three months from the date of issue of the circular for secondary evidence purpose to satisfy customers.
- Robust and reliable infrastructure is critical for the smooth operation of e-banking. Therefore SBP initiated a project to reform the ATM switches with the collaboration of switch operators i.e. M-Net and 1-Link. Through consultations with them and stakeholders, a number of initiatives have successfully been completed, such as standardization of Service Level Agreements (SLA) and Standard Operating Procedures (SOP) for ATM switch operators (i.e. 1Link and Mnet Services Ltd.). This initiative will improve the delivery of services and their performance would be compatible with the international best practices. The SLA has a built-in mechanism of monitoring compliance by a monitoring committee represented by switches operators/banks.
- Payment of utility bills has gained a critical importance for consumers, utility companies and banks. Customer is looking for convenience and wants to save precious time, utility companies look forward to timely payment and reconciliation and banks have to provide cost effective means for payment. Since the ATM network in Pakistan has gained much acceptance, SBP took the initiative to leverage the e-banking channels to provide a solution which meets the requirements of all the stakeholders. In consultation and agreement with banks and switch operators, a plan has been chalked out to offer utility bills payment on ATM network. Through this initiative bank are offering the facility of accepting the payment of utility bills through ATMs in phased manner. Under the first phase the banks will provide this facility through their own ATMs while in the second phase customers would be able to pay utility bills through any ATM linked with any switch. This initiative will reduce the suffering of general public that they experience while paying their utility bills.
- Use of plastic money i.e. (Debit / Credit / Smart Cards) has been increasing day by day. Like any other new technological product consumers also need to adopt new practices to mitigate new risks while taking full advantage of the e-banking services. In order to educate the customer, SBP issued guidelines for card holders in English and Urdu explaining the precautionary measures that they should take while executing transactions over different e-banking delivery channels such as ATMs, POS, Internet and Call Centers etc. This would create awareness and help them immensely to prevent from inconvenience.
- ATMs have become a popular mode of e-banking channel in Pakistan as transactions through ATMs constitute 51 percent of total e-banking transactions. However, there had also been growing number of complaints about malfunctioning of ATMs. To minimize such incidents, SBP issued guidelines whereby banks were required to continuously monitor their network, maintain/replenish cash and ensure maximum uptime especially during long weekends, such as Eid holidays.
- To remains vigilant, SBP is also seeking the statistics on major e-banking products from the banks for the purpose of continuous monitoring of the e-banking activities and trends.

13 Corporate Governance Issues in Banks

The significant bearing of corporate governance on financial health and soundness of financial institutions has augmented the regulators' endeavor to promote strengthen the good corporate governance practices amongst the financial institutions. In the recent past, fragile corporate governance systems have been at the core of a number of financial and corporate scams in the developed world. However, taking notice of the vulnerabilities, the developed countries have eventually reformed their corporate governance standards and discipline. The adoption of effective corporate governance framework is essential especially for the emerging countries like Pakistan, which have embarked upon the liberalization and deregulation of financial systems lately and lack ability to absorb the financial or corporate failure shocks.

Effective and strong risk management also has an intrinsic relationship with sound corporate governance system, but the two should not be confused. The corporate governance, in the sense of structures of control and accountability in an institution, is not always the same as management. Sometimes there are management failures which are simply the result of poor day to day judgments, which do not necessarily indicate a structural weakness, or a failure of oversight. Further, sometimes the failures are largely the result of wrong strategies where no corporate governance code can protect.

The regulators in Pakistan (SBP & SECP), being cognizant of the growing frequency and incidence of corporate scandals worldwide, are fully convinced of indispensability of a strong corporate governance framework and are striving to promote and strengthen the corporate governance culture. In this regard, they have taken various steps to establish an effective corporate governance framework, galvanize the efforts of key stakeholders to remove the irritants, promote ethical values and establish sound disclosure and auditing standards. State Bank of Pakistan, being the regulator and supervisor of banks and DFIs, has been at the forefront to strengthen corporate governance practices among the institutions coming under its purview.

State Bank of Pakistan, in its resolve to strengthen the regulatory framework on corporate governance and adopt the best practices in this regard, has recently made certain amendments in two important components of the code of corporate governance viz. 'Fit & Proper Test (FPT) criteria for Board Members, CEOs/Presidents and Key Executives' and 'Responsibilities of Board of Directors and Management' of the banks and DFIs. The amendments, interalia, include:

- The scope of FPT broadened to include sponsors and strategic investors in addition to Directors, CEOs, and Key Executives of banks / DFIs,
- Entry of sponsors and strategic investors and appointment of Directors & CEO with prior clearance in writing from SBP,
- Major shareholders to seek prior approval in writing from SBP for acquiring 5 percent or more shares of a bank/ DFI,
- Scope of Board of Directors and Management further clarified,
- Increase in mandatory requirement of independent directors and restriction on family and executive directors in banks,

- Board emphasized to remain independent of the management, focusing on policy making and general direction of the bank/ DFI, overseeing and supervising the affairs and business and not involving itself in day to day operations including credit decisions.

Once enacted, the effectiveness of a regulation or a regulatory measure largely depends upon the compliance culture amongst the institutions and eventual enforcement powers of the regulators. To ensure compliance of its codes and regulations including those related to the corporate governance, State Bank of Pakistan possesses adequate capacity and enjoys considerable powers and authority. It has in place an elaborate system of monitoring i.e. offsite monitoring, onsite inspection and Institutional Risk Assessment Framework to measure the level of compliance against the corporate governance regulations as enshrined in the Code of Corporate Governance, the Banking Companies Ordinance 1962, Prudential Regulations and FPT.

Notwithstanding the divergence in the level of compliance with the corporate governance regulations, the overall scenario depicts marked improvement over the period. For example, there is a cadre of better professionals both among the board members and managements, key players in the corporate governance hierarchy take active part in the decision-making processes, external influences have been marginalized and transparency and disclosures mirror international best practices. The significant up-gradation in supervisory capacities has been the fundamental force behind improved levels of corporate governance at banks. The policymaking and vigilance capabilities of the State Bank reflect marked improvement.

Although witnessing a substantial turnaround in terms of corporate governance practices, our regulatory framework on corporate governance continues to evolve. The issues identified amongst the banks/ DFIs during supervisory process serve as feedback and stimulant for the State Bank to further fortify the corporate governance framework or strengthen its implementation. Though State Bank of Pakistan is striving hard to adopt and implement the best international practices in corporate governance, the issues of compliance still remain at the banks' end. The issues generally include weaknesses in the areas of strategic planning, board's oversight, policy formulization, conflict of interests, constitution and performance of board's committees, review of system & controls environment, internal audit and compliance functions.

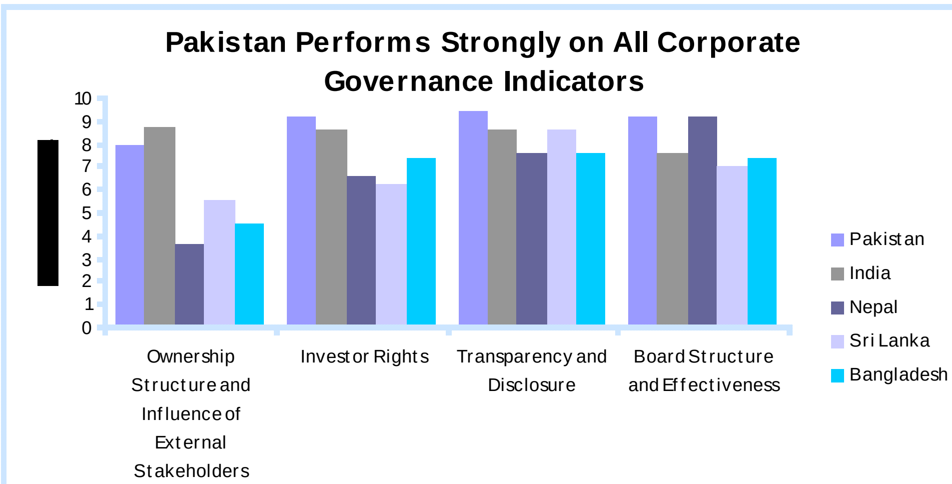
Eventually, however, the quantum of irregularities regarding corporate governance has considerably shrunk over the period. Towards this end, effective monitoring and vigorous follow up of the State Banks has contributed greatly. State Bank of Pakistan, besides penalizing heavily for violations of basic corporate governance regulations, also resorts to moral suasion to keep banks on board regarding the significance of sound corporate governance practices for their financial health and viability on a sustainable basis.

To conclude, Pakistan has been rated quite above the many of regional countries in observance of good corporate governance practices (Box-I). However, ensuring that our regulatory framework on corporate governance arrives at par with the international best standards requires a lot more to be done. There is a strong need for the industry to galvanize and self regulate itself; adopt greater disclosure and improve shareholder rights; enhance the quality of boards and their role in oversight, effectively manage the conflict of interest; and adopt corporate social responsibility programs aiming to promote a vision of accountability to a wide range of stakeholders.

Box- I3.1

<u>Pakistan Does Well in All Areas of Corporate Governance……*</u>

Pakistan does well in all areas of corporate governance, but the key to its superior performance are the detailed governance guidelines issued by its regulatory authorities, demonstrating better disclosure and greater shareholder rights. India follows closely behind. Sri Lanka, Bangladesh and Nepal have performed fairly well, though better on some indicators than others. All countries appear to have done reasonably well on investor rights, board structure, and accountability and auditing standards.



* An extract from 'Financial Performance and Soundness Indicators-PhaseIII' published by Finance and Private Sector Development, South Asia Region, The World Bank-August 2006.

14 Role of Credit Information Bureau in Financial System- A Perspective on ECIB in Pakistan

Credit information sharing system is a critical element of the institutional framework necessary to support a well–functioning and modern financial system which plays an important role at the economy-wide level. It can contribute to strengthen financial systems and promote stability by reducing transaction cost, improving portfolio quality, increasing competition and enhancing access to credit. It can also facilitate transactions by assisting in evaluation of risk and modeling consumer behaviors. Financial institutions having access to accurate and timely credit reports on potential borrowers can use this information, more precisely, to assess credit risk and result in improved portfolio quality based on sound business criteria. Moreover, it enables supervisors to accurately evaluate credit risk in financial institutions by providing benchmarks of standardized and objective criteria for credit analysis, such as credit reports, scoring cards, etc. In countries where credit reporting is maintained by the central bank or bank supervisor, the data is used in identifying questionable or poorly performing loans for review during on-site examination as well as for monitoring the portfolio quality of institutions and identifying economy-wide trends. Therefore, an efficient, credible and effective information sharing system has enormous benefits for all the stakeholders- lenders, borrowers and supervisors.

Credit reporting addresses a fundamental problem of credit market asymmetric information between borrowers and lenders that lead to adverse selection and moral hazard. The lenders can avoid extending loans to high risk borrowers, with poor repayment histories, defaults, or bankruptcies. At the same time, credit reports strengthen borrowers discipline and reduce moral hazard, since late or nonpayment with one institution may result in sanctions by many others. Credit reports include positive and negative information so that responsible borrowers can documents good credit histories thereby building reputation collateral.

Credit information sharing can play an important role in improving the efficiency of financial institutions by reducing both the cost and the time required to process loan applications. The lenders may also use this data for monitoring their existing portfolio, identifying potential problems, and to develop and market new products, thus contributing to their profitability through more accurate pricing and targeting. Since credit bureaus promote transparency and sharing the information advantage that FI have over their existing clients, they can also encourage greater competition leading to lower prices and eventually greater access to credit.

Credit Information Bureau of Pakistan

While some developed countries have a long tradition of credit reporting, in many developing countries it is a relatively new activity. State Bank considers functioning of effective credit information bureau integral to promote financial discipline and better credit risk management by the financial institutions. In its endeavor to facilitate financial institutions in making prudent lending decisions, the Credit Information Bureau (CIB) was established in 1992. Due to minimal lending in consumer sector the focus was initially on large and medium size borrowers, CIB was capturing corporate borrowers' record of more than Rs 0.5 million and above only. Over the years, SBP has significantly enhanced the scope of CIB operations. In April 2003, SBP enhanced the coverage and effectiveness of CIB by introducing eCIB online facilities. SBP's CIB became the first bureau of the region to introduce online facility to its member financial institutions. This development enabled financial institutions to upload their data directly into CIB system and also generate the CIB reports on real time basis.

The rapidly growing consumer/SME/micro financing portfolio immediately calls for the development of a healthy and efficient consumer credit reporting system. The markets for credit cards, mortgages, auto and personal loans have grown exponentially. The CIB at SBP has responded positively to the new challenges. The bureau's reporting, operational and IT systems have been revamped and significantly upgraded in the light of best international practices in the areas of credit information sharing. The scope and administration of CIB database has been further enhanced during early 2004 and SBP launched a new project called "eCIB data lowering limit" with the collaboration of Pakistan Banks Association (PBA) to achieve following objectives:

i) Remove the existing credit reporting limit of 0.5 million and above and to expand its database to cover all credits of its member financial institutions.

ii) Changing the composition of the information to include more financial and non-financial details of the borrowers.

iii) Improve the overall operational efficiency of eCIB by upgrading, communication infrastructure, hardware and software.

The project was aimed to transform CIB into state-of-the-art bureau having ability to meet the needs of financial institutions in a rapidly changing era. The CIB team put strenuous efforts to make the project a success. For this purpose, eCIB team conducted a series of testing workshops with the financial institutions. These included TOT program and hands on training to more than 400 users of 110 financial institutions on the installation, customization and usage of all features of the software application. These users have been imparting further training to others users of their organization and providing support at the entry level (Branches). CIB team also provides continuous counseling and active support/guidance through automated Help Desk System. The project was successfully completed in June 2006 and brings significant improvement in the overall operational and technological infrastructure of the CIB. The key improved features of the new eCIB system over the old CIB system are envisaged as below:

1. Improved efficiency in terms of speed, reliability and security of CIB data
2. Deployment of high capacity servers, security firewalls, broader bandwidth, point to point data encryption.
3. Multi-user and Multi-tiered Rich Client Data capturing software developed using latest programming tools and provided to 100 financial institutions. The software has been designed keeping in view all the data collection requirements of all financial institutions and can be customized according to the requirements of a FI. It can be deployed in centralized and decentralized environment. The software is capable to efficiently collect, consolidate and report thousands of records from all branches of a larger bank.
4. Highly sophisticated and completely automated Back Office (BO) system for processing data at CIB end. With the implementation of the BO system the task of data processing has been reduced from 15 days to three days only.
5. Web based interactive data inquiry systems to provide online Credit Information Reports to financial institutions, and allow online amendment & updates.

6. Replaced dial-up with scalable Virtual Private Network (VPN) that allows FIs to connect to the CIB with any of the fastest available medium.
7. Comprehensive data validation rules implemented to ensure correct entry of records. Validation rule engine has also been developed for creating and implementing new data validation rules.
8. Product wise availability of loan information. Before implementation of the new system such information was available in aggregate form only.
9. Existing credit reporting limits of Rs500,000/ has been eliminated. Under the new reporting system, all outstanding fund and non-fund based credit facilities, irrespective of any amount are being reported to CIB-SBP.
10. New separate reporting system has been introduced for consumer and commercial borrowers. The CIB will collect consumer and corporate credit data on two separate specified formats and also provides separate credit information reports for the consumer and corporate borrowers.
11. The credit report of the consumer is also reflecting the repayment history up to twelve months.
12. Record of last four credit inquiries from the financial institutions has also been made part of the respective borrower's credit report.
13. Formation of group of borrowers for CIB reporting purpose has left to the sole discretion of reporting FIs. The reporting Financial Institution will report the groups of borrowers in the line of the definition as given in the Prudential Regulations.

The improved capacity and scope of the CIB is benefiting the financial industry. The number of borrowers in CIB database has significantly increased from less than 0.2 million to over 4 million. Further, it has greatly expanded the outreach to a large number of borrowers who until now remained untapped because of the floor of Rs500,000/- for reporting purposes. This has important implications with regard to credit expansion to low-value borrowers of SMEs, agriculture and consumer finance sectors. Further, in order to facilitate the users of eCIB system, SBP has established a web based Help desk system for providing efficient support to the financial institution users of the new system and to help general public in lodging their complaints regarding credit reporting issues. The site can be accessed through URL http://www.sbp.org.pk/ecibhelpdesk.

15 Issues and Developments in the Banking System

15.1 MCR Enhancement & Capital Charge under Basel II

The level of capital is considered one of the key measures of stability of a financial system. Higher base of capital not only adds to the confidence of the stakeholders but also mitigates the moral hazard problem and increases the market competitiveness. SBP, while pursuing its two pronged strategy of strengthening the capital base, has been striving for the stability of the banking system. On one side, it focuses on the increase in the capital base by increasing the minimum capital requirement from time to time whereas on the other side, it enforced risk-based capital requirement in the form of adoption of International standard of capital-Basel I, initially and setting minimum standard of capital adequacy ratio during late 90s. Now implementation of Basel II would also rationalize the risk exposures vis-a-viz capital.

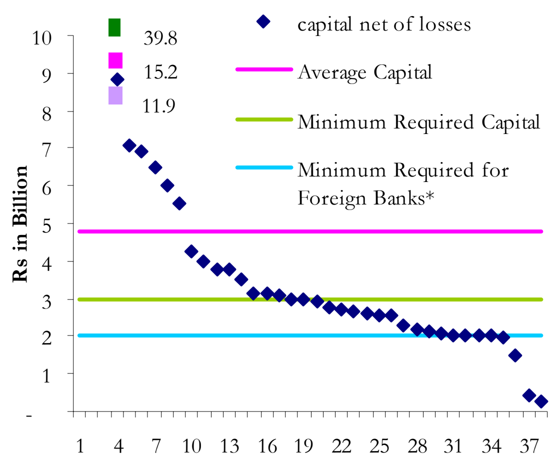
In combination, both of these approaches has benefited the financial system in terms of improved stability and resilience, operating efficiencies and also attracted foreign investment in this area. Growing asset base, largely financed by the steady deposit flows signify the increasing confidence of the depositors on the stability of banking system. Improved asset quality talks about the improved risk management, credit appraisal and monitoring standards.

As regards enhanced minimum capital requirement, the banks were required to hold Rs3 billion by the December 31, 2006. However, for the foreign banks, the head office of which holds capital equal to or more than USD100 million are not required to increase the capital base to Rs3 billion or so. In fact, foreign banks meeting this requirement, can operate with the capital of Rs2 billion only. The rest of the banks and all DFIs, are required to meet additional Rs1 billion each year to Rs6 billion by the end of year 2009.

Of the total 39 banks, 30 banks are meeting the MCR as per the requirement (see **Figure-15.1.1**). Of the rest, 2 are in process of privatization/consolidation and the rest are expected to meet soon.

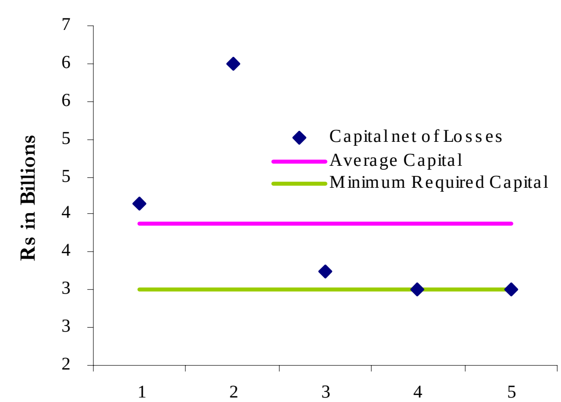
As for the DFIs, all the five DFIs (one is under privatization) are meeting this requirement of Rs3 billion (see **Figure-14.1.2**).

Figure-15.1.1:- Minimum Capital Requirement-Bank-wise Position as of December 31, 2006



*Foreign bank, the Head Office of which holds capital of USD100 million or more are required to hold only Rs2 billion MCR.

Figure-15.1.2:- Minimum Capital Requirement-DFI-wise Position of CY06



This strategy of increase in minimum capital requirement is aimed at and reflecting its benefits in the form of stronger banks. To add to the stability of the banking system, though the risk-based capital has already been institutionalized with the adoption of Basel I in late 90s (capital charge for market risk introduced in year 2004), it was further refined with the issuance of a comprehensive road map for the implementation of Basel II in Pakistan in year 2006. Looking at the scope of new capital requirement under Basel II, though both the credit and market risks were already been taken care of by the earlier capital standard, it is the first time that the capital charge for operational risk has also been taken into consideration. This measure would not only set a side a cushion in the form of capital for the probable operational losses, but also add to the understanding and institutionalize the measurement of the operational risk of the institutions.

While comparing the minimum capital requirement of Rs6 billion in year 2009, with the expected level of capital as per the Basel II -the standardized approach, it may be generalized that though the capital of the banking system would increase with the increase in the MCR, risk weighted assets may also witness a notable increase due to expanding credit portfolio. Further, if the increase in the risk weighted assets would maintain the previous trend of high growth, the resultant CAR of the banking system may lower from the existing levels. However, the present declining rate of growth in risk weighted assets may reduce the severity of concern. Moreover, since the CAR of the banking system is quite healthy, a fall of couple of percentage points may easily be sustained by the banking system.

Impact of Basel II Implementation on CAR of Pakistani Banking System

The impact Basel II implementation –standardized approach- can be assessed on the CAR of the Pakistani banking system by looking into both of the components of this indicator. When compared with the Basel I, the capital calculated under Basel II requirement may be a bit lower due to the exclusion of investment in commercial entities from Tier I capital and reduction in the share of revaluations reserves that is eligible to be included in Tier II of the capital.

Whereas on the risk weighted assets, we can assess the change in the risk weighted assets under each category, separately. The credit risk weighted assets are expected to reduce when compared with the one under Basel I since the better rated portfolio of the banks would carry a lower risk weight, as also consumer and mortgage portfolio which were earlier rated 100 percent under the Basel I have been assigned a risk weights of 75 percent and 35 percent respectively. Moreover, the inclusion of eligible collateral under Basel II would also reduce the overall exposures. However, on the other side, inter-bank exposures may carry a higher risk weight. On market risk side, although the methodology has remained unchanged, the broadening of the definition of trading portfolio can slightly increase the market risk weighted assets under the Basel II requirement. Whereas, since the operational risk is the newer aspect considered for keeping capital against that, the operational risk weighted assets would certainly add to the total risk weighted assets of the banking system.

Now, a probable decrease in the eligible capital under Basel II coupled with a likely increase in the risk weighted assets may slightly put strain on the existing CAR of the banking system. A broad assessment of the impact reveals that under Basel II, the CAR of Pakistani banking system may decrease by around 2 percentage points at this point of time. However, since generally, the banks are operating with good capital ratios and CAR of the banking system under Basel I is more than 12 percent, hence it can safely be estimated that the Basel II implementation may not lower the CAR of the banking system to below 10 percent this year.

15.2 Implementation of Basel II – An Update

International Convergence of Capital Measurement and Capital Standards – A Revised Framework (also known as Basel II framework) was issued by the Basel Committee on Banking Supervision in November 2005. The issuance of a new framework for banks was supported by several theoretical and empirical studies including rounds of country specific quantitative impact surveys and long drawn consultation with the industry.

The Basel II capital accord provides a comprehensive and more risk sensitive capital allocation methodology. This will enable banks to optimize their resources in terms of their risk exposures. Its implementation, however, has become a very challenging task for the regulators around the world, keeping in view the fact that it prescribes significant up-gradation of risk management standards and technological advancement within banks. In this respect, SBP has taken effective steps, and issued a clear-cut roadmap on 31st March 2005 for the implementation of Basel II in Pakistan. Under the roadmap, banks are initially required to go through a parallel run of one and half year for Standardized Approach starting from 1st July 2006. To ensure a smooth transition to the new regime, a number of steps have been taken by SBP and the banking system to provide a solid foundation for the launching of the parallel run.

In pursuance of the roadmap, banks submitted their individual plans mentioning the specific approach (Standardized or IRB), they intend to adopt and their internal arrangements for its implementation. Majority of the banks have expressed their intention to first adopt comparatively simple Standardized Approach keeping in view the requirement of more sophisticated systems for the advanced approaches. However, banks deserving to go for IRB Approach will first have to seek the approval of SBP. A comprehensive review exercise on the part of SBP culminated in a more specific bank-wise internal plans. To streamline the implementation process and to ensure better coordination, each bank deputed their respective coordinators at group head level along with formulation of Basel II units.

Under the Standardized Approach, the capital requirement against credit risk would be determined on the basis of risk profile assessment by rating agencies recognized by regulators as External Credit Assessment Institutions (ECAIs). To ensure transparency in recognition process, eligibility criteria for recognition of ECAIs was devised in consultation with all stakeholders on the basis of broad guidelines described in Basel II. Scrutiny resulted in the granting of ECAI status to two rating agencies namely PACRA and JCR-VIS as both were meeting the minimum requirements laid out in the criteria. The recognition implies that the banks would use ECAI's risk assessment rating of their portfolio for calculation of capital requirement under Basel II. Mapping of ratings with the appropriate risk weights has also been finalized in consultation with recognized ECAIs.

Detailed instructions for adoption of various approaches for calculation of capital adequacy requirements for credit, market and operational risk were issued on June 27, 2006. The parallel run for standardized approaches has started from 1st July 2006. It will help the stakeholders to better understand the implications of Basel II and resolve issues that may arise during the transformation.

Capital reporting formats under Basel II instructions were prescribed in March 2007. These formats primarily cover capital calculation under Standardized Approaches for credit & market risk and Basic Indicator and Standardized approaches for operational risk

The gap between hitherto disclosure practices and requirements under market discipline (Pillar III) of Basel II were identified and detailed requirements for public disclosure were issued in February 2006. These instructions provide for the disclosures to be made by the banks under different approaches of the Basel II adopted by them.

A detailed survey to assess the level of preparedness of the banks regarding Basel II implementation was conducted in February 2007. This survey remained helpful in identifying and assessing the issues prevalent in the banking industry at a large.

Implementation of Basel II poses considerable challenges for the banking system in Pakistan. To meet the gigantic task, the banks and SBP are engaged in capacity building in terms of upgrading their IT systems and enhancing expertise of human resource base. SBP conducted a number of seminars and workshops on new capital accord and risk management techniques for internal and external stakeholders and remained engaged in improving its IT systems to get extensive regulatory reporting in line with the maximum disclosure requirements under Basel II.

15.3 Role of ECAIs in Basel-II Implementation

The Standardized Approach for Credit Risk of Basel II capital framework greatly relies on the credit ratings of the counterparties issued by External Credit Assessment Institutions (ECAIs). Under this approach capital requirement of banks against credit risk is determined on the basis of risk profiles assessed by these ECAIS. In case a rating is not available, the banks have to treat the claims as unrated and assign risk weight accordingly. The process of assessment of capital adequacy of the banks based on the ratings assigned by the ECAIs has greatly enhanced the role and importance of these institutions.

Since Pakistan is in process of implementing Basel II framework, the role of credit rating agencies has greatly enhanced in Pakistan as well. This on one hand provides an opportunity to the domestic credit rating agencies, while on the other hand increases their responsibility. This also warrants greater oversight of SBP as regulator on the role and performance of credit rating agencies. In this regard SBP issued detailed Eligibility Criteria for Recognition of ECAIs in July 2005. Banks are required to consider the credit ratings assigned by the SBP recognized ECAIs only. This criteria has been developed after due consultation with various stakeholders and serves as a transparent policy document for revaluating and granting recognized status to the ECAIs. Accordingly, SBP invited applications from the credit rating agencies that were interested in becoming ECAI and as a result has recognized the two domestic credit rating agencies and have issued mapping of their ratings with that of SBP grades for assigning the risk weight.

Now, though it is critical for SBP, being regulator, that the process of rating should be transparent, of good quality and broadly speaking, objective, there is also a need that more credit assessment institutions with advanced expertise, quality analysts, integrated quantitative tools, models or innovative risk assessment methodologies should come up to promote fairness in rating the borrowers and also to lessen the moral hazard of having very few rating agencies.

15.4 Mergers & Acquisitions in Banking System of Pakistan

State Bank of Pakistan increased its focus on financial sector reforms in order to improve the stability and soundness of the financial sector. One of the main features of these reforms was guided consolidation of the financial sector in general and banking sector in specific with an aim to have fewer but stronger banks. Consolidation through mergers and acquisitions has not been confined to the banking sector only. Rather the scope has been much broader, encapsulating the entire financial sector, including leasing companies, investment banks and modarbas.

State Bank of Pakistan has processed 29 merger and acquisitions transaction since 2000, including 7 acquisitions and remaining are mergers. Majority of these transactions involve merger between Commercial Banks and Investment Banks, while other include merger between DFIs/Leasing Companies with commercial banks. Recent transactions involves higher foreign participation.

There were many factors, which caused such mergers to happen in Pakistan, the key factors are as follows:

- **Increase in Minimum Capital Requirements:** SBP over the time has increased capital requirements from Rs500 million in 2001 to Rs3 billion by end of 31st December, 2005, which will further increase to Rs 6 billion by 31st December, 2009. While the rising MCRs have ensured a strong capital base of banks, it has also been helpful in promoting mergers in the banking sector.
- **Restructuring of public sector and private entities:** State Bank of Pakistan like any other regulator has adopted different strategies to resolve the problem institutions including their mergers with sound financial institutions under section 47 of BCO, 1962.
- **Appetite for Commercial Banking License**: Presently there is a moratorium on issuance of new commercial banking license. Only option left with the interested parties for having a commercial banking license is through acquisition of majority shareholding in existing commercial banks.
- **Expansion & Growth:** A number of mergers and acquisitions in the banking sector of Pakistan have taken place from the perspective of fast expansion and inorganic growth. With the improved financial performance of the banking sector and enhancement in capital requirements, acquisition and then merger with existing commercial banking enhances the branch-network and reach of the banks without taking lot of pain for setting up new branches through out the year. Acquisition of Union Bank by Standard Chartered Bank and Prime Commercial Bank Limited by ABN Amro and acquisition of Rupali Bank by Arif Habib group are the recent examples.

State Bank of Pakistan took a number of important measures to trigger the process of consolidation in a smooth manner. It facilitated the consolidation deals by making the necessary amendments in the legal framework; section 48 was amended to allow the merge of NBFC with banks under the provisions of BCO, 1962. SBP also proposed amendment in income tax ordinance for providing tax incentives to facilitate mergers between financial institutions; new section 57-A incorporated to allow carry forward of tax losses of both amalgamated (target) and amalgamating (surviving) institutions. Further, SBP introduced the concept of Newco; i.e through issuance of new license to a new banking company for facilitating the merger of banking companies not incorporated in Pakistan.

This process of mergers and consolidation has reduced the number of banks from 46 in 1997 to 39 in 2006. If we exclude the 2 newly licensed Islamic banks then the Figure-will further come down to 37. This consolidation process has also contributed in strengthening the capital position of most of the merged entities. Moreover this is also adding to the competition since the market share of merged entities is increasing in terms of assets, advances and deposits. Further, one of the key concerns in most of the mergers is the concentration that mergers may engender. However in case of Pakistan, various concentration ratios for the banking sector suggest a promising trend. Despite significant M&A activity in the last five years, almost all the indicators of our banking sector concentration have taken a turn for better. This was because of the fact that generally the institutions that have undergone the process of mergers and acquisitions were the smaller or medium sized.

Going forward, if the process continued aiming at strengthening and further developing the market through competition, the banking sector can reap its benefits in the form of more stable and resilient banking system in Pakistan.

15.5 Resolution of Problem Banks

State Bank of Pakistan (SBP) being the central bank of the country ensures, as far as possible, systemic stability of the financial sector and prudent business practices of each financial institution, and thus protects the interests of the stakeholders. Accordingly, SBP supervises the performance of each banking company thoroughly to assess its operational and financial soundness, different risks assumed thereon and compliance with the relevant rules and regulations. Nevertheless, due to the external variables like dynamic market conditions and various internal factors of each institution, there is always a probability of unsatisfactory performance by some banks. It is, therefore, important to implement precise policies and systems for early identification of problem financial institutions and effective resolution of their problems.

Besides monitoring the basic indicators, ratios and limits pertaining to prudent banking, SBP ensures that the management of a bank upholds high ethical values, and is competent enough to assess and monitor the risks attached to the banking business. As a regulator SBP has a coherent strategy for dealing with problem banks/ DFIs which is based on the strategy of getting a realistic and timely diagnosis of the problem; choosing the best alternative and timely implement it in each particular situation; leaving public intervention as a last resort mechanism, when market-based solutions and liquidation are not possible; allocating available resources according to the gravity of the problem, under a strict efficiency criteria; and ensuring that parties responsible for the crisis bear most of the costs involved in the resolution.

Going this way, the effective implementation of prudent policies by SBP has successfully resolved the matters regarding problem banks in the country. Hence, total number of problem financial institutions on average decreased from five to three during 2002-2006. Resultantly, total assets, advances, deposits and non-performing loans of the problem banks declined enormously (see **Figure-15.5.1**). Total assets came down considerably, from Rs224 billion to about Rs38 billion. Similarly, advances, deposits and NPLs show a significant decrease over time. Consequently, the percentage share of these financial indicators of problem banks in the industry decreased substantially over this period (see **Figure-15.5.2**). Non-Performing Loans (NPLs) once touching a threatening level of 36.5 percent of the industry in 2002, came down drastically to 9.4 percent in 2006.

Figure-15.5.1:- Problem Banks' Major Indicators

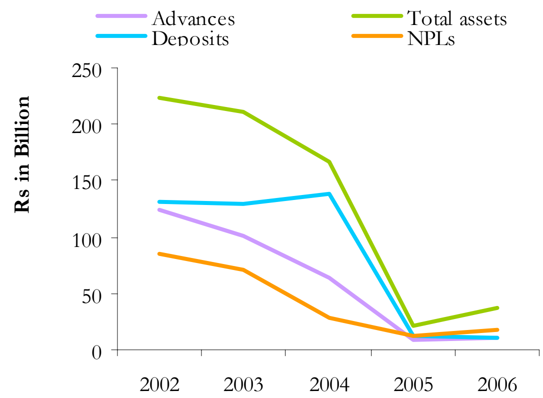
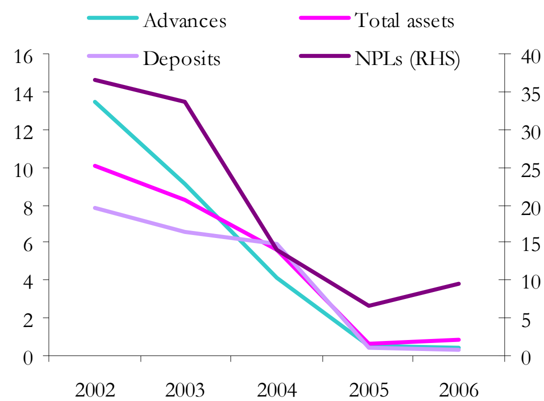
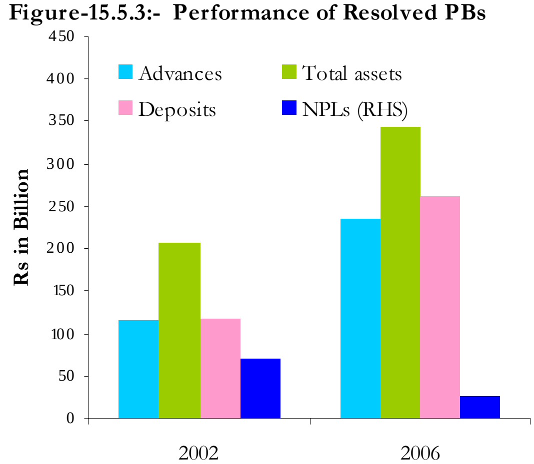


Figure-15.5.2:- PBs Percentage Share in Industry (in%)



As for the three financial institutions, which have been rated as unsatisfactory during 2006, the major problems related to these financial institutions remained inadequate strategic direction & oversight from board, poor asset quality, weak systems & controls, poor earnings, failure in meeting SBP capital requirements, provisioning shortfall, weak credit administration, poor risk management, slow progress towards restructuring, absence of policies/manuals, weak MIS and human resources.

Figure-15.5.3:- Performance of Resolved PBs



The overall performance of the already resolved problem banks, depict a sound picture over the past five years owing to the growth in their total assets, capital, deposits and advances (see **Figure-15.5.3**). Moreover, decline in the non performing loans shows an improvement in the asset quality of these institutions. Total assets, advances and deposits of these banks almost doubled during this period. Furthermore, the capital increased by 626 percent and non-performing loans decreased by 63 percent. The growth in these indicators suggests that banks, which were once problem bank, are now contributing very positively in the industry's performance and growth.

15.6 Brief on Branch Licensing Policy

State Bank of Pakistan Act, 1956(SBP Act, 1956) and Banking Companies Ordinance-1962 (BCO, 1962) provide legal framework for licensing of bank branches. SBP Act-1956's constitution to regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and optimum utilization of the country's productive resources, provides impetus to give policy for effective branch network ensuring Pakistan's economic development and outreach of banking services spread over both in rural and urban areas. SBP has introduced a comprehensive branch licensing Policy under section 28 of BCO 1962 to allow the banks to independently make their branch housing decisions within a broad parameter. In terms of the Branch Licensing Policy, Commercial Banks, Development Finance Institutions, Islamic Banks, Islamic Bank Branches and Microfinance Banks are required to submit their Annual Branch Expansion Plan (ABEP) by 30th November of each year. State Bank evaluates their applications for branch expansion in light of parameters set under Branch Licensing Policy (BLP) of Commercial/Microfinance banks and IBD Circular No. 2 of 2004. As per policy, banks with supervisory composite rating below 'Fair' are not eligible to open further branches.

As on 31st May, 2007, there were 7974 branches, booths and offshore banking units with 7876 offices in Pakistan and remaining 93 offices abroad. Further, around 1500 bank branches have been set up in rural areas and the remaining branches are distributed in major and small cities of the country.

Improved outreach has received due emphasize in State Bank's Branch Licensing Policy. As per existing policy, the commercial banks having more than 100 branches are required to open 20 percent of their branches outside the jurisdiction of the big Cities/Tehsil Headquarters and in Tehsil Headquarters where no branch of any bank exists. Further, realizing the need for enhancing the outreach of banking services and to provide banks with flexibility of options available under the branch licensing policy, the new options are being considered for introduction in the revised branch licensing policy, which includes the opening of sub-branches under which banks can perform limited general banking function and it will be an extended arm of some nearest branch to be decided by the concerned bank; sales & service centre, which will allow the banks to perform functions like product information and queries, customer support and drop box facility for the collection of payment through financial instruments like cheques, pay order etc. only and will not perform any banking activities and the mobile banking, under which the banks are required to ensure availability of mode of communication, proper security arrangements for the safety of cash/documents and staff, movement of unit within the specified territorial limits, use of systems/technology, awareness of the people about the schedule visits and insurance arrangements for mobile team and assets.

15.7 Consolidated Supervision Framework

In the wake of financial liberalization, Pakistan's financial sector has undergone a metamorphosis. New banks in private sector were allowed the operations in early 1990s and since then majority of the nationalized banks have been privatized. Over the years private sector has taken the leading role. In the backdrop of this, the financial landscape has been increasingly witnessing the entry of several new players into the banking sector with diversified presence across major segments of financial as well as non-financial sector, entry of some of the banks into other financial segments like insurance, capital market institutions etc. leading to emergence of financial conglomerates and emergence of new players who have presence in diversified sectors not only at home but abroad as well.

These developments are raising a number of supervisory concerns that could have bearing on the stability of the banking system. A few of these concerns are as follows:

- Any trouble in another group entity could affect the stability of the bank/DFI. Such other group entity could be a subsidiary of the bank (i.e. downstream of risk) or parent of the bank or affiliate under the control of parent (i.e. upstream risk). The risk may be in the form of direct credit exposure to such failing related party causing liquidity and solvency pressure on the bank/DFI. And even when there is no direct credit exposure, trouble in an affiliate in the group can shake the confidence of bank/DFI's own depositors and customers - a risk that could some times have gross repercussions for the health of the bank/DFI.
- Bank/DFI together with other group entities under its control could take exposures on single borrower, borrowing group, or sector that are beyond prudential limits
- Increasing complexities in the ownership and managerial structure of a group can make the supervision of financial institutions in the group difficult.
- Possibilities of regulator arbitrage and non-arm length dealings in intra group transactions

These issues warrant a comprehensive framework for the consolidated supervision both by the supervisors as well as supervisees. Consolidated supervision evaluates the strength of an entire group, taking into account all the risks which may affect a bank/DFI, regardless of whether these risks are carried in the books of the bank/DFI or related entities.

International experiences show that divergent approaches are being followed across the world for consolidated supervision. The structure adopted ranges from a single regulatory authority (UK) through a formal coordinating agency arrangement where a multiple regulatory authorities are involved (Netherlands) to a consolidated supervision in a multi-regulatory scenario through enhanced inter regulatory coordination (USA).

As for the Pakistan, presently, the supervision of financial sector rests with two regulators, viz. State Bank of Pakistan in respect of Banks, DFIS, MFIs, and Exchange Companies and Securities & Exchange Companies of Pakistan in respect of NBFCs, Insurance, Securities Trading Firms and similar institutions engaged in range of financial activities.

The main focus of State Bank of Pakistan is to supervise banks and DFIs on solo basis. Though a number of tools are available for consolidated supervision, these tools are used discretely on need basis. Realizing the importance of consolidated supervision in the emerging scenario, State Bank of Pakistan is in the process of developing a framework for consolidated supervision. The envisaged framework is likely to comprise a detailed set of guidelines to banks/DFIs for regulatory reporting and application of regulatory prudential limits on group wide basis as well as a close coordination with SECP for the supervision of financial conglomerates and the enhanced focus on the effects of intra group linkages with industrial and commercial group entities.

15.8 RCOA-An update

Effective supervision, inter alia, is highly dependent on timely and accurate data submission by banks so as to make accurate analysis of the financial data & take policy decisions. In the absence of central data warehouse at SBP, Reporting Institutions (Banks/DFIs/MFBs) were submitting around 180 returns to different departments of SBP containing varied nature of data relating to different activities the reporting institutions undertake. This, on the one hand, entailed substantial reporting burden on the banks and on the other hand, created significant data reconciliation and consistency issues at SBP.

To streamline data reporting by Reporting Institutions, a project on Reporting Chart of Accounts (RCOA) was initiated by BSD with financial assistance from the FIRST Initiative. M/s Deloitte (M. Yousaf Adil Saleem & Co.) were hired as a consultant to develop the RCOA. Software support was provided by M/s Hyundai Information Technology. It was aimed at improving the quality of reporting, eliminate duplication and redundancy and reduce the reporting burden on Reporting Institutions.

Weekly portion of banking and money module under Data Ware House (DWA) has been implemented successfully and now banks are submitting the said data only through the DWH portal. Relevant output reports have also been generated from the said data acquired through the DWH portal. Since the RCOA document contained all the variables in a single report, devoid of the reporting lines required for any particular frequency e.g. at weekly frequency SBP require around 700 reporting lines, whereas at quarterly frequency SBP require around 10,000 reporting lines. Therefore, need was felt to decompose the RCOA, make it frequency sensitive, culminating into devising separate Data File Structures for different frequencies. Revised Quarterly Data File Structure has been finalized and delivered to Data Warehouse Team for deployment on portal. Once deployed, all other steps required for discontinuity of parallel run would be vigorously followed which are expected to be completed within the current calendar year. Revised Monthly Data File Structure is also at the stage of finalization. As regards Annexures, the parallel run of A-03, A-05, and A-07 is expected to be stopped by the end of June, 2007. Further, majority of the banks are also submitting data for other frequencies under RCOA through DWH portal.

Once implemented comprehensively, RCOA system will streamline the data reporting to SBP, improve the reliability of data, eliminate the duplication in reporting, lessen the reporting burden on Reporting Institutions (Elimination of multiple reporting to various SBP Departments) and hence enhance the efficiency.

5.9 Derivatives Business in Pakistan

Although derivatives are a relatively new concept in Pakistan, actually started in year 2003, its volume grew many folds in the last couple of years. The number of authorized derivatives dealers (ADD) has increased to five from the three during the last year. However, till now, no institution has obtained the status of non market maker financial institution (NMI).

Nevertheless, the institutions which are not ADD, can also undertake derivative business transaction with prior approval from SBP.

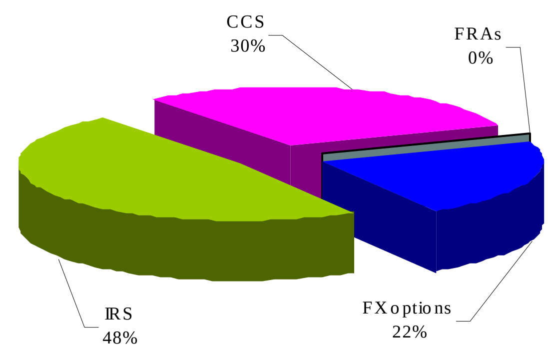
As for the development of over the counter (OTC) financial derivatives market, Financial Derivatives Business Regulations (FDBR) issued by SBP in November 2004 allows three types of transactions viz. Interest Rate Swaps (IRSs), FX options and Forward Rate Agreements (FRAs). Of these three products allowed under FDBR, the first two appear to hold the major share of OTC market since FRAs are very few. The FRAs going extinct, may be attributed to the perceptions of interest rates as well as the absence of a developed market, which is imperative to create demand for such products. IRS are found to be the most popular one and its volume grew significantly to Rs162 billion in March 07 from around Rs98 billion in March 06 (see **Table 15.9.1**). In relative terms, IRS transactions are nearly half of the total derivatives volume (see **Figure-15.9.1**). FX Options comes the second under derivative products allowed under FDBR, and it captures around 22 percent share of the total derivatives market. Its volume grew from Rs18 billion to Rs74 billion during the same period. Cross currency swaps (CCS), which currently are allowed against the one-off approval of SBP, also holds the major share of the OTC market. With its 30 percent overall share, its volume as of March-07 was at Rs101 billion. This indicates that corporate are opting to manage their PKR interest rate swaps through CCS.

Table-15.9.1:- Volume of Financial Derivatives

(Rs in Milions)

Products	Mar-05	Mar-06	Mar-07
FX options	5,971	17,869	74,304
IRS	8,521	97,660	162,276
FRAs	-	-	-
CCS	-	-	101,126

Figure-15.9.1:- Derivatives March-07



Although the derivatives market is growing in Pakistan, however, it is facing some teething problems, of which the major are; a less developed market for the derivatives business, less number of ADDs and absence of NMIs, unavailability of the market data and the absence of benchmarks for vanilla products. Once these problems are addressed, the derivatives market is expected to grow at a higher pace and would largely serve to provide risk management solutions.

16 Policy Initiatives and Supervisory Developments

16.1 Guidelines Issued During the Year

16.1.1 Policy Framework in Banks / DFIs

The role of the Board of Directors is crucial in setting strategic direction and standards of management. This is achieved by devising policies that are effective and socially responsible. These policies go a long way towards establishing good governance in an organisation and ensure success and long term survival of an organization.

In view of the importance of policy framework the SBP has issued consolidated instruction on policy framework to ensure that banks/DFIs have policies in various areas that are synchronized and have uniformity according to varied nature of their respective operations. Accordingly, the banks/DFIs are advised to formulate policies in the following areas and ensure their regular updation: -

1. Risk Management Policy
2. Credit Policy
3. Treasury & Investment Policy
4. Internal Control System and Audit Policy
5. I.T. Security Policy
6. Human Resource Policy
7. Expenditure Policy
8. Accounting & Disclosure Policy.

The above policies to be formulated by each bank / DFI with the approval of their Board of Directors shall be in line with complexity of their operations and cover, as a minimum, the requirements set out in the guidelines. The Board should also clearly define the periodicity for review / updation of the policies. Banks/DFIs would be free to formulate policies in any other areas in addition to those listed above. Islamic banks / Islamic banking branches shall ensure that their policies in the above areas are in line with the Shariah Principles.

While preparing/reviewing the policy document, banks/DFIs must distinguish between Policy Documents and Procedural Manuals, as both are distinct from each other. Policy document should delineate guiding principles and the procedural manuals should describe what step by step operational activities are to be performed to accomplish those principles. It should be clearly noted that existence of a Procedural Manual in any area can in no way be deemed a substitute for the Policy Document.

16.1.2 Guidelines for Commercial Banks to Undertake Microfinance Business

Pakistan is one of the few countries in the world, which has a separate legal and regulatory framework for Microfinance Bank. With the turn of the century, the country took long stride in this sector by establishing Khushahi Bank and promulgation of MFIs Ordinance, 2001. The framework allows Microfinance Banks (MFBs) to extend microfinance services to the poor and their micro enterprises. The creation of favorable policy environment coupled with rising acceptability of microfinance as a viable business proposition has been instrumental in attracting greater private sector interest in establishing MFBs. Presently; six Microfinance Banks are operating in the country. Besides the formal MFBs there are about 100 NGO-MFIs engaged in provision of micro credit to the poor. The combined outreach of MFBs and NGO-MFIs, however, is around a million loan clients, which is less than 5 percent of the potential market of 30 million potential loan clients. To explore the huge un-served/underserved market, a multi institutional approach is required.

With a branch network of more than 3000 branches in rural and semi rural/peri-urban areas, backed by stable sources of funds and well established systems, the Commercial banks are better placed to extend microfinance services to the low income population.

SBP has prepared guidelines for commercial banks to provide microfinance services under four different modes which include, i) establishment of Micro Finance counters in the existing branches, ii) designating stand alone Micro Finance branches either through conversion of existing branches or opening new Micro Finance branches, iii) establishing independent Micro Finance subsidiary with independent and professional board and management under MFIs Ordinance 2001 and iv) developing linkages with MFBs licensed by SBP and NGO-MFIs that are not licensed by SBP to extend wholesale funds for onward lending.

The guidelines discuss the approaches and institutional arrangements the commercial banks may opt for extending Micro Finance services to their clients, the applicable Prudential Regulations on Micro Finance portfolio and operations of the commercial banks. The commercial banks interested in building MF portfolio are required to review the different institutional/organizational arrangements and select, one or the combination of more than one mode, based on their organization structure, capacity and overall objectives.

The Microfinance operations of commercial banks through MF Counters at conventional branches, Standalone MF branches and wholesale funds to NGO-MFIs will be subject to Prudential Regulations issued separately under Banking Companies Ordinance 1962 for commercial banks undertaking microfinance. However, MF operations through establishment of independent MF subsidiary, with independent and professional board and management, will be governed under MFIs Ordinance 2001 and Prudential Regulations applicable on Micro Finance Banks.

16.1.3 Guidelines for Fisheries Financing

Pakistan has a coastline of more than 1000 km and a total area of approximately 0.25 million sq km of marine and 0.08 million sq km of inland waters which provides a natural advantage to the country to increase output of the fisheries thereby reducing pressure on demand for mutton, beef and poultry and earning of foreign exchange. Fisheries sector is providing direct employment to about 379,000 fishermen and 400,000 people are employed in ancillary industries. It has a domestic consumption potential of 1 million metric tonnes and export of US$1 billion annually. However, the flow of bank credit to this sector is negligible i.e. 0.4 percent of the total agricultural credit disbursement.

SBP has developed guidelines for fisheries financing in consultation with key stakeholders including fisheries departments, fishermen cooperative societies, chambers of agriculture, farmers associations, agriculture research institutions, banking sector and MINFAL. It is expected that the flow of credit to this sector in the coming years would increase.

The Guidelines cover all areas of the fisheries financing including purposes and objectives of the loan both for marine and inland fisheries, eligibility of borrowers, types of financing, fixation of loan limit, repayment terms, loan monitoring mechanism, etc. Banks may adopt the guidelines in the present form or with some adjustments to suit their organizational & operational needs and market characteristics, subject to compliance with SBP Prudential Regulations for agriculture financing.

16.1.4 Guidelines for Livestock Financing

Livestock is the largest sub-sector of the agriculture accounting for 47 percent of value addition in the sector and constitutes about 11 percent to the GDP. Agriculture sector has witnessed increase in disbursement of advances during the last few years, however, livestock sub-sector could not get its due share in the substantially enhanced flow of credit to the sector. The share of livestock in total disbursements of agricultural loans is quite low i.e. less than 2 percent in FY06.

In view of the significance of this sector in terms of contribution to GDP & employment creation, SBP established a Committee of Experts in August, 2005 to come up with some strategy for increasing share of institutional finance to this sub-sector of agriculture having huge potential for growth. In light of the recommendations of the Expert Committee and input from the stakeholders including banking sector and MINFAL, SBP has framed 'Guidelines for Livestock Financing' to facilitate and encourage Banks/FIs in enhancing credit flow to the livestock sector. The Guidelines cover all areas of the livestock financing business including products development and their review, purposes and objectives of the loan, eligibility of borrowers, delivery channels, monitoring mechanism, etc. With the issuance of these guidelines Banks/FIs are expected to considerably enhance the credit flow to this important sector of the economy.

16.1.5 Guidelines for Standardization of ATM Operations

ATM is one of the most important e-banking delivery channels in Pakistan. Account holders have the facilities to withdraw cash, inquire balances and transfer funds 24/7 throughout the year. Despite the benefits the customers avail due to availability of ATM facilities, incidences where ATM retain cash due to technical reasons and cause inconvenience to the customers. In order to reduce such occurrences, SBP has issued guidelines for compliance by all the commercial banks and switch operators:

Daily ATM cash balancing and reconciliation should be done at a fixed time which should not be during peak hours and should not cause disruption of ATM services for extended hours.

In case of debiting customer account without cash disbursement, branches should immediately complete process of Automatic Credit after necessary verification in due course. Branch must report its Card Facilitation Centre (CFC) details of claims settled, outstanding claims and balance in suspense account on daily basis. After crediting account of the customer, the issuing bank must inform the customer in writing immediately. Customers whose account has been debited without cash disbursement should not be charged for minimum balance to the extent of the un-disbursed amount at time for which it remained payable.

Further Banks should develop detailed documented procedure for Automatic Credit and arrange training of relevant staff. They are also required to identify at least two key personnel of CFC who will be responsible to respond queries. The CFC shall maintain a data base of resolved, unresolved cases of its own customers and balance in suspense account. Installation of external camera(s) in ATM cabins/rooms is recommended at a location from where PIN could not be captured.

16.1.6 Fit & Proper Test (FPT)

In order to further strengthen the regulatory framework on corporate governance, it has been decided to amend the existing Fit & Proper Test (FPT) criteria for appointment of the members of Board of Directors, Chief Executive Officer (CEO) and Key Executives of a bank / DFI. Furthermore, the scope of FPT has been enhanced to include sponsors & strategic investors in addition to Directors, CEOs & Key Executives of all banks/DFIs.

The fitness & propriety will be assessed on the following broad elements:

1. Integrity, Honesty & Reputation
2. Track Record
3. Solvency & Integrity
4. Qualification & Experience
5. Conflict of Interest
6. Others

First three elements are applicable to all categories of individuals, whereas the last three elements will be considered while assessing the FPT of Directors, CEO & Key Executives of banks/DFIs. In addition to above requirements, sponsors and strategic investors are evaluated respectively in terms of "Guidelines & Criteria for setting up of a Commercial Bank" & "Criteria for Establishment of Islamic Commercial Banks" issued by SBP and Code of Corporate Governance issued by SECP.

The appointment of strategic investors, Directors and CEO require prior clearance in writing from SBP However the appointment of Key Executives will not require prior clearance of SBP, the banks/DFIs must themselves ensure while appointing them that they qualify FPT in letter and spirit. Further the sponsors are required to seek prior approval of SBP along with prescribed information as well as the relevant criteria for establishment of the bank. The strategic investors contemplating to acquire strategic/controlling stake are required to seek prior approval from SBP either directly or through the concerned department/Ministry of

Government executing strategic transaction of the bank. The major shareholders are required to seek prior approval in writing from SBP for acquiring 5 percent or more shares.

16.1.7 Writing-off Of Irrecoverable Loans and Advances

In the backdrop of financial sector reforms, rapid changes in banking sector during the last decade and representations received from different stakeholders, SBP has revised the instructions on write-off of irrecoverable/bad loans/advances. In terms of these instructions the Board of Directors (BOD) may grant approval under a well defined and transparent write-off policy. The write off policy, if not already in place, may be made or revised accordingly by the BOD. The BOD at their discretion may delegate adequate and appropriate powers down the line to the President/Chief Executive Officer and other senior officers of the bank/DFI as they deem fit. To ensure proper management and supervision of write offs of bad/irrecoverable loans/advances under delegated powers, an effective internal control and supervisory mechanism may be put in place.

Before considering/processing of a write off proposal, the banks/DFIs shall ensure that all liquid securities/assets held by them under lien, pledge etc have been realized and sale proceeds thereof have been appropriated towards adjustment of outstanding amount of principal. No write off will be allowed where forced sale value of securities held, is more than the recoverable outstanding amount. However, the said condition shall not be applicable on the cases recommended/settled under any general incentive scheme of SBP or such other Committee(s) as notified by SBP or present Committee for Revival of Sick Industrial Units (CRSIU). The write off of loans/advances, if any, in the names of Directors or their relative/dependent(s)/concern(s) in which they have any interest of 5 percent or more and in the name of Chief Executive of the bank/DFI shall require prior approval of State Bank of Pakistan (SBP).

The Banks/DFIs (a) with the approval of BODs may add any other condition(s) as they deem fit, (b) shall report full particulars of loans/advances written off to Credit Information Bureau of SBP and (c) submit to BODs a report on quarterly basis with necessary details in respect of write off of loans, by President/Chief Executive and other senior officials of bank/DFI under delegated powers, for information.

In exceptional case(s) where banks/DFIs, on commercial considerations or for the purpose of cleaning the balance sheet, are unable to comply with one or more of the above guidelines, may put up the case to BODs for consideration. BODs may then decide the case on merit and by recording reasons in writing for approval or otherwise of the case(s). These cases shall be reported immediately to Director, Banking Inspection Department for information.

Banks/DFIs may consider cases for rescheduling and restructuring in respect of sick industrial units and non performing loans/advances under a well defined and transparent policy to be decided and approved by their BOD. Rescheduling and restructuring done simply to break time frame or allow un-warranted improvement in classified category of loans/advances is not permissible. Re-scheduling and restructuring shall always be done under a proper and appropriate agreement in writing by following the due course of law.

16.1.8 Fit And Proper Criteria For Shariah Advisors

To further promote professionalism in Islamic Banking Institutions (IBIs), Fit and Proper criteria for appointment of Shariah Advisor has been revised by SBP. The revised guidelines specify the educational qualification, experience, exposure, track record, etc. for appointment as Sharia Advisor.

Under the revised criteria Shariah Advisor shall not hold any executive/non-executive position in any other financial institution, except working as Shariah Advisor of Islamic mutual funds of the same IBI. In case Shariah Advisor of an IBI is already working on some executive/non-executive position in any other financial institution (other than Islamic mutual funds of the same IBI) the position should be regularized within a period of 6 months by relinquishing either of the posts. The Shariah Advisor shall also not have substantial interest (5 percent or above) in any business of exchange company, member of stock exchange and corporate brokerage house nor be an employee of the aforementioned entities. Moreover, Shariah Advisors of all IBIs will sign a declaration of Fidelity & Secrecy under section 33A of the BCO 1962 before assuming office. The declaration will be kept in safe custody with the IBI.

16.2 Supervisory Developments

Our banking system has undergone massive transformation since initiation of reforms process. Privatization of state owned banks and establishment of banks in the private sector being the linchpin of the reforms has unleashed competition amongst the banks. While competition eventually leads to benefit both the banks and their customers, it also has an associated increase in complexities and risk-exposures in the banking system. The challenge of trade off obliges the supervisor to play its role in ensuring stability of the financial system. State Bank of Pakistan is striving hard through proactive application of on-site inspection and eventual enforcement actions and off-site supervision to monitor the risks to the financial system.

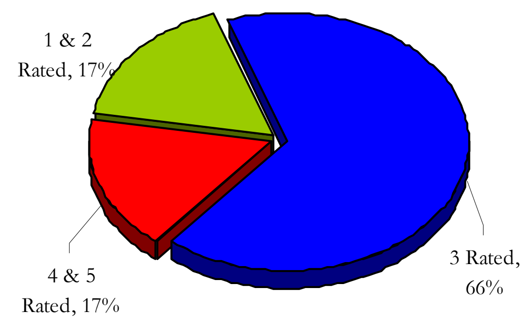
16.2.1 On-Site Inspection

State Bank conducts on-site inspections which entail detailed and comprehensive evaluation of all the areas of a bank. The on-site inspection is based on the CAMELS-S methodology. A bank/DFI is rated on each of its components viz., Capital Adequacy, Assets Quality, Management, Earning, Liquidity, Sensitivity to Other Risks and Systems and Controls. Each component is rated on a scale of 1 (strong) to 5 (unsatisfactory) and on the basis of individual component rating; an overall composite rating is assigned to the institution.

The examination assesses a bank's financial health, adequacy of strategies, policies and management system, compliance with applicable rules and regulations and quality of reporting to the off-site supervision function, while highlighting major shortcomings and suggesting necessary management actions required addressing the concerns.

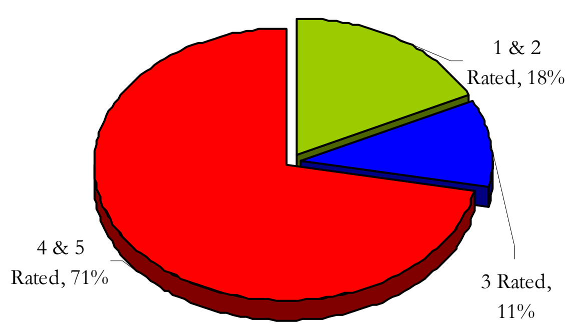
The proactive approach adopted by the State Bank has brought about a visible improvement in the performance of the banking system, which is evident from migration of banks from a composite rating of 4 and 5 (marginal and unsatisfactory) to a

Figure-16.2.1:- Rating-wise Market Share of Banks in Terms of Total Assets - 2006



* Latest available On-site Inspection

Figure-16.2.2:- Rating-wise market share of Banks in terms of Total Assets - 1998



rating of 3 (fair). The share of banks with rating of 4 and 5 in total assets of the banking system has reduced to 17 percent in CY06 from 71 percent in CY98 (See **Figures 16.2.1 & 16.2.2).**

The improved quality of onsite inspections as well as other comprehensive supervisory approaches has inculcated a regime whereby weaker banks have either closed down, undergone reconstruction or merged with stronger banks to improve their operations.

The performance of SBs leaves a lot to be desired. The peculiar nature of their business as well as high cost of restructuring is a contributory factor to their poor performance. A number of measures for restructuring of these institutions have been taken so as to enable them to play meaningful role in the financial system.

With regard to DFIs, the on-site inspection function has equally been helpful in improving their performance which were not faring well a couple of years back. It has been helpful in identification of malpractices and mismanagement in the operations of DFIs leading to their reconstruction or liquidation otherwise. Presently, the majority of DFIs has improved on-site inspection ratings.

With regard to on site inspection, the initiation of inspection of overseas operations of domestic banks was also one of the major supervisory developments during CY06. SBP, in the light of the existing regulatory practices and the nature of issues running through international operations of most of the domestic banks, has initiated a focused on-site inspection of selected overseas branches at Hong Kong and Dubai regions during the year 2006. Earlier, the practice of inspecting overseas branches of local banks was discontinued a decade back. During this period, the major reliance for evaluation of overseas operations was on the supervisory reports generated by the host regulatory authorities alongside the internal audit reports of the banks.

16.2.2 Off-Site Monitoring

In response to the changing market dynamics and complexities in the banking system, the off-site monitoring function at SBP has undergone significant changes. State Bank of Pakistan has realigned its efforts to monitor the health of individual institutions and assessment of overall banking system. Mainly, the CAELS framework forms the basis for analyzing the individual banks. However, with the introduction of more sophisticated indicators to identify the inherent risks the off-site monitoring function has become more exhaustive and meaningful. To perform the offsite monitoring function in a more focused and effective manner, SBP, as part of its organizational restructuring process, has bifurcated the offsite monitoring and banking sector assessment functions.

Further, in order to gauge the vulnerability of the banks to various risk shocks, SBP has instituted a framework of stress testing. This framework is based on single factor sensitivity and regression based analysis. Under the single factor sensitivity analysis, exposures of all the banks towards five major risks i.e. interest rate risk, credit risk, real estate price risk, equity price risk and exchange rate risk are assessed after giving unusual but plausible shocks to the underlying risk. This forward looking approach to risk management significantly helps in assessing overall risk exposures as well as structural vulnerabilities in banks that could trigger potential externalities and market failures. SBP has also issued guidelines on stress testing with the objective of infuse sound risk management practices amongst the banks and DFIs and make the stress testing exercise more effective, consistent and focused. These guidelines contain framework for regular stress testing, techniques and scope of stress testing along with methodologies and calibration of shocks.

Since the assessment of various risks prevailing in the banking sector depends upon proper identification and quantification of these risks, SBP has also been working on the development of a model aiming at quantification of various risks in the banks and DFIs. The model would prompt early warning signals where level of credit, market and operational risk of individual institutions shows increasing trend hence strengthening the offsite monitoring function.

16.2.3 Institutional Risk Assessment Framework

SBP has also instituted the Institutional Risk Assessment Framework (IRAF) which is an encompassing framework that provides for a continuous system of monitoring, enhancing the SBP's capacity to identify the weaknesses and problems at an early stage and to take timely remedial action. The framework brings together crucial offsite surveillance and onsite inspection information, through an automated system for proactive supervision of banks and early detection of banking crisis.

The framework assigns a risk score/rating to individual banks on the basis of four inputs viz. compliance with standards, codes and guidelines; supervisory and regulatory findings; financial performance and conditions and market information and intelligence.

Besides the in-house feedback and inputs, the framework also depends on a 'Questionnaires for Self-Assessment', submitted by banks/DFIs on half-yearly basis. These questionnaires are comprehensive in nature and designed to capture the level of compliance in wide ranging areas including corporate governance, system of internal controls, risk management and prudential regulations.

16.2.4 SBP Restructuring – Structure Follows Strategy

In today's era of change, one of the crucial challenges facing the corporate leadership is to build sustainable, competitive and dynamic organizations. Changing environment necessitates change in strategic initiatives which in turn calls for organizational restructuring and repositioning to stay effective. The points of leverage here are the philosophies and vision of the leaders and decision makers of the organizations. As, the sense of purpose, vision and commitment of an organization's leadership play critical role in the results it accomplishes.

State Bank of Pakistan, in pursuit of its vision 'to transform itself into a modern and dynamic central bank, highly professional and efficient, fully equipped to play a meaningful role in economic and social development of Pakistan', is continuously striving to align its strategic and corporate objectives with the developments in the market and the best practices followed by other central banks. As part of its endeavor, the management of State Bank, being cognizant of the emerging regulatory challenges, to modernize the central bank's operational strategies and strengthen its internal governance systems, has successfully restructured the organizational structure of the bank.

The process of reorganization was finalized after comprehensive reviews and deliberations across the organization at different levels. Following were the key developments which necessitated the organizational restructuring of the central bank:

- Growing complexities of economic management of Pakistan, which require more productive monetary management and its comprehensive and regular monitoring.
- Changes in the size and emerging cross shareholding patterns of banks ownership structure and diversification in business activities of the banks operating in Pakistan.
- Need for implementing SBP plans expeditiously to modernize payment systems and adopt Real Time Gross Settlement System for the banks.
- Need for SBP to strengthen its strategy and institutional framework for domestic and foreign exchange liquidity management as well as foreign exchange reserve management.
- Need for development of better Back Office and Risk Management systems.
- Need to develop market based mechanism for enhancement in the flow of credit to priority sectors like Infrastructure Financing, SME Finance, Agricultural and Micro Financing etc.
- Need for central bank to adopt best international practices of accounting and auditing and strengthen its institution wide capacities.

An organization is much more than boxes containing job titles and names connected by lines representing a reporting structure. Besides organizational structure, an organization is recognized by multiple dimensions spanning the people, processes, and technology represented within it.

One of the main features of SBP restructuring was the establishment of four distinct 'Clusters' in the bank viz.

- Banking Cluster
- Monetary Policy & Research Cluster
- Financial Markets & Reserve Management Cluster
- Corporate Services Cluster

In turn, Clusters have also been reorganized, while ensuring that each Cluster and the constituent 'Groups' and 'Departments' are of optimal size with well balanced and appropriate number of 'Divisions' and 'Units'. Under the new organizational structure, the head of each Department/ Division/Unit is responsible for well defined goals with an adequate Manager-Staff Coefficient Ratio. Each Group in-charge is responsible for aligning the departments' structure to achieve the spirit of the reorganization and make necessary adjustments in their business plans, staffing and training programs.

In addition to the establishment of distinct Clusters, reconstitution of Groups; and rationalization of the business processes through down-the-line reorganization of constituent Departments/Division/Units, the following functionaries have setup to work under direct supervision of the Governor, State Bank:

- Office of the Corporate Secretary

- Strategic & Corporate Planning
- External Relations
- General Counsel's Office
- Risk Management
- Internal Audit & Compliance
- Governor's Secretariat

Further, to strengthen the organizational structure in line with corporate governance best practices, four Management Committees have been constituted viz.

- Monetary Policy Committee
- Enterprise Risk Management Committee
- Investment Committee
- Human Resource & Corporate Strategy Committee

The principal benefits of the organizational restructuring are targeted to streamline business processes and reduce lags, improve transparency to enhance corporate governance, facilitate clear management information for optimal decision-making and ensure fair treatment of all stakeholders in a transparent manner.

Annex-A

Financial Soundness Indicators

Indicators	1997	2001	2002	2003	2004	2005	2006
CAPITAL ADEQUACY							
Risk Weighted CAR							
Public Sector Commercial Banks	(1.3)	9.6	12.3	11.0	13.4	14.5	15.2
Local Private Banks	11.9	9.5	9.7	9.0	10.1	10.7	12.7
Foreign Banks	14.6	18.6	23.2	23.0	17.4	16.4	15.0
Commercial Banks	**6.0**	**11.3**	**12.6**	**11.1**	**11.4**	**11.9**	**13.3**
Specialized Banks	(6.2)	(13.9)	(31.7)	(28.2)	(9.0)	(7.7)	(8.3)
All Banks	**4.5**	**8.8**	**8.8**	**8.5**	**10.5**	**11.3**	**12.7**
Tier 1 Capital to RWA							
Public Sector Commercial Banks	(2.0)	7.1	8.6	8.2	8.6	8.8	11.1
Local Private Banks	11.4	8.4	6.6	7.1	7.5	8.3	10.4
Foreign Banks	14.4	18.6	23.0	23.0	17.1	16.1	14.3
Commercial Banks	**5.5**	**9.7**	**9.7**	**9.1**	**8.6**	**9.1**	**10.8**
Specialized Banks	(6.3)	(13.9)	(31.7)	(28.7)	(15.0)	(13.6)	(13.3)
All Banks	**4.1**	**7.3**	**6.2**	**6.5**	**7.6**	**8.3**	**10.0**
Capital to Total Assets							
Public Sector Commercial Banks	0.3	3.7	5.6	6.1	8.7	12.8	12.2
Local Private Banks	4.9	3.8	5.2	5.3	6.5	7.1	9.2
Foreign Banks	7.9	8.5	10.6	9.9	8.9	9.5	10.1
Commercial Banks	**3.1**	**4.6**	**6.1**	**6.1**	**7.2**	**8.5**	**9.9**
Specialized Banks	8.8	(10.3)	(23.0)	(10.2)	(9.4)	(8.1)	(8.0)
All Banks	**3.5**	**3.8**	**4.8**	**5.5**	**6.7**	**8.0**	**9.4**
ASSET QUALITY							
NPLs to Total Loans							
Public Sector Commercial Banks	30.8	25.9	25.5	20.4	13.3	10.0	9.0
Local Private Banks	10.2	16.3	15.4	11.3	9.0	6.4	5.2
Foreign Banks	5.0	4.3	3.8	3.1	1.6	1.2	1.0
Commercial Banks	**20.1**	**19.6**	**17.7**	**13.7**	**9.0**	**6.7**	**5.7**
Specialized Banks	50.6	53.0	54.7	55.6	54.1	46.0	39.1
All Banks	**23.5**	**23.4**	**21.8**	**17.0**	**11.6**	**8.3**	**6.9**
Provision to NPLs							
Public Sector Commercial Banks	52.9	56.6	57.1	65.8	77.0	86.8	84.5
Local Private Banks	57.8	40.5	58.6	62.7	69.9	76.5	78.7
Foreign Banks	65.9	74.1	73.3	78.7	101.9	145.9	191.7
Commercial Banks	**54.2**	**53.2**	**58.2**	**64.8**	**72.4**	**80.5**	**81.5**
Specialized Banks	22.8	59.2	66.9	61.5	64.9	64.8	64.1
All Banks	**46.6**	**54.7**	**60.6**	**63.9**	**70.4**	**76.8**	**77.8**
Net NPLs to Net Loans							
Public Sector Commercial Banks	17.0	13.1	12.8	8.1	3.4	1.5	1.5
Local Private Banks	4.6	10.4	7.0	4.5	2.9	1.6	1.1
Foreign Banks	1.8	1.1	1.1	0.7	(0.0)	(0.6)	(1.0)
Commercial Banks	**10.3**	**10.3**	**8.3**	**5.3**	**2.7**	**1.4**	**1.1**
Specialized Banks	44.1	31.5	28.5	32.5	29.3	23.1	18.7
All Banks	**14.1**	**12.1**	**9.9**	**6.9**	**3.8**	**2.1**	**1.6**
Net NPLs to Capital							
Public Sector Commercial Banks	2,081.0	160.2	83.4	50.0	16.2	5.4	6.4
Local Private Banks	43.3	125.2	54.8	39.1	24.3	12.7	7.1
Foreign Banks	10.0	5.8	4.7	3.2	(0.2)	(3.0)	(5.1)
Commercial Banks	**143.6**	**100.7**	**54.2**	**36.9**	**19.0**	**8.8**	**6.2**
Specialized Banks	380.0	-	-	-	-	-	-
All Banks	**183.8**	**150.5**	**85.5**	**54.4**	**29.2**	**14.1**	**9.7**

Annex-A

Financial Soundness Indicators

Indicators	1997	2001	2002	2003	2004	2005	2006
EARNINGS							
Return on Assets (Before Tax)							
Public Sector Commercial Banks	(3.4)	-	1.3	1.8	2.4	3.3	4.0
Local Private Banks	1.4	0.9	1.4	2.2	1.7	2.7	3.1
Foreign Banks	3.0	1.7	2.3	2.6	2.5	3.6	3.2
Commercial Banks	**(0.8)**	**0.6**	**1.5**	**2.1**	**2.0**	**2.9**	**3.2**
Specialized Banks	(0.2)	(8.4)	(10.2)	(3.3)	(0.4)	(1.0)	(1.3)
All Banks	**(0.8)**	**0.1**	**0.9**	**1.8**	**1.9**	**2.8**	**3.1**
Return on Assets (After Tax)							
Public Sector Commercial Banks	(3.1)	(0.5)	0.6	1.0	1.3	2.2	2.7
Local Private Banks	0.5	0.4	0.7	1.4	1.2	1.8	2.1
Foreign Banks	1.4	0.8	1.5	1.5	2.0	2.5	2.1
Commercial Banks	**(1.3)**	**(0.0)**	**0.8**	**1.2**	**1.3**	**2.0**	**2.2**
Specialized Banks	(0.2)	(8.8)	(12.1)	(3.7)	(0.8)	(1.2)	(1.8)
All Banks	**(1.2)**	**(0.5)**	**0.1**	**1.0**	**1.2**	**1.8**	**2.1**
ROE (Avg. Equity& Surplus) (Before Tax)							
Public Sector Commercial Banks	(272.7)	0.5	26.3	29.9	30.8	30.7	32.4
Local Private Banks	29.0	25.4	32.3	41.5	28.8	39.8	36.2
Foreign Banks	37.7	19.3	24.2	25.0	26.7	38.9	30.0
Commercial Banks	**(23.8)**	**12.2**	**27.5**	**33.7**	**29.0**	**36.9**	**34.7**
Specialized Banks	(1.8)	-	-	-	-	-	-
All Banks	**(20.2)**	**1.4**	**21.1**	**35.4**	**30.5**	**37.3**	**35.2**
ROE (Avg. Equity &Surplus) (After Tax)							
Public Sector Commercial Banks	(255.0)	(12.2)	11.5	17.3	17.2	20.6	21.7
Local Private Banks	10.9	10.3	17.3	25.8	20.2	27.0	25.0
Foreign Banks	17.2	9.1	15.2	14.8	21.5	27.1	20.4
Commercial Banks	**(36.2)**	**(0.3)**	**14.3**	**20.3**	**19.6**	**25.1**	**23.7**
Specialized Banks	(2.0)	-	-	-	-	-	-
All Banks	**(30.7)**	**(12.6)**	**3.2**	**20.0**	**20.3**	**25.0**	**23.8**
NII/Gross Income							
Public Sector Commercial Banks	36.1	69.9	69.5	64.1	63.7	71.5	69.5
Local Private Banks	50.2	72.1	65.5	55.9	62.0	72.8	73.5
Foreign Banks	56.1	59.4	57.5	55.3	57.7	61.5	65.8
Commercial Banks	**46.5**	**68.9**	**66.1**	**58.9**	**61.9**	**71.2**	**72.1**
Specialized Banks	88.5	86.7	78.0	62.2	81.9	87.7	40.1
All Banks	**48.7**	**70.4**	**67.1**	**59.2**	**62.8**	**71.8**	**70.9**
Cost / Income Ratio							
Public Sector Commercial Banks	140.0	62.3	56.9	43.9	39.5	34.5	31.8
Local Private Banks	60.9	67.3	60.0	53.2	56.2	42.9	40.7
Foreign Banks	43.6	54.5	45.4	48.2	49.0	42.2	49.8
Commercial Banks	**85.8**	**62.7**	**56.7**	**48.0**	**51.7**	**41.1**	**39.4**
Specialized Banks	74.6	59.0	84.7	67.5	57.8	47.8	62.6
All Banks	**85.2**	**62.4**	**59.1**	**50.5**	**52.0**	**41.7**	**40.3**
LIQUIDITY							
Liquid Assets/Total Assets							
Public Sector Commercial Banks	39.4	36.5	49.0	49.1	43.9	35.6	33.9
Local Private Banks	40.6	39.8	47.1	42.9	34.3	32.4	31.1
Foreign Banks	47.6	50.3	48.5	49.2	39.8	41.8	41.0
Commercial Banks	**41.4**	**39.9**	**48.1**	**46.1**	**37.0**	**34.0**	**32.2**
Specialized Banks	14.1	13.6	16.4	22.9	25.3	25.8	23.0
All Banks	**39.5**	**38.5**	**46.7**	**45.1**	**36.6**	**33.7**	**31.9**
Liquid Assets/Total Deposits							
Public Sector Commercial Banks	46.0	43.4	59.6	59.0	52.6	44.7	42.6
Local Private Banks	49.9	49.6	60.2	54.5	42.3	40.4	40.6
Foreign Banks	57.9	78.3	74.2	68.9	53.4	57.9	61.1
Commercial Banks	**49.4**	**50.3**	**61.5**	**57.8**	**45.7**	**42.8**	**42.0**
Specialized Banks	102.8	79.8	98.5	135.0	154.1	183.2	205.4
All Banks	**50.0**	**50.7**	**61.8**	**58.5**	**46.5**	**43.6**	**42.7**
Advances/Deposits							
Public Sector Commercial Banks	48.4	53.8	44.3	45.7	49.7	59.8	64.6
Local Private Banks	56.6	57.9	52.3	58.2	67.3	70.9	74.5
Foreign Banks	54.3	66.8	72.0	63.8	70.1	68.8	80.1
Commercial Banks	**51.8**	**56.9**	**51.0**	**53.6**	**63.6**	**68.4**	**72.7**
Specialized Banks	551.7	450.5	453.8	379.1	370.5	400.7	528.4
All Banks	**57.6**	**61.7**	**54.9**	**56.4**	**65.8**	**70.3**	**74.6**

Annex-B

Group wise Balance Sheets & Income Statements of Banks as of 31-12-2006

(Figures rounded off to nearest Million Rs)

	PSCBs		LPBs		FBs	
Financial Position	Amount	% age	Amount	% age	Amount	% age
ASSETS						
Cash & Balances With Treasury Banks	94,960	11.4%	281,574	9.1%	29,212	13.1%
Balances With Other Banks	48,420	5.8%	101,156	3.3%	13,484	6.0%
Lending To Financial Institutions	38,785	4.6%	158,141	5.1%	12,365	5.5%
Investments - Net	179,883	21.5%	588,138	19.0%	38,477	17.2%
Advances - Net	429,716	51.4%	1,767,878	57.0%	120,223	53.7%
Other Assets	32,278	3.9%	124,538	4.0%	6,166	2.8%
Operating Fixed Assets	12,046	1.4%	70,305	2.3%	3,010	1.3%
Deferred Tax Assets	101	0.0%	10,065	0.3%	859	0.4%
TOTAL ASSETS	**836,189**	**100%**	**3,101,795**	**100%**	**223,796**	**100%**
Foreign Banks	-		-		-	
Commercial Banks	11,675	1.4%	41,183	1.3%	2,544	1.1%
Borrowings From Financial Institution	23,951	2.9%	277,857	9.0%	39,026	17.4%
Deposits And Other Accounts	665,642	79.6%	2,372,730	76.5%	150,093	67.1%
Sub-ordinated Loans	-	0.0%	23,468	0.8%	-	0.0%
Liabilities Against Assets Subject To Finance Lease	54	0.0%	822	0.0%	7	0.0%
Other Liabilities	30,138	3.6%	93,852	3.0%	9,345	4.2%
Deferred Tax Liabilities	2,686	0.3%	5,949	0.2%	94	0.0%
TOTAL LIABILITIES	**734,145**	**87.8%**	**2,815,861**	**90.8%**	**201,110**	**89.9%**
NET ASSETS	102,043	12.2%	285,934	9.2%	22,686	10.1%
			-		-	
REPRESENTED BY:			-		-	
Share Capital	12,278	1.5%	121,694	3.9%	17,469	7.8%
Reserves	19,351	2.3%	81,669	2.6%	-	0.0%
Unappropriated Profit	35,807	4.3%	56,072	1.8%	5,268	2.4%
	67,435	**8.1%**	**259,436**	**8.4%**	**22,737**	**10.2%**
Surplus/Deficit On Revaluation Of Assets	34,608	4.1%	26,498	0.9%	(51)	0.0%
TOTAL	**102,043**	**12.2%**	**285,934**	**9.2%**	**22,686**	**10.1%**
OPERATING POSITION						
Mark-Up/ Return/Interest Earned	58,098	114.3%	222,391	131.3%	18,777	120.6%
Mark-Up/ Return/Interest Expenses	22,751	44.8%	97,912	57.8%	8,535	54.8%
Net Mark-Up / Interest Income	**35,347**	**69.5%**	**124,479**	**73.5%**	**10,242**	**65.8%**
Provisions & Bad Debts Written Off Directly	3,108	6.1%	13,074	7.7%	1,493	9.6%
Net Mark-Up / Interest Income After Provision	**32,240**	**63.4%**	**111,406**	**65.8%**	**8,749**	**56.2%**
Fees, Commission & Brokerage Income	6,721	13.2%	20,059	11.8%	3,155	20.3%
Dividend Income	4,404	8.7%	7,468	4.4%	20	0.1%
Income From Dealing In Foreign Currencies	1,590	3.1%	6,666	3.9%	1,261	8.1%
Other Income	2,770	5.4%	10,741	6.3%	893	5.7%
Total Non - Markup / Interest Income	15,486	30.5%	44,934	26.5%	5,329	34.2%
	47,725	**93.9%**	**156,339**	**92.3%**	**14,078**	**90.4%**
Administrative Expenses	15,852	31.2%	68,039	40.2%	7,725	49.6%
Other Expenses	325	0.6%	943	0.6%	31	0.2%
Total Non-Markup/Interest Expenses	**16,177**	**31.8%**	**68,982**	**40.7%**	**7,755**	**49.8%**
Profit Before Tax and Extra Ordinary Items	31,548	62.1%	87,357	51.6%	6,323	40.6%
Extra ordinary/unusual Items (to be specified)	12	0.0%	1,737	1.0%	-	0.0%
PROFIT/ (LOSS) BEFORE TAXATION	**31,536**	**62.0%**	**85,620**	**50.5%**	**6,323**	**40.6%**
Taxation - Current	9,686	19.1%	25,363	15.0%	2,397	15.4%
- Prior Years	533	1.0%	155	0.1%	(69)	-0.4%
- Deferred	148	0.3%	994	0.6%	(292)	-1.9%
PROFIT/ (LOSS) AFTER TAX	**21,170**	**41.6%**	**59,109**	**34.9%**	**4,288**	**27.5%**

Annex-C

Group wise Balance Sheets & Income Statements of Banks as of 31-12-2006

(Figures rounded off to nearest Million Rs)

	SBs		Comm. Banks		All Banks	
Financial Position	Amount	% age	Amount	% age	Amount	% age
ASSETS						
Cash & Balances With Treasury Banks	2,311	1.9%	405,746	9.7%	408,057	9.5%
Balances With Other Banks	14,439	12.0%	163,060	3.9%	177,499	4.1%
Lending To Financial Institutions	292	0.2%	209,290	5.0%	209,582	4.9%
Investments - Net	16,599	13.8%	806,498	19.4%	823,097	19.2%
Advances - Net	71,292	59.2%	2,317,817	55.7%	2,389,110	55.8%
Other Assets	12,656	10.5%	162,982	3.9%	175,638	4.1%
Operating Fixed Assets	2,388	2.0%	85,361	2.1%	87,749	2.0%
Deferred Tax Assets	448	0.4%	11,025	0.3%	11,473	0.3%
TOTAL ASSETS	**120,426**	**100%**	**4,161,779**	**100%**	**4,282,205**	**100%**
LIABILITIES						
Bills Payable	351	0.3%	55,401	1.3%	55,753	1.3%
Borrowings From Financial Institution	86,439	71.8%	340,834	8.2%	427,273	10.0%
Deposits And Other Accounts	13,491	11.2%	3,188,465	76.6%	3,201,956	74.8%
Sub-ordinated Loans	5,835	4.8%	23,468	0.6%	29,303	0.7%
Liabilities Against Assets Subject To Finance Lease	20	0.0%	884	0.0%	904	0.0%
Other Liabilities	23,921	19.9%	133,335	3.2%	157,256	3.7%
Deferred Tax Liabilities	8	0.0%	8,729	0.2%	8,737	0.2%
TOTAL LIABILITIES	**130,065**	**108.0%**	**3,751,116**	**90.1%**	**3,881,181**	**90.6%**
NET ASSETS	(9,639)	-8.0%	410,664	9.9%	401,025	9.4%
REPRESENTED BY:						
Share Capital	14,452	12.0%	151,441	3.6%	165,893	3.9%
Reserves	1,739	1.4%	101,020	2.4%	102,759	2.4%
Unappropriated Profit	(26,864)	-22.3%	97,147	2.3%	70,283	1.6%
	(10,672)	**-8.9%**	**349,608**	**8.4%**	**338,935**	**7.9%**
Surplus/Deficit On Revaluation Of Assets	1,034	0.9%	61,056	1.5%	62,090	1.4%
TOTAL	**(9,639)**	**-8.0%**	**410,664**	**9.9%**	**401,025**	**9.4%**
OPERATING POSITION						
Mark-Up/ Return/Interest Earned	8,266	90.1%	299,267	126.9%	307,533	125.5%
Mark-Up/ Return/Interest Expenses	4,771	52.0%	129,199	54.8%	133,970	54.7%
Net Mark-Up / Interest Income	**3,496**	**38.1%**	**170,068**	**72.1%**	**173,564**	**70.8%**
Provisions & Bad Debts Written Off Directly	4,371	47.6%	17,675	7.5%	22,045	9.0%
Net Mark-Up / Interest Income After Provision	**(875)**	**-9.5%**	**152,394**	**64.6%**	**151,519**	**61.8%**
Fees, Commission & Brokerage Income	17	0.2%	29,935	12.7%	29,952	12.2%
Dividend Income	28	0.3%	11,892	5.0%	11,920	4.9%
Income From Dealing In Foreign Currencies	1	0.0%	9,518	4.0%	9,519	3.9%
Other Income	5,631	61.4%	14,404	6.1%	20,035	8.2%
Total Non - Markup / Interest Income	5,678	61.9%	65,749	27.9%	71,426	29.2%
	4,803	**52.4%**	**218,142**	**92.5%**	**222,945**	**91.0%**
Administrative Expenses	3,993	43.5%	91,616	38.9%	95,608	39.0%
Other Expenses	691	7.5%	1,299	0.6%	1,990	0.8%
Total Non-Markup/Interest Expenses	**4,684**	**51.1%**	**92,914**	**39.4%**	**97,598**	**39.8%**
Profit Before Tax and Extra Ordinary Items	119	1.3%	125,228	53.1%	125,347	51.2%
Extra ordinary/unusual Items (to be specified)	-	0.0%	1,749	0.7%	1,749	0.7%
PROFIT/ (LOSS) BEFORE TAXATION	**119**	**1.3%**	**123,479**	**52.4%**	**123,598**	**50.5%**
Taxation - Current	603	6.6%	37,445	15.9%	38,047	15.5%
- Prior Years	-	0.0%	619	0.3%	619	0.3%
- Deferred	16	0.2%	849	0.4%	865	0.4%
PROFIT/ (LOSS) AFTER TAX	**(500)**	**-5.4%**	**84,566**	**35.9%**	**84,066**	**34.3%**

Annex - D

Bank-wise Major Statistics as of 31-12-2006

(Figures rounded to nearest Million Rs)

Sr. No.	Name of the Bank	Loans & Advances (Net)	Total Assets	Deposits	Capital	Profit/(Loss) before Tax	Profit/(Loss) After Tax
1	National Bank of Pakistan	316,110	635,133	501,872	81,954	26,311	17,022
2	First Women Bank Limited	3,066	8,989	6,965	935	256	166
3	Bank of Punjab	101,320	164,855	137,728	16,126	4,769	3,804
4	Bank of Khyber	9,219	27,211	19,077	3,029	200	177
5	Punjab Provincial Cooperative Bank	6,799	15,734	1,657	1,933	156	155
6	Industrial Development Bank of Pakistan	1,248	8,133	7,286	(28,035)	(1,801)	(1,803)
7	Zari Taraqiati Bank Limited	61,514	86,934	2,882	14,175	1,532	995
8	SME Bank Ltd	1,731	9,625	1,666	2,288	232	153
9	Allied Bank Limited	144,034	252,027	206,031	17,688	6,661	4,397
10	Arif Habib Rupali Bank Limited	1,424	5,696	2,526	3,073	50	94
11	Askari Commercial Bank Limited	99,179	166,034	131,839	11,053	3,347	2,250
12	Atlas Bank Limited	7,834	17,021	8,843	2,998	(141)	9
13	Bank Al Falah limited	149,999	275,686	239,509	12,242	2,566	1,763
14	Bank Al Habib Limited	70,796	114,998	91,420	6,522	2,689	1,761
15	Crescent Commercial Bank Limited	2,395	8,103	5,578	1,504	(869)	(609)
16	Faysal Bank Limited	74,469	115,470	74,414	13,797	3,870	2,817
17	Habib Bank Limited	335,985	562,916	439,724	53,112	20,503	14,276
18	Habib Metropolitan Bank Limited	83,324	148,668	102,493	10,868	3,143	2,096
19	JS Bank Limited	1,693	12,544	7,198	3,004	-	-
20	KASB Bank Limited	14,513	26,539	21,276	2,129	53	137
21	Muslim Commercial Bank Limited	198,239	342,108	257,462	40,844	18,501	12,143
22	Mybank Limited	13,487	26,549	19,169	5,066	623	493
23	NIB Bank Limited	31,052	46,429	30,567	4,332	30	126
24	PICIC Commercial Bank Limited	34,884	70,290	59,467	4,076	1,279	969
25	Prime Commercial Bank Limited	32,124	52,340	40,692	3,717	527	360
26	Saudi Pak Commercial Bank Limited	29,022	59,112	49,015	3,909	(425)	(319)
27	Soneri Bank Limited	35,412	70,730	53,001	5,612	1,449	985
28	Standard Chartered Bank (Pakistan) Limited	129,438	246,318	156,878	40,230	7,360	5,709
29	United Bank Limited	247,310	423,320	335,078	29,863	14,292	9,468
30	Bank Islami Pakistan Limited	959	4,025	1,778	2,003	(34)	(8)
31	Dubai Islamic Bank Pakistan Limited	3,274	8,434	4,323	3,530	(633)	(412)
32	Meezan Bank Limited	27,031	46,439	34,449	4,763	780	604
33	ABN Amro Bank	39,719	71,433	53,051	4,896	3,044	2,035
34	Al Baraka Islamic Bank	9,693	18,868	13,821	2,191	170	144
35	The Bank of Tokyo – Mitsubishi	3,776	6,717	1,459	2,366	138	122
36	Citibank, N.A.	51,289	91,316	63,104	6,029	2,575	1,645
37	Deutsche Bank A.G.	4,175	9,312	3,327	2,763	172	199
38	The Hongkong & Shanghai Banking Corporation	11,202	23,387	14,714	2,416	248	167
39	Oman International Bank S.A.O.G	368	2,763	618	2,025	(25)	(25)
	Total	**2,389,110**	**4,282,205**	**3,201,956**	**401,025**	**123,598**	**84,066**

Annex - E

<u>Bank-wise Performance Indicators as of 31-12-2006</u>

Sr. No.	Name of the Bank	Capital Adequacy Ratio	NPLs to Loans	NPLs to Loans (net)	ROA (after Tax)
1	National Bank of Pakistan	16.5%	10.4%	1.3%	2.8%
2	First Women Bank Limited	24.5%	1.5%	0.0%	1.7%
3	Bank of Punjab	10.1%	2.3%	1.2%	2.8%
4	Bank of Khyber	20.4%	28.7%	14.1%	0.7%
5	Punjab Provincial Cooperative Bank	4.5%	39.2%	29.7%	2.1%
6	Industrial Development Bank of Pakistan	-568.2%	96.6%	77.8%	-44.8%
7	Zari Taraqiati Bank Limited	25.2%	28.2%	16.8%	1.2%
8	SME Bank Ltd	58.9%	78.4%	2.4%	1.8%
9	Allied Bank Limited	12.8%	6.9%	1.9%	2.0%
10	Arif Habib Rupali Bank Limited	56.2%	9.0%	0.0%	3.0%
11	Askari Commercial Bank Limited	10.9%	3.6%	0.1%	1.4%
12	Atlas Bank Limited	15.8%	6.0%	1.6%	0.1%
13	Bank Al Falah limited	9.5%	1.5%	0.0%	0.7%
14	Bank Al Habib Limited	9.7%	0.5%	0.2%	1.7%
15	Crescent Commercial Bank Limited	28.7%	63.0%	38.1%	-6.9%
16	Faysal Bank Limited	11.4%	4.6%	2.3%	2.5%
17	Habib Bank Limited	12.8%	7.6%	2.4%	2.7%
18	Habib Metropolitan Bank Limited	11.9%	0.5%	-0.4%	1.8%
19	JS Bank Limited	39.1%	6.0%	0.0%	0.0%
20	KASB Bank Limited	7.4%	6.7%	2.2%	0.6%
21	Muslim Commercial Bank Limited	18.6%	4.1%	0.0%	3.8%
22	Mybank Limited	19.3%	7.3%	4.5%	2.3%
23	NIB Bank Limited	11.6%	3.2%	0.6%	0.3%
24	PICIC Commercial Bank Limited	9.9%	4.9%	3.0%	1.4%
25	Prime Commercial Bank Limited	13.5%	5.1%	3.4%	0.7%
26	Saudi Pak Commercial Bank Limited	9.5%	14.7%	7.3%	-0.6%
27	Soneri Bank Limited	13.4%	1.0%	-0.2%	1.5%
28	Standard Chartered Bank (Pakistan) Limited	10.2%	5.4%	-1.1%	3.2%
29	United Bank Limited	11.1%	6.2%	1.1%	2.5%
30	Bank Islami Pakistan Limited	62.0%	0.0%	-0.1%	-0.2%
31	Dubai Islamic Bank Pakistan Limited	56.1%	0.0%	0.0%	-4.9%
32	Meezan Bank Limited	12.8%	1.5%	0.6%	1.6%
33	ABN Amro Bank	11.7%	0.9%	-0.8%	3.1%
34	Al Baraka Islamic Bank	16.8%	2.5%	0.7%	0.9%
35	The Bank of Tokyo – Mitsubishi	53.1%	0.0%	0.0%	2.2%
36	Citibank, N.A.	11.1%	1.1%	-1.7%	2.0%
37	Deutsche Bank A.G.	18.9%	0.0%	-0.5%	2.7%
38	The Hongkong & Shanghai Banking Corporation	12.3%	0.6%	0.0%	0.9%
39	Oman International Bank S.A.O.G	488.5%	4.2%	-1.0%	-1.1%

Annex-F

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	52.3%	75.1%	93.3%	100%
Share of Total Deposits	55.4%	78.3%	94.6%	100%
Share of Gross Income	59.3%	78.2%	96.3%	100%
Share of Risk Weighted Assets	50.9%	73.3%	92.7%	100%
Capital Adequacy				
Capital/RWA	14.0%	13.1%	13.1%	12.7%
Tier 1 Capital / RWA	10.8%	10.3%	10.3%	10.0%
Net Worth / Total Assets	9.7%	9.8%	9.5%	9.4%
Asset Composition				
Sectoral Distribution of Loans (Domestic)				
- Corporate Sector:	45.6%	74.6%	92.9%	100.0%
- SMEs:	52.3%	70.8%	85.4%	100.0%
- Agriculture	37.2%	44.0%	94.0%	100.0%
- Consumer Finance:	56.7%	77.6%	96.9%	100.0%
- Commodity Financing	72.8%	96.1%	98.2%	100.0%
- Staff Loans	63.1%	81.6%	93.7%	100.0%
- Others	47.7%	61.5%	85.7%	100.0%
- Total	50.1%	74.1%	92.5%	100.0%
NPLs / Gross Loans	6.8%	6.0%	6.2%	6.9%
Net NPLs / Capital	6.8%	5.4%	8.5%	9.7%
Earning & Profitability				
ROA	2.6%	2.5%	2.3%	2.1%
ROE	9.2%	9.1%	9.1%	8.7%
Net Interest Margin / Gross Income	74.2%	73.7%	71.1%	70.8%
Income from Trading & Foreign Exchange / Gross Income	3.9%	4.8%	5.2%	5.5%
Non-Interest Expense / Gross Income	35.8%	36.1%	37.7%	39.8%
Liquidity				
Liquid Assets / Total Assets	30.3%	28.9%	28.6%	28.9%
Liquid Assets held in Govt. Securities / Total Liquid Assets	48.0%	49.7%	50.2%	48.9%
Liquid Assets / Total Deposits	38.2%	37.0%	37.8%	38.7%

Chronology of Policy Announcements **Annex-G**

Date of Announcement	CIRCULAR NO.	POLICY DECISION
2006 **23-January**	**BPD-03 Circular Letter**	**CLARIFICATION—LEVY OF SERVICE CHARGES ON ZAKAT ACCOUNTS MAINTAINED FOR DISBURSEMENT OF** **ZAKAT FUNDS** It has been observed that the banks are recovering service charges on account of services connected with the collection and disbursement of Zakat, which is not permissible. Banks are, therefore, advised to ensure that there is no violation of the provisions of Zakat & Ushur Ordinance or any other law and ensure compliance in letter and spirit.
2006 **30-January**	**SMED-01 Circular**	**RATE OF MARKUP FOR COMMODITY OPERATIONS OF THE GOVERNMENT AND THEIR AGENCIES** It has been decided that, henceforth, the markup rate for financing provided by the banks to the Governments and their agencies under commodity operations shall be negotiated bilaterally on the basis of KIBOR of relevant tenor. Further, the instructions issued to banks through which markup rate of 9.5 percent was fixed by SBP for COF have been withdrawn.
2006 **01-February**	**BPD-04 Circular Letter**	**BENCHMARKING OF CORPORATE LENDING PRODUCTS** **TO KIBOR** To encourage transparency and promote consistency in the market-based pricing of loans, Banks/DFIs were directed to use Karachi Inter-bank Offered Rate (KIBOR) as a benchmark for determining pricing of all Rupee Corporate/Commercial banking lending. It has been observed that some banks are using longer tenor benchmark rates for shorter tenor loans. This practice is not correct. It is, therefore, clarified that: a) For fixed rate time loans, the tenor of the benchmark rate should be the same as the tenor of the fixed loan. For tenors exceeding 3 years and not covered by KIBOR, banks are advised to use appropriate benchmarks such as secondary market yields on the relevant tenor of Pakistan Investment Bonds. b) For floating rate time loans, the tenor of the benchmark rate should be the same as of re-pricing tenor set for the floating rate loan.

2006 **14-March**	**SMED-05 Circular**	**<u>PROCUREMENT OF WHEAT BY THE PRIVATE SECTOR-2006</u>** With a view to encourage the participation of the private sector in wheat procurement, it has been decided that the banks may provide financing facilities to their eligible borrowers <u>for procurement of indigenous wheat only during the wheat procurement season 2006</u>, subject to the following conditions: - a) The banks will be free to determine the rate of. b) The banks may fix minimum margin requirement of 10 percent of the value of the wheat stock. However, the banks shall not provide any financial facilities (funded or non- funded) to enable the borrowers to meet the margin requirements. c) The loans provided to the private sector will be for the procurement of **indigenous wheat only** and shall be repayable on or before **31st January, 2007** positively.
2006 **13-April**	**SMED-07 Circular**	**AMEMDMENTS IN PRUDENTIAL REGULATION Nos. 12 AND 14** **<u>FOR MICROFINANCE BANKS (MFBs)</u>** In order to ensure soundness and stability of the Microfinance banking industry following amendments have been made in the existing classification, provisioning and write-off criteria under the Prudential Regulation for Microfinance Banks:- i) Elimination of OAEM category. ii) Revision of aging criteria whereby now the loans /advances overdue by 30 days or more will be classified as Substandard, 90 days or more as Doubtful and 180 days or more as Loss. iii) Provisioning requirement for substandard category has been increased to 25 percent. iv) MFBs shall maintain a Watch List of all accounts delinquent by 5 – 29 days. v) The MFB/MFI shall maintain a General Provision equivalent to 1.50 percent of the net outstanding advances. vi) All Non-Performing Loans (NPLs) shall be written off, one month after the loan is classified as "Loss", this shall, however, not extinguish the MFBs' right of recovery of such written-off loans. vii) Classification and provisioning shall be made at the end of every month.
2006 **29- May**	**BPD-01** **Circular**	**<u>AUTO LOANS</u>** State Bank of Pakistan has decided with immediate effect that for Auto Loans, Banks/DFIs shall not report overdue/default of those borrowers/lessees to Credit Information Bureau (CIB) of State Bank of Pakistan, whose vehicle financed/leased by them has been stolen or snatched, provided the respective Bank/DFI is fully secured to recover the entire outstanding amount from an insurance company under a valid insurance policy.

2006 30-May	BSD-07 Circular	**<u>HELD TO MATURITY SECURITIES</u>** Banks and DFIs, interalia, were required to classify their existing investment portfolio into "Held-for-Trading", "Available-for-Sale" and "Held-to-Maturity" categories by 30th September, 2004. It has been observed that some of the banks and DFIs have moved their risky portfolio to the Held-to-Maturity category to avoid booking revaluation deficit and categorized their good portfolio in rest of the two i.e. Held-for-Trading and Available-for-Sale categories. At the same time they are using Held-to-Maturity securities for managing liquidity by entering into repo transactions in the inter-bank market. To discourage such practices, SBP has decided that the securities classified as Held-to-Maturity by the banks and DFIs should neither be sold nor used for entering into repo transactions in the inter-bank market or borrowing under SBP repo facility/discount window with effect from July 01, 2006. However, the banks and DFIs are allowed for a one time reclassification of their securities and this process of reclassification should be completed by June 15, 2006. The banks and DFIs shall also ensure that the securities acquired/ purchased after June 15, 2006 shall at the time of their acquisition/purchase be categorized into any of the three categories and the decision taken to that effect shall be recorded in writing on the investment proposal/deal ticket.
2006 02-June	BPD-02 Circular	**<u>AGGREGATE CLEAN EXPOSURE</u>** State Bank of Pakistan has reviewed the Prudential Regulation R-4 for Corporate/ Commercial Banking on Clean Exposure that requires the Banks/DFIs to ensure that aggregate exposure against all their clean facilities shall not, at any point in time, exceed the amount of their equity. It has been decided to set higher limits for assuming unsecured exposure on case to case basis, taking into account the following factors: a) CAMEL rating of the bank/DFI. b) Quality of unsecured portfolio in terms of percentage of classified advances and write-offs/charge-offs. c) Past track record of dealing in the relevant clean products. The banks/DFIs, who wish to take clean exposure in excess of their equity level, will be required to obtain prior approval from State Bank of Pakistan; and their requests will be processed in the light of the above criteria. All other instructions on the subject will, however, remain unchanged.
2006 05-June	BPD-03 Circular	**<u>PROPER ARRANGEMENTS IN COMMERCIAL BANKS FOR DEPOSITING UTILITY BILLS</u>** In view of the suo-moto action taken by the Supreme Court of Pakistan regarding the collection of utility bills and provision of drinking water and sheds facilities, the State Bank of Pakistan has directed all branches of the scheduled commercial banks to collect utility bills from the consumers in terms of BPRD Circular No. 38

		dated the November 10, 1997 and subsequent instructions on the subject. Banks may also appropriately inform the general public through press/media in this regard. Further, all the banks that are already collecting utility bills are again directed to make special arrangements to ensure provision of drinking water and sheds in accordance with the Municipal Laws to the consumers, as has already been advised earlier vide BPRD Circular No. 38/1997. State Bank will carry out surprise checks of the bank branches ensuring adherence to the above instructions.
2006 **09-June**	**BPD-04 Circular**	**MARGIN RESTRICTIONS FOR FINANCING AGAINST <u>THE SECURITY OF SUGAR STOCK (BOTH RAW AND REFINED)</u>** With a view to discourage hoarding of sugar and to ensure stability in its prices, State Bank of Pakistan has decided that with immediate effect the banks shall ensure that all advances against the security of sugar stock are fully adjusted and renewals/fresh disbursements of such advances are made only after a clean up period of at least one month. It is clarified that all renewals/fresh disbursements henceforth will be subject to 50 percent cash margin requirement against the security of sugar stocks and the banks should not finance the cash margin themselves. Further, the banks shall report all such advances to State Bank of Pakistan on fortnightly basis.
2006 **13-June**	**SMED-02 Circular Letter**	**EXPORT FINANCE SCHEME (EFS) PART II** **<u>RELAXATION TO THE EXPORTERS OF TENTS & TARPAULINS</u>** In lieu of the emergency situation and the imposition of the ban on the export of tents etc due to the earthquake of 2005, it has been decided to treat local supplies of tents & tarpaulins made to the Federal/ Provincial Relief Commissioners for earthquake victims as "exports" for the purpose of Export Finance Scheme Part II for the year 2005-06 only, as one time blanket permission. Accordingly, Banks are advised to take into account these supplies as 'export receipts' supported by the relevant invoices and delivery challans (Goods Receipt Note), duly backed by the certificates issued by the Federal/ Provincial Relief Commissioners.
2006 **27-June**	**SMED-03 Circular Letter**	**<u>EXPORT FINANCE SCHEME-EXTENSION OF LIMIT</u>** In order to ensure that the financing facilities are available to the exporters till finalization of their new limits under Part-II of Scheme, it has been decided as under: - a) Limits sanctioned by banks to individual exporters under Part-II of Scheme for 2005-06 shall continue upto August 31, 2006, to enable the exporters to avail financing facilities under the Scheme. b) The facility under Part-II is self regulating, the exporters shall continue to foresee their export earnings during 2005-06, work out their own estimate as to the quantum of their entitlement for the 2006-07 and should accordingly adjust their existing borrowings on or before end June 2006 to avoid utilization of excess facilities under Scheme during the period of roll

		over which would be subject to fine.
2006 **27-June**	**SMED-10 Circular**	**GUIDELINES FOR COMMERCIAL BANKS TO** **<u>UNDERTAKE MICROFINANCE BUSINESS</u>** To facilitate the downscaling financial services of the commercial banks, State Bank has prepared guidelines for them to provide Microfinance services under four different modes which include, i) Establishment of MF counters in the existing branches. ii) Designating stand alone MF branches. iii) Establishing independent MF subsidiary. iv) Developing linkages with MFBs and NGO-MFIs. The MF operations of commercial banks under Modes I, II & IV will be subject to Prudential Regulations issued separately under BCO 1962 for commercial banks undertaking microfinance. However, MF operations under Mode-III will be governed under MFIs Ordinance 2001 and Prudential Regulations applicable on Micro Finance Banks.
2006 **27-June**	**SMED-11 Circular**	**PRUDENTIAL REGULATIONS FOR COMMERCIAL** **<u>BANKS TO UNDERTAKE MICRO FINANCE BUSINESS</u>** Realizing the growing acceptability of the Microfinance as an effective tool for poverty alleviation and a viable business proposition, State Bank of Pakistan has formulated a regulatory frame work for establishing Micro Finance Banks and has issued guidelines for Commercial Banks to undertake MF business if wish to. The guidelines have envisaged four modes through which include, i) Establishment of MF counters in the existing branches. ii) Designating stand alone MF branches. iii) Establishing independent MF subsidiary. iv) Developing linkages with MFBs and NGO-MFIs. The Microfinance operations under Mode-III would be governed by MFIs Ordinance 2001 and Prudential Regulations for Micro Finance Banks. However, The micro finance operations of the commercial banks conducted under Modes I, II & IV, as envisaged in the guidelines shall be subject to the following Prudential Regulations. **Part – A: PRs for Micro Finance Operations under Mode I & II** **<u>Definitions:</u>** (a) “poor persons” means persons who have meager means of subsistence and whose total income during a year is less than such minimum limit as may be prescribed by State Bank from time to time

(b) "Microfinance" means the financial services to the poor which does not exceed such amount as prescribed by State Bank from time to time.

(c) "NGO-MFI" means an institution, which extends Micro credit and allied services to the poor through sources other than public savings and deposits.

PR-1. Maximum Loan Size

For micro credit, the maximum limit of a loan to a single borrower is Rs. 100,000. The loans amounting to more than Rs. 100,000/-, or loans granted to person other than 'poor person', shall not be treated as Micro Credit.

PR-2. Maximum Exposure of a borrower from banks/ MFBs/FIs/NGO-MFIs

The banks shall ensure that total exposure of its micro-credit client from banks/MFBs/FIs/ NGO-MFIs etc. does not exceed Rs.100,000/- in aggregate. For this purpose, they will obtain a certificate from the clients regarding borrowings from banks/MFBs/FIs/NGO-MFIs.

PR-3. Classification of Loans & Advances and Provisioning Requirements

a) Classification of Loans & Advances

i) Substandard: Payments/installments overdue by 30 days

ii) Doubtful: Payments/installments overdue by 90 days

iii) Loss: Payments/installments overdue by 180 days or more

The banks will maintain a Watch List of all accounts delinquent by 5 – 29 days. However, such accounts shall not be treated as NPL for the purpose of Classification/Provision.

b) Provisioning Requirements

i. General Provision: The banks shall maintain a General Provision quivalent to 1.5 percent of the net outstanding advances.

ii. Specific Provisions:

- Substandard: 25 percent of outstanding principal net of cash collaterals
- Doubtful: 50 percent of outstanding principal net of cash collaterals
- Loss : 100 percent of outstanding principal net of cash collaterals

PR-4. Rescheduling / Restructuring of loans

The banks shall reschedule / restructure the NPLs as per the policy approved by their BOD. The rescheduled/restructured loans shall, however, remain classified, unless serviced regularly for 6 months.

PR-5. Writing-off Non-Performing Loans (NPLs)

All Non-Performing MF Loans (NPLs) shall be written off, one month after the loan is classified as "Loss". This shall, however, not extinguish the banks' right of recovery of such written-off loans

PR-6. Pricing of MF Products and Services

The banks shall implement appropriate pricing policies, which ensure access of

		affordable financial services to the poor as well as operational and financial self-sustainability of its Micro finance operations. **PR-7. Operational Policies** The banks shall formulate operational policies for all areas of MF operations including micro-credit, deposit mobilization, internal audit, human resource, rescheduling/ restructuring, write-off of loans/advances, branch selection criterion and mobile banking function etc. and shall submit these policies, duly approved by its Board of Directors, to State Bank for information within 6 months of commencement of MF operations. **<u>Part – B: PRs for Micro Finance Operations under Mode IV:</u>** **PR-8. Personal Guarantees** NGO-MFIs generally have nominee directors on their board which are exempted from furnishing personal guarantees; however, in case of directors other than nominees, banks are free to decide the suitability of obtaining Personal Guarantees which may be linked to credit track record / rating, financial strength, and operating performance of the NGO-MFIs. In case of facilities secured against liquid assets, personal guarantees may not be obtained. This Prudential Regulation, for Microfinance operations, shall supersede Regulation R-2 applicable for SME financing. **PR-9. Securities** All the facilities extended to NGO-MFIs shall be appropriately secured as defined in Prudential Regulations for SME financing and Prudential Regulations for Corporate /commercial banking, whichever is applicable. However, the banks may take exposure on NGO-MFIs against loan receivables at the lending bank's own discretion. While extending facilities against the security of loan receivables, banks shall obtain monthly statements of receivables from NGO-MFIs. **PR-10. Minimum Conditions for Taking Exposure** 1. While considering proposals for any exposure (including renewal, enhancement and rescheduling / restructuring) banks should give due weightage to the credit report relating to NGO-MFI obtained from a Credit Information Bureau (CIB) of State Bank of Pakistan. If Credit Information Bureau (CIB) of State Bank of Pakistan does not have any information on particular NGO-MFI, the credit report may be obtained directly from its creditors. The banks may take exposure on the borrowers having overdue/default in CIB keeping in view their risk management policies and criteria, provided they properly record reasons and justifications in the approval form. 2. Banks shall, as a matter of rule, obtain a copy of financial statements duly audited by a practicing Chartered Accountant, relating to the business of NGO-MFIs irrespective of facility amount. The banks shall do financial analysis and satisfy themselves about the operational self sufficiency and financial self sustainability of the NGO-MFIs. The banks, however, may waive the requirement of obtaining copy of financial statements, when the exposure is secured against liquid assets. 3. Banks shall not approve and / or provide any exposure (including renewal, enhancement and rescheduling / restructuring) until and unless the Loan Application Form (LAF) prescribed by the banks is accompanied by a 'Borrower's

		Basic Fact Sheet' under the seal and signature of the NGO-MFI, as per approved format of the State Bank of Pakistan. This Prudential Regulation for microfinance operations shall replace Regulation R-8 applicable for SMEs Financing and Regulation R-3 for Corporate / Commercial Financing respectively.
2006 **01-July**	**BPD-12 Circular Letter**	**PRUDENTIAL REGULATION M-1- OBTAINING COMPUTERIZED NATIONAL IDENTITY CARD (CNIC) FROM ALL THE** **BANKs/DFIs CUSTOMERS /CLIENTS** In the light of representation from Pakistan Bank Association regarding difficulties in meeting the extended deadline of June 30, 2006 for complying with the above instructions, it has been decided to extend the deadline for meeting the subject requirement as under: a) Dormant account customers / clients whose attested copy of Computerized National Identity Card (CNIC) is not available in bank/DFI's record shall be allowed operations in such account only upon producing the attested copy of his/her CNIC and fulfillment of all other formalities for activation of the account. b) For all other bank clients/customers including depositors & borrowers, banks/DFIs shall obtain the attested copies of CNICs by June 30, 2007. Banks/DFIs shall discontinue relationship with such customers who fail to submit a copy of their CNIC by the above deadline. Banks/DFIs are encouraged to carry on public campaign through print/ electronic media for creating public awareness on requirement of CNIC for banking purposes.
2006 **03-July**	**EPD-10 Circular Letter**	**6 percent RESEARCH AND DEVELOPMENT SUPPORT** **<u>TO THE GARMENTS INDUSTRY</u>** In accordance with MoC's decision, 6 percent R&D support to garment industry was also allowed on export of readymade textile garments from EPZ units on the production of bank certificate that the export proceeds of R&D Support claims have been received in Foreign Currency. Authorized Dealers are advised that they may credit PKR denominated R&D Support payments from SBP in the relevant Non-Resident PKR Accounts of EPZ's Units, maintained with them and thereafter allow withdrawals/debits in PKR for equivalent utilization. Authorized Dealers must ensure at all times that total PKR withdrawals/debits to these accounts, do not exceed the total amount of R&D Support received from SBP and credited to Non-Resident PKR Accounts. The reporting of the above transactions will be made under the existing procedures.

2006 **08-July**	**BPD-05 Circular**	**PRUDENTIAL REGULATIONS - ANTI MONEY** **<u>LAUNDERING MEASURES</u>** State Bank of Pakistan has made the following amendments/additions, in public interest, in the Prudential Regulations for Corporate / Commercial Banking with immediate effect in order to ensure compliance with Financial Action Task Force recommendations on anti-money laundering, 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: **1. REGULATION M-1 KNOW YOUR CUSTOMER (KYC)** (<u>i</u>) "While opening bank account of "proprietorships", the requirements laid down for individuals at serial No.(1) of the Annexure to this regulation shall apply except the requirement mentioned at No.(3) of the Annexure. Banks / DFIs should exercise extra care in view of the fact that constituent documents are not available in such cases to confirm existence or otherwise of the proprietorships." (ii) Copies of CNIC wherever required in annexure to this regulation shall invariably be verified, before opening the account, from NADRA through utilizing on-line facility or where the banks/ DFIs or their branches do not have such facility through arrangement with regional offices of NADRA. **2. REGULATION M-2 ANTI-MONEY LAUNDERING MEASURES** Banks/ DFIs are required to include accurate and meaningful originator information (name, address and account number) on funds transfers and the information should remain with the transfer or related message throughout the payment chain. However, banks/ DFIs may, if satisfied, substitute the requirement of mentioning address with CNIC, Passport, Driving license or similar identification number for this purpose. **3. REGULATION M-5 SUSPICIOUS TRANSACTIONS** Para (2) has been substituted as following: 2. If the bank / DFI suspects, or has reasonable grounds to suspect, that funds are the proceeds of a criminal activity or terrorist financing, it should report promptly, its suspicions, through Compliance Officer of the bank / DFI to Banking Policy Department of the State Bank of Pakistan. The report should contain, at a minimum, the following information: 1. Title, type and number of the accounts. 2. Amounts involved. 3. Detail of the transactions. 4. Reasons for suspicion.
2006	**FE-08**	**NOSTRO ACCOUNTS WITH EXCHANGE COMPANIES ABROAD**

08-July	**Circular**	**AND SALE OF FOREIGN EXCHANGE IN THE** **<u>INTERBANK MARKET</u>** It has been decided that Nostro Accounts with Exchange Companies abroad will be closed latest by 25th July 2006. Accordingly, FCYs on account of home remittances or against export of foreign currencies (other than US $) should either be received in Exchange Company's Nostro Accounts with the Banks abroad or in FCY A/Cs maintained with Banks in Pakistan. Exchange Companies will be further required to report, on transaction-to-transaction basis, export of foreign currencies (other than US $) and date of receipt of credit, the name of branch & the bank. It has also been decided that as from 10th of July, 2006 (inclusive), all Exchange Companies shall ensure that a minimum of 10 percent of foreign currencies exported by them and a minimum of 10 percent of foreign currencies received by them on account of inward home remittances, in equivalent US $, must invariably be sold in the interbank market on an ongoing basis. A report as of last day of the month must be submitted to this department by every Exchange Company, giving aggregate FCY amounts mobilized under the above two categories and amounts sold in the interbank market along with the name of the counter parties & relevant dates.
2006 **14-July**	**BPD-06 Circular**	**<u>DISCLOSURE OF LENDING / DEPOSIT RATES</u>** **<u>BY BANKS/DFIs</u>** In order to create awareness and to facilitate the public in making informed decisions, the State Bank of Pakistan has decided that henceforth banks/DFIs shall make complete disclosure of the lending and deposit rates of all consumer products offered by them by posting this information on their website as well as prominently displaying on entrance/ or window of their branches. Banks/DFIs would also disclose annualized percentage rates on all consumer products. In case of deposits, the expected rate of return under the PLS system will be clearly indicated for each tenure. For lending products, Banks/DFIs shall also clearly indicate whether the rate is fixed or floating. In case of floating rate, in addition to mentioning the existing rate, the information regarding the tenure of the benchmark (KIBOR or any other rate plus a pre-defined spread) used and periodicity of re-pricing should also be disclosed. The banks/DFIs, in addition to the above, will also take adequate measures to inform their customers about the intricacies of ATM, Credit Card and their charges as well as the cardholders' obligations.
2006 **14-July**	**FE-09 Circular**	**REMITTANCE OF MEMBERSHIP/AFFILIATION FEE TO <u>PROFESSIONAL BODIES/PRINCIPALS ABROAD</u>** Authorized Dealers are allowed to make remittances on behalf of individuals covering subscriptions or membership fee at actual, to bonafide scientific, technical, professional and educational Institutions aboard. With a view to further enhance scope of this permission, it has since been decided that in addition to the individuals, the above facility will also be available to institutions/professional

		bodies in Pakistan with international affiliations. Consequently, Authorized Dealers may allow remittances on account of membership/affiliation fees payable by a local business/professional entity to the principals abroad.
2006 **18-July**	**BSD-09 Circular**	**<u>MAINTENANCE OF CASH RESERVE REQUIREMENT(CRR) AND STATUTORY LIQUIDITY REQUIREMENT (SLR</u>** SBP decided to revise the reserve requirements with effect from 22nd July, 2006 as under:- **Cash Reserve Requirement (CRR)** a) Weekly average of 7 percent (subject to daily minimum of 4 percent) of total Demand Liabilities (including Time Deposits with tenor of less than 6 months); and b) Weekly average of 3 percent (subject to daily minimum of 1 percent) of total Time Liabilities (including Time Deposits with tenor of 6 months and above). **Statutory Liquidity Requirement (SLR)** 18 percent (excluding CRR) of total Time and Demand Liabilities. Further, all Time and Demand Liabilities, except borrowings from SBP and interbank borrowings, shall be accounted for in the calculation of Time and Demand Liabilities for the purpose of CRR and SLR. The break-up of Time and Demand Liabilities to be used for calculating the required CRR and SLR is given in the enclosed annexure-A. Moreover, the separate CRA and SCRA in US$ against FE-25 Deposits would continue to be maintained at the prescribed rate.
2006 **21-July**	**BPD-07 Circular**	**<u>MASTER CIRCULAR- UNCLAIMED DEPOSIT</u>** In terms of Section 31 of Banking Companies Ordinance, 1962 all Banks/DFIs in Pakistan are required to surrender to State Bank of Pakistan (SBP) all those deposits which have not been operated upon during the period of last ten years, except deposits in the name of a minor or a Government or a court of law. In order to facilitate Banks/DFIs, instructions on the following subjects issued since 1968 till to date have been reviewed and consolidated -: 1. Definition of unclaimed deposit / instrument 2. Reporting of unclaimed deposits/ instruments 3. Surrender of unclaimed deposit 4. Notice to the holder of unclaimed deposit/instrument 5. Preservation of documents 6. Information in account opening form (AOF) 7. Procedure for refund of unclaimed deposit surrendered to SBP

2006 **21-July**	**FE-10 Circular**	It has been decided to allow non-residents to trade in shares in Futures Market through Special Convertible Rupee Account (SCRA) subject to the following procedure: (i) A separate sub-account under SCRA shall be opened by foreign investors through which an investor will route receipts/payments, initial margin, mark-to-market settlement, transaction charges, commission, fees etc. (ii) Margins relating to Futures Contracts may also be routed through this account. However, while allowing refund of the margin through SCRA to a non-resident, the Authorized Dealer should ensure that the broker has quoted the date and instrument number under which the margin was received by them. (iii) Authorized Dealers shall report information on market value of foreign investments through future trading in their weekly returns to the Statistics Department on the revised proforma. The daily statement showing inflow/outflow and opening/closing balances in the SCRA shall however, continue to be reported to the Statistics Department on the prescribed proforma.
2006 **22-July**	**BSD-10 Circular**	**STATUTORY LIQUIDITY AND CASH RESERVE REQUIREMENTS** It has been decided to revise the Cash Reserve Requirements (CRR) for Islamic Banks (IBs) / Islamic Banking Branches (IBBs) as under with effect from 22nd July 2006:- a) Weekly average of 7 percent (subject to daily minimum of 4 percent) of total Demand Liabilities (including Time Deposits with tenor of less than 6 months); and b) Weekly average of 3 percent (subject to daily minimum of 1 percent) of total Time Liabilities (including Time Deposits with tenor of 6 months and above). Moreover, IBs / IBBs would continue to meet the Statutory Liquidity (SLR) of 8 percent (excluding CRR) of their Time and Demand Liabilities in the prescribed manner.
2006 **24-July**	**BPD-14 Circular Letter**	**APPROPRIATE UTILIZATION OF LOAN PROCEEDS** To avoid enhancement of level of risk due to misuse of loan and loss for the lending bank resultantly, banks/DFIs are advised to ensure that loans are utilized for the acquired purpose. In this respect, risk of diversion of loans to real estate and capital markets for speculative purposes and export finance loan should be closely monitored to ensure that they are not diverted. The banks/DFIs ensure suitable steps to check the misuse of loans including the following: • At the time of approval of a financing facility (fund based or non fund based), the banks/DFIs shall obtain a written confirmation from the client, that the funds will be used for the stated purpose only. • The banks/DFIs should develop an effective internal system to monitor

		utilization of the loan facilities to prevent any diversion of funds.
2006 **24-July**	**BPD-08 Circular**	**STATEMENT OF ACCOUNTS TO PLS/CURRENT ACCOUNT <u>HOLDERS & BASIC BANKING ACCOUNT HOLDERS</u>** In order to minimize the difficulties being faced by Banks in delivery of statement of accounts to their account holders, as also to ensure that the customers receive the periodic statement of accounts regularly, the existing instructions have been revisited and consolidated as under:- (a) The banks shall dispatch, free of charge, statements of accounts periodically (at least twice in a year on six monthly basis) to all their account holders (PLS/Current accounts) within 15 days from the close of half-year, i.e. 30th June & 31st December. (b) The statement of accounts shall be dispatched free of charge and irrespective of amounts of balance in the accounts of depositors/customers. (c) The statement of accounts of account holders/customers having a balance exceeding Rs.10,000 or above shall be sent either through a courier company or express post services of Pakistan Post. (d) The banks may charge a maximum of Rs.50 for: (i) each duplicate statement of account (ii) additional statement of account (over and above two periodical statements indicated at (a) above). (e) The banks shall make arrangements with the delivery companies for confirmation of dispatch of all statement of accounts to the account holders. (f) Where statement of account is returned/ undelivered, the banks may make all efforts to update record/address of the account holders. **Basic Banking Account (BBA)** The statement of accounts to BBA customers/account holders would, however, continued to be dispatched once a year. The banks may charge a maximum of Rs.50 for duplicate statement.
2006 **29-July**	**BPD-09 Circular**	**<u>SIGNIFICANT INVESTMENT/STAKE BY BANKS/DFIs</u>** It has been decided that the banks/DFIs will obtain prior approval in writing from the State Bank while purchasing shares of a company in excess of 5 percent of their paid-up capital or 10 percent of the capital of investee company, whichever is lower. These limits will be calculated as under: • In the case of Investee Company, 10 percent limit will be calculated by taking 10 percent of the number of its paid-up shares. • In the case of investing bank, 5 percent limit will be calculated by taking 5 percent of paid-up shares of the bank and then multiplying with their face value. In this respect, the bank's/DFI's request will be considered in the light of the

		nature of relationship of the investing bank and the investee company along with other factors. In case, shares in excess of above limit are acquired by the bank/DFI through settlement of a facility or by any other means, the information to this effect will be conveyed to the State Bank of Pakistan within three days of the acquisition of such shares. Furthermore, the shares so acquired should be disposed off within one year to comply with the limits.
2006 **31-July**	**BPD-10 Circular**	**MARGIN RESTRICTIONS FOR FINANCING AGAINST THE SECURITY OF SUGAR STOCK (BOTH RAW AND REFINED)** Banks/DFIs are advised that: a) The deadline for adjustment of financing facilities against the security of sugar stock (pledged/hypothecated) whose expiry date was 31st July 2006 extended up to 31st October 2006. b) Ensure one-third minimum decline every month in outstanding against security of sugar stock for full adjustment by the deadline. c) Observe a cleanup period of at least one month after the settlement of each loan. d) Their progress will be closely monitored by State Bank through weekly statements which should be submitted within three (3) working days of the end of the reporting week. e) The above directions and instructions shall not be applicable on financing against the security of molasses, ethanol, etc. and financing provided to Trading Corporation of Pakistan. The banks/DFIs are allowed to extend financing facilities against the securities of imported sugar without the requirement of 50 percent cash margin and this shall be adjusted within 45 days of the disbursement of funds. To avoid the misuse of this relaxation, banks are required to obtain and retain sufficient documentary evidence in order to establish that the pledged sugar was imported after 9th June 2006.
2006 **01-August**	**BPD-11 Circular**	**CUSTOMERS' PRIOR CONSENT FOR AVAILING ANY INSURANCE OR OTHER PRODUCT/SERVICE** In order to address the number of representations received from the banks' account holders/customers complaining certain premium charges by the banks under the head "insurance covers" on consumer products, viz., credit cards, Debit/ATM cards, etc without obtaining prior consent in writing from them, it has been decided that henceforth no bank/DFI shall charge any amount under the head of "insurance premium" (by what so ever name called) without obtaining the consent of each existing & prospective customer in writing. Further the banks/DFIs may also use the following modes for obtaining prior consent of their customers provided proper record is maintained by banks/DFIs:- i) Customer's consent on recorded lines via out bound/in bound call center

		(after due verification) ii) ATM screens – screen pop up before conducting transaction and after inputting pin code iii) Signed consent acquired with credit card application or as separate form iv) IVR (Integrated Voice Recording)
2006 **01-August**	**BPD-16 Circular Letter**	<u>**STRATEGIC INVESTMENT UNDER REGULATION R-6**</u> Banks are required to cap their investment in shares at 20 percent of their equity except strategic investment**.** Strategic investment was defined "an investment which a bank/DFI makes with the intention to hold it for a longer term of duration and should be marked as such at the time of investment and can only be disposed-off with the prior approval of State Bank of Pakistan." In order to make it more objective and replacing the condition of prior approval from SBP, the following criteria is prescribed for strategic investments: (a) The strategic investment will continue to be excluded from the 20 percent aggregate exposure limit in stocks. (b) The strategic investment, marked as such at the time of investment, shall be retained by the banks/DFIs for at least 5 years. (c) If there are a series of purchases of stocks of a company, the minimum retention period of 5 years shall be counted from the date of the last purchase. (d) The banks/DFIs' investment in a company can be segregated to be categorized as strategic and non-strategic. (e) A committee clearly designated/empowered by the bank should take decision for strategic investment. All Record of transactions/decisions should be properly kept in a separate file. The banks/DFIs may review their existing strategic investment portfolio in the light of the above criteria, and investments, not falling in strategic portfolio, may be shifted to the Trading Portfolio. However, if any such shifting results in an excess over the 20 percent limit, the excess should be regularized and brought back within the 20 percent limit within 3 months.
2006 **01-August**	**EPD-12 Circular Letter**	**PROCEDURE FOR DISBURSEMENT OF SUBSIDY ON THE** <u>**IMPORTED WHOLE GRAM BLACK**</u> Ministry of Food, Agriculture and Livestock have clarified that the subsidy of Rs. 8 per Kg on imported whole gram black (for splitting into Dal Channa) is available on import of gram/ chick peas having botanical name as Cicer Arietinum. Yellow peas are not eligible for the said subsidy. Authorized Dealers are, therefore, advised to ensure before forwarding subsidy claims that the evidence by the concerned agency of the exporter's country should be submitted showing botanical name of the gram/chick peas being imported as "Cicer Arietinum".

2006 **04-August**	**EPD-13 Circular Letter**	**AGENCY AGREEMENTS OF EXCHANGE COMPANIES** **<u>WITH FOREIGN ENTITIES ABROAD</u>** Exchange Companies were required to close their Nostro Accounts with Exchange Companies abroad latest by 25th July 2006. Accordingly all permissible inflows/ outflows of Exchange Companies are only to be routed through either their Nostro Accounts with banks abroad or their FCY Accounts maintained with Commercial Banks in Pakistan. Thus, Funds against all individual inward remittances must first be received in Exchange Company's accounts as above and all outward remittances must also be separately accounted for. Under no circumstances, should an Exchange Company resort to netting off inflows and outflows. All Exchange Companies are therefore advised to review all their existing agency agreements with foreign entities abroad and confirm in writing to this department within 15 days hereof that all such agreements are in conformity with the above-mentioned instructions along with an up-to-date list of all agreements. Furthermore, details of all exchange companies' Nostro accounts & FCY accounts with banks in Pakistan should also be provided to SBP within 15 days.
2006 **16-August**	**BPD-12 Circular**	**PROPER ARRANGEMENTS** **<u>IN COMMERCIAL BANKS FOR DEPOSITING UTILITY BILLS</u>** Banks were required to complete all necessary formalities with the Utility Companies and submit a compliance report to State Bank of Pakistan latest by 31st July, 2006. It has been decided to allow a final extension to all the banks for completion of the required arrangements / formalities upto 31st August 2006. Banks failing to finalize the arrangements within the above period will be considered as non-compliant banks and the same will be indicated in our report to the Supreme Court. State Bank of Pakistan will carry out surprise checks of the banks' branches to ensure adherence to the above instructions.
2006 **28-August**	**ACD-01** **Circular**	**<u>GUIDELINES FOR LIVESTOCK FINANCING</u>** State Bank of Pakistan has framed 'Guidelines for Livestock Financing', in light of the recommendations of the Expert Committee and input from the stakeholders including banking sector and MINFAL, to facilitate and encourage Banks/FIs in enhancing credit flow to the livestock sector. The guidelines cover all areas of the livestock financing business including loan purpose and objectives, product development, eligibility of borrowers, delivery channels, monitoring mechanism etc. Banks may adopt the guidelines in its present form or with some modifications that suit their organizational needs and market characteristics.

2006 **05-September**	**BPD-18 Circular Letter**	**<u>REPLACEMENT OF DIESEL OIL BY CNG</u>** Government of Pakistan has chalked out a policy for gradually phasing out inter-city diesel engine public transport in Karachi, Hyderabad, Lahore, Faisalabad, Peshawar, Quetta and Islamabad/Rawalpindi by end 2007. Since it will require a huge investment the banks/DFIs are encouraged to develop credit products for financing of CNG buses/mini/buses/wagons and their manufacturing facilities in Pakistan in terms of their respective credit policies.
2006 **26-September**	**BPRD-22 Circular Letter**	**PRUDENTIAL REGULATION M-1-VERIFICATION COST OF COMPUTERIZED NATIONAL IDENTITY CARDS (CNICS) OF <u>THE BANK/DFI CUSTOMERS/ CLIENTS</u>** Banks/DFIs should not pass on the cost of verification of CNIC from NADRA database to their account holder(s) (either existing or prospective) as this verification is not a direct service to the Bank/DFI rather it is to mitigate financial institution's own risk.
2006 **12-October**	**BPRD-14 Circular**	**RECOVERING PENALTY_AMOUNT IMPOSED BY** **<u>STATE BANK OF PAKISTAN FROM CUSTOMERS</u>** The banks/DFIs are advised to stop the practice of recovering the amount of penalty imposed by State Bank of Pakistan for violating SBP regulations/guidelines/directives etc. from their customers as it is the duty of the banks/DFIs to make sure that all SBP regulations/guidelines/directives are meticulously complied with at all times and this impact of penalty should not be passed on to their customers who do not have any responsibility in this respect. In exceptional cases where a specific requirement is not being complied with, banks/DFIs should approach SBP for exemption/relaxation which will be considered on the merit of the case.
2006 **13-November**	**OSED-04 Circular**	**RESERVE REQUIREMENTS AGAINST FE-25 DEPOSITS** **<u>MAINTAINED BY IBS & IBBS</u>** As new Islamic Banks **(IBs**) /Islamic Banking Branches **(IBBs)** are being established which are desirous of offering FE-25 deposits schemes to their customers in a Shariah compliant manner, the following instructions are being issued to **IBs/IBBs** regarding reserve requirements against FE-25 deposits. **Cash Reserve Requirement (CRR)**: IBs will maintain CRR prescribed in BSD Circular 16 of 2002 against the F.E. 25 deposits, in a current account in US$ with SBP. Currently this requirement is 5 percent of total FE-25 deposits to be maintained on daily basis. Conventional Banks having Islamic Banking Branches will be required to open a separate current account in US$ with SBP for the purpose.

		Special Cash Reserve (SCR): In addition to the CRR, **IBs/IBBs** will maintain Special Cash Reserve at 6 percent of their total FE-25 deposits in the same current account in US$ on non-remunerative basis till some Shariah compliant foreign currency instruments are developed.
2006 **21-November**	**EPD-21 Circular Letter**	**ACU TRANSACTIONS IN ACCORDANCE WITH THE** **<u>ACU MECHANISM</u>** It has been observed that during the course of ACU transactions, Commercial Banks face difficulty in maintaining an efficient and prompt operational relationship with correspondent banks due to the following reasons: 1. Reconciliation problems as Banks do not receive comprehensive bank statements regularly/timely from their correspondent banks. Some banks take months to issue bank statements. All required details are not available in the bank statements. 2. Settlement problem as some correspondent banks do not answer promptly to the queries made by local commercial bank. 3. No compensation even if the delays are due to lapses of the correspondent banks. In order to tackle such difficulties, Authorized Dealers are advised to ensure the following course of action:- • Improve services of the banks and act promptly to any queries raised by their counterparties in ACU countries. • Issue ACU Dollar account statements as and when a transaction occurs and on a monthly basis.
2006 **08-December**	**BPRD-28 Circular Letter**	**REQUIREMENT OF DOCUMENTS FOR OPENING ACCOUNT <u>UNDER PRUDENTIAL REGULATION M-1</u>** Keeping in view the banks requests for waving of conditions for obtaining the (i) board resolution and (ii) certificate of commencement of business of Joint Stock Companies for the purpose of opening bank account as it is not issued in few countries, it has been decided to relax the both conditions of only such foreign companies/entities belonging countries where said requirement are not enforced under their law/regulations. However such foreign companies will have to provide the following documents in lieu thereof: (a) Power of Attorney from the competent authority for opening bank accounts. (b) A certificate from the company Secretary, duly authorized by the Board, that the entity started its business from certain date and that certificate of Commencement of Business is not issued in that country.

2007 **16-January**	**BPRD-01 Circular Letter**	**COPIES OF CNICS OF GOVERNING BODY & EXECUTIVE BODY OF PAKISTAN DEFENCE OFFICERS HOUSING AUTHORITY OR SIMILAR OTHER AUTHORITIES** Bank/DFIs were described the minimum set of documents to be obtained for opening bank accounts of various categories of customers including attested photocopies of identity cards of all the directors in case of Joint Stock Companies. It has been decided that banks should obtain copies of CNICs of all the members of Governing and Executive Bodies of DHA or ask for delegation of power to Administrator and accept copy of CNIC of Administrator as well as authorized signatories for the purpose of opening accounts of DHA or similar other authorities subject to the condition that all other requirements shall be complied with in letter and spirit. The existing accounts of DHA or similar other authorities, shall be regularized on the above lines within a period of three months from the issuance of this circular letter.
2007 **18-January**	**BSD-01 Circular**	**MAINTENANCE OF CASH RESERVE REQUIREMENT (CRR) AND STATUTORY LIQUIDITY REQUIREMENT (SLR)** It has been decided to revise the daily minimum requirements for Cash Reserves to 6 percent and 2 percent of demand and time liabilities respectively with effect from 19th January 2007 for all banks/DFIs including Islamic Banks. While the weekly average CRR will remain the same. 2. Cash Reserve Requirements will now stand as follows: a) Weekly average of 7 percent (subject to daily minimum of 6 percent) of total demand liabilities (including Time Deposits with tenor of less than 6 months). b) Weekly average of 3 percent (subject to daily minimum of 2 percent) of total time liabilities (including Time Deposits with tenor of 6 months and above).
2007 **07-February**	**BSD-02 Circular Letter**	**MINIMUM CAPITAL REQUIREMENTS FOR BANKS/DFIs** All banks and DFIs who are anticipating shortfall in MCR compliance for the coming year-ends (viz. December 2007 and onward) are required to develop realistic plans on annual basis to meet the prescribed MCR and send a copy of same duly approved by their Board of Directors to Banking Surveillance Department by 30th April of every year (i.e. upto 2009). The plan to meet the threshold of Rs. 4 billion by 31st December 2007 may be submitted by 30th April 2007. Failure of the banks/DFIs to meet the prescribed MCR of Rs4 billion by December 2007 will automatically invoke penal provisions.
2007 **30-March**	**BPRD-10 Circular Letter**	**PRUDENTIAL REGULATION M-1, OPENING OF ACCOUNTS** In terms of Prudential Regulations M-1 the requirement of documents for opening of a bank account of a trust is as follows :

		i) Attested copy of Certificate of Registration. ii) Attested copy of identity cards of all the trustees. iii) Certified copy of 'Instrument of Trust'. It has been decided that submission of attested copy of registered Instrument of Trust or Trust Deed shall ipso facto meet the requirement laid down under (i) & (iii) above and it would not be necessary to obtain separate certificate from the registration authority. Moreover, banks can open bank accounts of trusts covered under section 227 of Companies Ordinance, 1984 including Provident Funds, Gratuity Funds and Pension Funds after obtaining evidence of registration with any Government authority. However, it shall be the responsibility of banks/ DFIs to ensure that opening of Trust Accounts and subsequent operations in the accounts are in accordance with the spirit of Know Your Customer / Customer Due Diligence (KYC/ CDD) and other Anti Money Laundering/ Combating Financing of Terrorism (AML/ CFT) safeguards.
2007 **03-April**	**BPRD-02 Circular**	**DEDUCTION OF WITHHOLDING TAX ON CASH WITHDRAWAL** In terms of CBR's Circular, the rate of withholding tax has been enhanced from 0.1 percent to 0.2 percent of the amount withdrawn. Furthermore, the limit of Rs.25,000/- per transaction has been changed to per day basis. Banks have been advised to immediately discontinue the practice of clubbing cash/ATM transactions done on different dates into single posting date for the purpose of determining the amount of withholding tax on such transactions. Furthermore, the excess amount of withholding tax, deducted from the customers should be refunded to them.
2007 **04-April**	**BSD-03 Circular**	**POLICY FRAMEWORK IN BANKS / DFIS** The banks / DFIs are advised to formulate policies in the following areas, as a minimum, and ensure their regular updation: - 1. Risk Management Policy 2. Credit Policy 3. Treasury & Investment Policy 4. Internal Control System and Audit Policy 5. I.T. Security Policy 6. Human Resource Policy 7. Expenditure Policy 8. Accounting & Disclosure Policy The Board should also clearly define the periodicity for review / updation of the policies. Islamic banks / Islamic banking branches shall ensure that their policies in the above areas are in line with the Shariah Principles. All Banks/DFIs are required to complete the process of reviewing existing policies and/or formulating new policies by September 30, 2007 and submit a confirmation to the same, with references to the Board approvals, latest by 15th October 2007. Further report on compliance with such developed policies shall be sent to BSD within one month from the each calendar half year.

2007 **23-April**	**BPRD-03 Circular**	**AMENDMENTS IN REGULATION G-1 OF PRUDENTIAL <u>REGULATIONS</u>** For further improving and strengthening of the Corporate Governance practices, some amendments have been made in section B & C of Prudential Regulation G-1 for Corporate and Commercial Banking. **B. RESPONSIBILITIES OF THE BOARD OF DIRECTORS** The Board of Directors shall assume its role independent of the influence of the Management and should know its responsibilities and powers in clear terms. The BOD focuses on policy making and general direction, oversight and supervision of the affairs and business of the bank / DFI and does not play any role in the day-to-day operations. The Board shall approve and monitor the objectives, strategies and overall business plans of the institution and shall oversee that the affairs of the institution are carried out prudently within the framework of existing laws & regulations and high business ethics. All Board members should preferably attend at least 1-2 weeks training program(s) which will enable them to play effective role as a director of bank/DFI. The Board shall clearly define the authorities and key responsibilities of both the Directors and the Senior Management without delegating its policy-making powers to the Management and shall ensure that the Management is in the hands of qualified personnel. The Board shall approve and ensure implementation of policies in Key banking operations areas and also ensure existence of an effective 'Management Information System' to remain fully informed of the activities, operating performance and financial condition of the institution, As regards Internal Audit or Internal Control, a separate department shall be created which shall be manned preferably by professionals responsible to conduct audit of the bank's/DFI's all areas. The Head of this department will report directly to the Board of Directors or Board Committee on Internal Audit. The Board should meet frequently (preferably on monthly basis, but in any event, not less than once every quarter) and the individual directors of an institution should attend at least half of the meetings held in a financial year. The Board should ensure that it receives sufficient information from Management on the agenda items well in advance of each meeting to enable it to effectively participate in and contribute to each meeting. Any advisor, if appointed by the Board member, shall neither attend the Board meeting(s) on behalf of the Board member nor shall regularly sit in the Board meeting(s) as an observer or any other capacity. The Board should carry out its responsibilities in such a way that the external auditors and supervisors can see and form judgment on the quality of Board's work and its contributions through proper and detailed minutes of the deliberations held and decisions taken during the Board meetings. To share the load of activities, the Board may form specialized committees with well-defined objectives, authorities and tenure. These committees, preferably comprising of 'Non-Executive' Board members. These committees of the Board should neither indulge in day-to-day affairs/operations of the bank nor enjoy any credit approval authority for transaction/limits. These committees should apprise the Board of their activities and achievements on regular basis. The Board should ensure that it receives management letter from the external

		auditors without delay. It should also be ensured that appropriate action is taken in consultation with the Audit Committee of the Board to deal with control or other weaknesses identified in the management letter. A copy of that letter should be submitted to the State Bank of Pakistan so that it can monitor follow-up actions. **C. MANAGEMENT** No member of the Board of Directors of a bank / DFI holding 5 percent or more of the paid-up capital of the bank/DFI either individually or in concert with family members or concerns/companies in which he / she has the controlling interest, shall be appointed in the bank/DFI in any capacity except as Chief Executive of the bank/DFI. Further, maximum two members of Board of Directors of a bank/DFI including its CEO can be the Executive Directors. The banks/DFIs during a calendar year may pay a reasonable and appropriate remuneration for attending the Board or its committee (ies) meeting(s), to their non-executive directors and chairman. However, the remuneration to be paid shall be linked to the actual number of Board or committee meetings attended by an individual director / chairman i.e. no fixed remuneration on periodical basis (monthly or yearly etc.) shall be paid to the non-executive directors. Furthermore, the scale of remuneration to be paid to the non-executive directors and chairman for attending the Board and / or committee meetings shall be approved by the shareholders on a pre or post facto basis in the Annual General Meeting. However, no such remuneration shall be paid to the executive directors, except usual TA/DA as per banks/ DFIs standard rules and regulations. Banks/DFIs shall also ensure that except as mentioned above, no additional payment or perquisites will be paid to the non-executive directors and chairman. Furthermore, no consultancy or allied work will be awarded to the non-executive directors or to the firms / institutions/ companies etc. in which they hold substantial interest. The Directors on the Boards of banks/DFIs should not appoint, at the bank's/DFI's expense, any advisor(s) to assist them in discharge of their duties / responsibilities as members of the Board of Directors of a bank/DFI. In case any Board member feels it necessary to appoint an advisor for his/her assistance, his/her remuneration/expenses shall be borne by the concerned Board member himself/herself. Furthermore, the advisor so appointed by the Board member shall be required to sign an appropriate confidentiality agreement to ensure confidentiality of documents / information that may come to his/her knowledge, before assuming any such role.

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.

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 the 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 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.

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-I

1997-1998	2004	2005	2006
Public Sector Com. 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 Alfalah 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 N.V. • Albaraka Islamic Bank B.S.C. • 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 AG • Doha Bank • Emirates Bank International • Habib Bank AG 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 Com. 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 Alfalah 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 Limited • NDLC-IFIC Bank Ltd. • Crescent Commercial Bank Ltd. • Habib Bank Ltd. • Dawood Bank Limited **C. Foreign Banks (11)** • ABN AMRO Bank N.V. • Albaraka Islamic Bank B.S.C. • American Express Bank Ltd. • The Bank of Tokyo – Mitsubishi • Citibank, N.A. • Deutsche Bank AG • 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)** • Zarai Taraqiati Bank Ltd. • Industrial Development Bank of Pakistan • Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks (35)** Include A + B + C **All Banks (38)** Include A + B + C + D	**A. Public Sector Com. 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. • My 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[5]. • MCB Bank Ltd. • Allied Bank Limited. • United Bank Ltd. • Meezan Bank Limited • NIB Bank Ltd. • Crescent Commercial Bank Ltd. • Habib Bank Ltd • Dawood Bank Ltd.[6] **C. Foreign Banks (11)** • ABN AMRO Bank N.V. • Albaraka Islamic Bank B.S.C. • American Express Bank Ltd [7]. • The Bank of Tokyo – Mitsubishi.[8] • Citibank N.A. • Deutsche Bank AG • Habib Bank AG Zurich [9] • The Hongkong & Shanghai Banking Corporation Ltd. • Oman International Bank S.A.O.G. • Rupali Bank Ltd.[10] • Standard Chartered Bank [11] **D. Specialized Banks (4)** • Zarai Taraqiati Bank Ltd. • Industrial Development Bank of Pakistan • Punjab Provincial Co-operative Bank Ltd. • SME Bank Ltd.[12] Commercial Banks (35) Include A + B + C **All Banks (39)** Include A + B + C + D	**A. Public Sector Com. Banks (4)** • National Bank of Pakistan • First Women Bank Ltd. • The Bank of Khyber • The Bank of Punjab **B. Local Private Banks (24)** • Askari Commercial Bank Ltd. • Bank Alfalah Ltd. • Bank AL Habib Ltd. • Mybank Limited • Faysal Bank Ltd. • Habib Metropolitan Bank Ltd. • KASB Bank Ltd. • Prime Commercial Bank Ltd. • Saudi Pak Commercial Bank Ltd • PICIC Commercial Bank Ltd. • Soneri Bank Ltd. • Standard Chartered Bank (Pakistan) Ltd. • MCB Bank Ltd. • Allied Bank Limited • United Bank Ltd. • Meezan Bank Limited • NIB Bank Limited • Crescent Commercial Bank Ltd. • Habib Bank Limited • Atlas Bank Limited. • Arif Habib Rupali Bank Ltd. • Dubai Islamic Bank Pakistan Ltd.[13] • BankIslami Pakistan Ltd.[14] • JS Bank Limited **C. Foreign Banks (7)** • ABN AMRO Bank N.V. • Albaraka Islamic Bank B.S.C. • Bank of Tokyo - Mitsubishi UFJ, Limited • Citibank N.A. • Deutsche Bank AG • The Hongkong & Shanghai Banking Corporation Limited • Oman International Bank S.A.O.G. **D. Specialized Banks (4)** • Zarai Taraqiati Bank Ltd. • Industrial Development Bank of Pakistan • Punjab Provincial Co-operative Bank Ltd. • SME Bank Limited **All Commercial Banks (35)** Include A + B + C **All Banks (39)** Include A + B + C + D

1. Union Bank Ltd was amalgamated with Standard Chartered Bank (Pakistan) Ltd on 29-12-2006.
2. The name of Dawood Bank Ltd. was changed to Atlas Bank Limited on 4-03-2006.
3. American Express Bank Ltd was merged with JS Bank Ltd. on 29-12-2006.
4. Habib Bank AG. Zurich was merged with Metropolitan Bank on 20-10-2006. The name of the merged entity is Habib Metropolitan Bank Ltd.
5. Rupali Bank Ltd. was amalgamated into Arif Habib Rupali Bank Limited w.e.f. 4-08-2006.
6. Standard Chartered Bank was amalgamated with Standard Chartered Bank (Pakistan) Ltd on 29-12-2006.
7. Dubai Islamic Bank Pakistan Limited started its operations March quarter of 2006.
8. Bank Islami Pakistan Limited started its operations during June quarter of 2006.