Quarterly
Performance Review of the Banking System
Quarter ended December-2002

STATE BANK OF PAKISTAN
Banking Supervision Department

Preface

A financially sound and dynamic banking system is a prerequisite for the sustained and balanced economic growth. The assessment of the soundness of the banking system and disclosure thereof, is gaining importance all over the world.

The underlying review for the quarter ended December 31, 2002, is aimed at promoting disclosure of information about the financial health of banking system.

The review is based on the un-audited reports viz. Quarterly Report of Condition and other data submitted by banks to the State Bank. The assessment of financial soundness has been made mainly using the micro-prudential indicators and wherever felt necessary the relationship with and/or impact of some of the macroeconomic variables on the banking system has also been discussed.

The publication of the Quarterly Review is a first attempt and any comments/views for further improvement would be welcomed.

JAMEEL AHMAD
DIRECTOR
Banking Supervision Department

The Team

Team Members

Muhammad Anwar Saeed

Amer Hassan

Junaid Ahmed

Zahid Mahmood

Bashir Ahmad

Rizwana Rifat

Naveed Lodhi

Team Leader

Jameel Ahmad

Contents

PERFORMANCE REVIEW OF THE BANKING SYSTEM
For the Quarter Ended December 31, 2002

The review covers the performance of and the developments which took place within the banking system during the quarter ended December 31, 2002. It is based on the Quarterly Reports of Condition (un-audited) of scheduled banks covering their domestic as well as overseas operations. The banks have been divided into three groups, namely Public Sector Banks (NCBs, Specialized and Provincial banks), Local Private Banks (Private and Denationalized Banks) and Foreign Banks. However, to give more accurate picture, in some sections Public Sector Banks have been further split into Public Sector Commercial Banks and Specialized Banks.

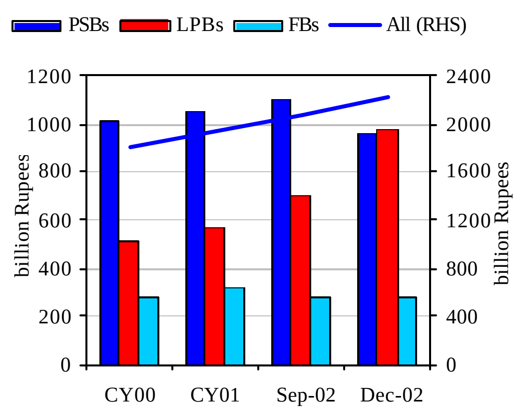
1 Overview

During the quarter under review the credit demand of private sector started to pick up and the loans of the banking system experienced an upsurge of Rs 77 billion to Rs 1,068.8 billion. On the other hand as a logical follow up of the rate cut, yields on government securities came down drastically which caused a slow down in the growth rate of investment portfolio of banks. The other notable development that has finally taken shape during the quarter was the privatisation of the United Bank Limited. With this change in ownership, the market share of local private banks has risen to 44 percent against 43 percent of public sector banks.

2 Sources and Uses of Funds

The total assets of the banking system recorded an impressive growth of Rs 128.7 billion or 6.2 percent over the last quarter to Rs 2,209 billion, which is almost equal to the combined growth for last three quarters of Rs 140.6 billion (see **Figure-2.1**). The growth may be termed strong but unlike last three quarters it has been significantly financed through borrowings that witnessed a growth of Rs 43.1

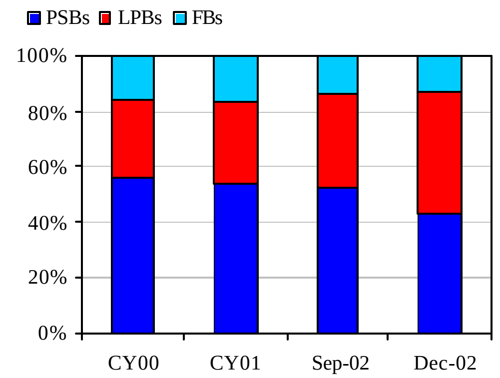
Figure 2.1: Assets of Banking Sector



billion or 17.1 percent. Deposits on the other hand managed an increase of Rs 46.2 billion to Rs 1,662.6 billion translating into a growth of 2.9 percent as compared to 3.5 percent in the last quarter. The larger part of these funds went on to finance loans that surged by Rs 77 billion. Increase in investments although still significant i.e. Rs 58.7 billion but fell short of previous quarters' average growth.

Sector-wise position shows the local private banks succeeded in increasing their share of the market with an over the quarter assets growth of Rs 87 billion[1] or 12.4 percent followed by public sector banks with Rs 32.9 billion or 3.6 percent (excluding UBL). The foreign banks, however, recorded a nominal growth in their assets mainly because of decline in their deposit base. The tremendous growth registered by local private banks, coupled with privatisation of UBL, helped them to increase their market share to 44 percent. (see **Figure-2.2)**.

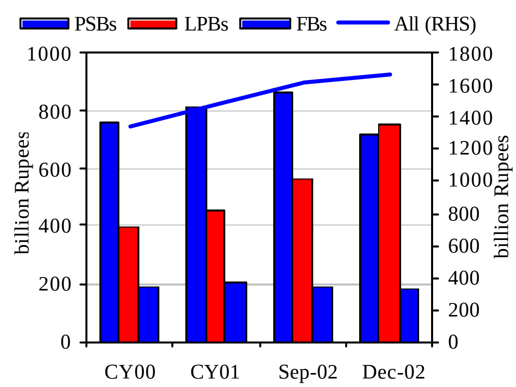
Figure 2.2: Group-wise Share in Total Asset



2.1 Deposits

The banking system continued to experience rise in deposits during the current quarter as well (see **Figure-2.3**). The persistent upward trend in workers' remittances from abroad appears to be the major factor. Total deposits of the banking system increased by Rs 46.2 billion from Rs 1,616.4 billion in the last quarter to Rs 1,662.6 billion in

Figure 2.3: Deposits of Banking Sector

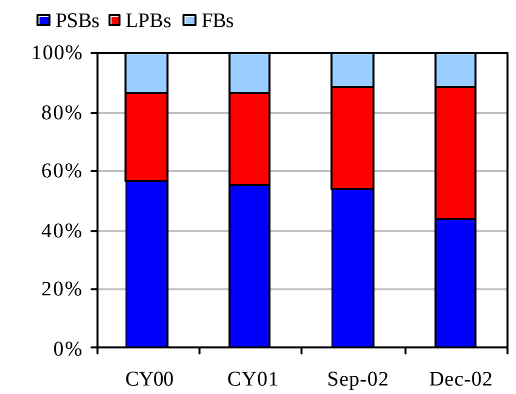


[1] Excluding UBL

the current quarter. Local private banks led this rise with more than 80 percent[2] of the increase. The expanding branch network, comparatively attractive rates and increasing confidence reposed by the public were the major factors for their enviable contribution. The public sector banks posted a modest growth in their deposit base whereas foreign banks under-performed during this period as their deposits shrank by Rs 3.3 billion.

On recording strong growth in their deposit base and privatisation of UBL, local private banks have emerged with 45.4 percent share of total deposits of the banking system as against 34.8 percent in the last quarter (see **Figure-2.4**). The public sector banks lost ground and their share decreased to 43.5 percent in the current quarter as against 53.6 percent in the last quarter. The share of foreign banks also dropped to 11.1 percent as of end December 2002 from 14.1 percent as of end December 2001.

Figure 2.4: Group-wise Share in Deposits



All the categories of customers' deposits witnessed increase during this quarter. The increase was, however, more pronounced in case of current account deposits, which rose from Rs 338.8 billion in the last quarter to Rs 370.7 billion in the current quarter.

2.2 Borrowings

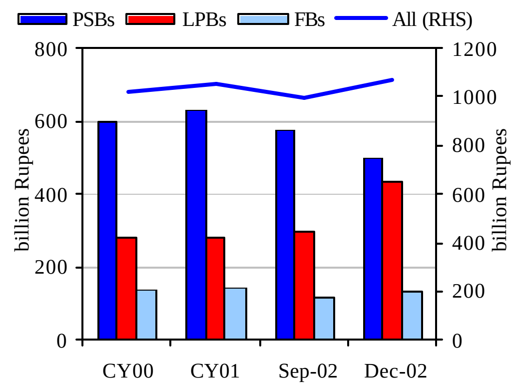
Total borrowings of the banking system increased by Rs 43.1 billion from Rs 251.8 billion in the last quarter to Rs 294.9 billion in the current quarter. This increase is almost equal to the increase in deposits and is surprising considering the fact that the market is teeming with liquidity. One possible explanation may be the speculative motive to capture the current return in the declining interest rates. The break-up shows that the borrowings against repurchase agreement were mainly responsible for this rise as call borrowings and export refinance borrowings from SBP contracted during the quarter.

[2] Excluding UBL

2.3 Loans

During the quarter under review, loans of banking sector showed a significant surge of Rs 77 billion (7.8%) to Rs 1068.8 billion – also exceeding the last year's corresponding quarter level by 1.5 percent (see **Figure-2.5**). The growth is the result of decline in the lending rates by the banks coupled with seasonal nature of credit demand that has a tendency of picking up from September. The increase was mainly witnessed in the category of loans, cash credit and running finance (see **Table-2.1**).

Figure 2.5: Loans of Banking Sector



Lately banks have started to venture into new areas of consumer financing, mortgage loans, lease finance etc. However total outstanding amount under these came to just Rs 18.7 billion or less than 2 percent of total loans outstanding as of 31st December 2002.

Table2.1: Composition of Loans of Banking Sector

billion rupees

	CY00	CY01	Sep-02	Dec-02
Loans/ cash credit/run fin.	941.2	971.8	907.1	978.9
Investment in fin. lease	0.8	0.9	4.9	4.8
Bills discounted/purchase	78.1	80.4	80.0	85.1
Total	1020.1	1053.1	992.0	1068.8

Out of total increase of Rs 77 billion, largest share of Rs 49.9 billion[3] went to local private banks. Foreign banks had a rise of Rs 13.8 billion in their portfolio. Public sector banks were almost flat with an increase of just Rs 8.4 billion.

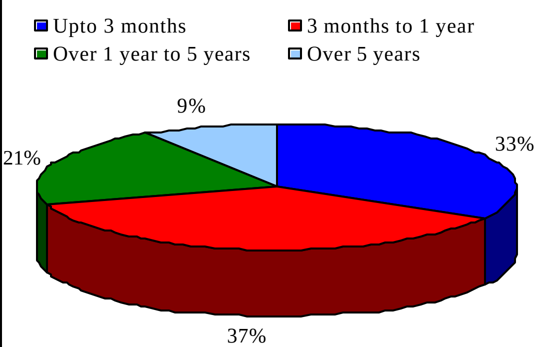
Recent rate cut brought about a reduction in average lending rates (1.58 percent) bolstering the credit pick up since. More interesting was the fact that rates have started coming off well before the last rate cut by SBP in Nov-02 (for this matter,

[3] Excluding UBL

they are on a downward trajectory since first quarter). The foreign banks were most aggressive as their rates came off by 235 basis points followed by domestic private banks with 170 basis points and privatised banks with 166 basis points over the last quarter. Nationalized banks were more reluctant initially, in fact for the first two months of the quarter their rates actually went up (from 11.62 percent to 12.18 percent), however the effect of last rate cut immediately translated into the lowering of their average lending rate to 10.80 percent by the end quarter under review (a decline of 148 basis point over the quarter).

Lending in foreign currency picked up momentum during this quarter. Loans in foreign currency now stood at Rs 148 billion (including overseas loans) up by Rs 30 billion over the previous quarter. With this increase, the share of foreign currency denominated loans rose to around 14 percent of total loans as of end of current quarter from 12 percent as of end of last quarter. Actually these are mainly the deposits under FE-25 that fuelled the momentum resulting in a win-win situation both for borrowers and the banks. Sector-wise position shows that local private banks led the way with their total portfolio (Fcy loan) at Rs 70.5 billion, up from Rs 56 billion as of last quarter. PSBs' portfolio of Rs 53 billion increased to Rs 66.4 billion. However, foreign banks showed an increase of just over Rs 2 billion.

Figure 2.6: Maturity Profile of Loans



The maturity profile of loans shows that major portion of the loans is maturing within one-year timeframe (see **Figure-2.6**). This is simply because banks are mainly providing working capital loans. Though they have recently been allowed to venture into housing finance, however, it will take some time to have any impact

Table 2.2: Industry-wise Exposure of Banking System

As of December 31, 2002

percent

Industry	**Exposure**
Textile	25.1
Agribusiness	8.6
Chemical & pharmaceuticals	4.0
Prod. & trans. of energy	2.5
Transportation, storage & communication	1.8
Sugar	1.6
Cement	1.6
Auto & transportation equipment	1.6

on their maturity profile.

The industry-wise distribution of loans of banking system shows that around 25 percent of the loans are concentrated in textile sector (see **Table-2.2**). It is, however, in line with the size and representation of textile sector in overall industrial sectors of the economy.

2.4 Investment

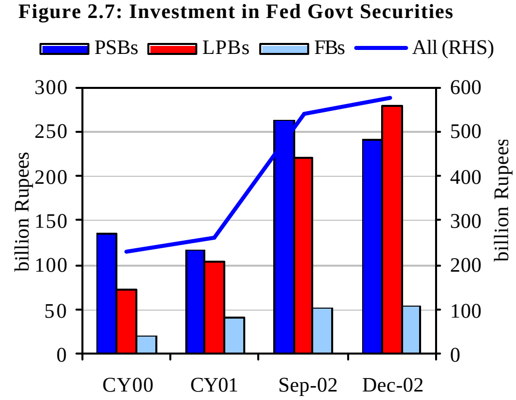
Continued with the previous stance of locking in more assets into investments, banks amassed another Rs 58.7 billion (including increase in surplus on revaluation) in their investment portfolio during the quarter under review (see **Table-2.3**). Investment in government securities being the major component of investment portfolio recorded an increase of almost two third of the total increase. Investment in government papers that remained the centre of activity since long have become relatively less attractive option for the banks after getting a big rate cut in November 2002. Consequently, the growth of investment during the quarter under review witnessed a slow down as compared to the first three quarters of the calendar year 2002 (see **Figure-2.7**). This may also be attributed to the squeezed auction targets in OMOs announced by SBP.

Table 2.3: Total Investment of Banking Sector

billion rupees

	CY00	CY01	Sep-02	Dec-02
Government papers				
MTBs	95.8	126.6	345.0	373.6
FIBs	84.0	53.1	45.7	40.2
PIBs	2.0	41.3	100.2	117.1
Provincial govt. securities	1.7	1.6	1.6	1.5
Others	46.8	40.0	47.0	44.9
Equity investment	16.0	25.4	29.7	24.8
TFCs, bonds, deben and PTCs	40.7	42.8	42.7	48.1
Others	23.9	23.6	20.0	24.0
Total investment	311.0	354.4	631.8	674.3
Provision/surplus/deficit	-6.6	-4.6	0.7	16.9
Total after provision/surplus/deficit	304.3	349.8	632.5	691.2

Figure 2.7: Investment in Fed Govt Securities



The scrip-wise position shows that investment in PIBs increased by around Rs 17 billion to Rs 117.1 billion over the last quarter. Even after the last discount rate cut when market rate started falling rapidly, investment in PIBs was the preferred strategy of the banks with a view to ensure the maximum return on their investment. Local private banks being the most aggressive in the stance reported an increase in their holding by Rs 11.8 billion or 22 percent (isolating UBL shift) over the last quarter. Foreign banks following the same move recorded an increase of Rs 3.1 billion to Rs 12.2 billion in December 02. Public sector banks, however, stayed almost at their previous level of holding as the reported decline was on account of transfer of UBL to local private banks.

The banks remained aggressive in holding the ample volume of MTBs. The fact is obvious in the bidding pattern of the banks whereby average-bidding volumes during the quarter stayed 270 to 300 percent of the auction targets announced by the SBP. This enthusiasm was mainly due to the excess liquidity in the market. As a result, banking sector posted an increase of Rs 28.6 billion to Rs 373.6 billion at the end of the quarter. The main influx to this is attributed to public sector banks that showed a growth of around 24 percent (excluding UBL). Local private banks seemingly reported an increase but this is only due to the shift of the UBL to private sector. Foreign banks were not keen in increasing their holding of MTBs as the same came off by Rs 0.6 billion.

Table 2.4: Banks' Exposure to Public Sector

Percent

	CY00	CY01	Sep-02	Dec-02
Public sector banks	39.5	37.2	48.8	51.5
Local private banks	33.6	37.6	49.2	39.8
Foreign banks	33.0	23.4	33.6	29.6
All banks	36.6	35.5	47.3	44.3

Source: Weekly Statement (domestic operations)

The high growth in the investment in government securities resulted in significant increase in the banks' exposure to public sector,[4] which rose to 47.3 percent[5] as of Sep-02 from 35.5 percent as of Dec-01 (see **Table-2.4**). The slow down in the growth of investment coupled with increase in credit to private sector during the quarter under review, however, brought down their exposure to 44.3 percent as of end December 2002. Nonetheless the ratio is still high. Isolating the investment in government securities, the banks' exposure to public sector came down by 3.7 percentage points to around 17 percent as of end December 2002.

[4] Loans and investment to public sector (PSEs, autonomous bodies, government/government securities).

[5] As percent of total loans and investment both to public sector and private sector.

3 Performance of Banking System

3.1 Capital Adequacy

All the banks under the capital enhancement plan were required to raise their respective capital base (paid-up capital net of losses) in two phases (Rs 750 million by 1st Jan-02 and Rs 1 billion by 1st Jan-03). Developments on this front showed a mixed picture. So far, of total 41 banks, 26 have met the requirement of Rs 1 billion. Of the remaining 15 banks, some are under the process of merger or liquidation, whereas others have been granted extension in meeting the requirement.

Paid-up capital of the banking system experienced a contraction of around Rs 23 billion over the last quarter (see **Table-3.1**). The said decline was, however, solely due to restructuring of UBL's balance sheet. The bank set off its accumulated losses of around Rs 25 billion against its paid-up capital reducing the capital to Rs 5.2 billion. The shifting of UBL into local private banks also caused a reduction in the paid-up capital of public sector banks. Though, foreign banks recorded an increase in their paid-up capital during the quarter under review but when compared with the corresponding quarter of last year, they experienced a contraction. But that was due to acquisition of two foreign banks by local private banks. The decline in the paid-up capital during the quarter under review, however, did not have any impact on the equity[6] of the banking system, which expanded by Rs 16 billion over the last quarter. The said increase in equity was mainly achieved through surplus on revaluation of assets due to conspicuous appreciation in the value of government securities in the wake of prevailing low yields and last interest rate cut by SBP.

Table3.1: Capitalization of the banking sector

billion rupees

	CY00	CY01	Sep-02	Dec-02
Paid-up-capital				
Public sector banks	49.4	52.0	59.9	29.8
Local private banks	11.6	14.1	17.6	24.1
Foreign banks	22.0	23.0	20.8	21.5
All banks	82.9	89.1	98.4	75.4
Equity				
Public sector banks	39.8	24.2	34.8	24.8
Local private banks	17.9	21.8	32.7	56.7
Foreign banks	24.6	27	27.3	29.6
All banks	82.2	73	94.8	111.2

6 Including surplus on revaluation of assets.

The capital adequacy ratio of the banking system witnessed a slight deterioration of 0.4 percentage points[7]. This, however, was solely due to specialized banks.

Table3.2: Capital Adequacy Indicators

percent

	CY00	CY01	Dec-02
Capital Adequacy Ratio (CAR)			
Public sector banks:			
PSCBs	10.4	9.6	11.4
Specialized Banks	-3.3	-13.9	-31.1
Local private banks	9.2	9.5	9.8
Foreign banks	18.0	18.6	21.9
All banks	9.74	8.76	8.4
All banks (excld. Spec.Banks)	11.4	11.3	12.2
No. of banks below 8 percent CAR			
Public sector banks:			
PSCBs	0	0	0
Specialized Banks	2	2	2
Local private banks	3	3	2
Foreign banks	0	0	0
All banks	5	5	4

Factoring out specialized banks, the capital adequacy ratio of the banking system ameliorated from 11.3 percent as of end Dec-01 to 12.2 percent as of end Dec-02. The public sector commercial banks and other two groups posted improvement over the last year (see **Table-3.2**). The improvement in the capital adequacy ratio of local private banks also resulted in reducing their number of non-compliant banks from 3 as of end December 2001 to 2 as of end of December 2002.

3.2 Non-Performing Loans

The NPLs of the banking system showed an increase of Rs 11.6 billion from Rs 232.6 billion as of September 30, 2002 to Rs 244.2 billion[8] as of December 31, 2002 (see **Table-3.3**). The single major contribution was that of Zarai Taraqiati Bank (ZTB) whose NPLs increased by Rs 12.6 billion during the quarter. This is because of the unique

Table 3.3: Non-performing Loans

Billion rupees

	CY01	Sep-02	Dec-02
NPLs			
Public sector banks	185.0	180.1	174.0
Local private banks	43.4	45.5	63.1
Foreign banks	7.8	7.1	7.1
All banks	236.2	232.6	244.2
Net NPLs			
Public sector banks	78.5	65.2	67.4
Local private banks	26.7	31.3	31.5
Foreign banks	1.4	1.6	1.6
All banks	106.6	98.2	100.5

[7] In Dec-02, the capital adequacy ratio of some of the banks is as of Jun -02, as their Dec-02 position is awaited.

[8] Domestic operations.

behaviour of ZTB's NPLs due to their seasonal lows and highs. Major portion of recovery is effected in the last quarter of their financial year causing substantial decline in the NPLs during the quarter ending June 30 and a rise in the quarter ending December 31 when recovery efforts are slack. NPLs involving overseas operations exhibit gradual reduction over the last few quarters. The current quarter saw a further decline of Rs 0.6 billion from Rs 31.4 billion as of September 2002 to Rs 30.8 billion. Comparing with the March 2002 position, the overall decline comes to around Rs 7 billion.

Isolating the shift of UBL from public sector banks to local private banks on its privatization, the sector-wise position shows that local private banks witnessed a slight increase of Rs 1.5 billion in their NPLs during the quarter under review whereas foreign banks remained almost static at around Rs 7 billion. The public sector banks though experienced an increase of Rs 10.8 billion but that was due to the increase in the NPLs of one of the specialized banks. Factoring out this, the public sector banks posted a decline of about Rs 2 billion in their NPLs during the quarter under review. The shift in the category of UBL, however, changed the above position significantly causing addition in the NPLs of local private banks with the corresponding reduction in the NPLs of public sector banks. Accordingly, their share mix also changed substantially. Nevertheless, public sector banks still held the major share of 71 percent of the total NPLs of the banking system followed by local private banks with 26 percent as compared to 77 percent and 20 percent respectively as of end of last quarter.

Table 3.4: NPLs Indicators

Percent

	CY01	Sep-02	Dec-02
NPLs to total loans			
Public sector banks	31.8	32.8	37.1
Local private banks	15.3	15.0	14.9
Foreign banks	5.3	6.1	5.1
All banks	23.3	24.0	23.7
Net NPLs to net loans			
Public sector banks	17.5	15.8	19.6
Local private banks	10.2	11.2	8.2
Foreign banks	1.0	1.5	1.2
All banks	12.6	12.2	11.7
Provision to NPLs			
Public sector banks	62.9	67.5	65.0
Local private banks	45.9	42.4	55.8
Foreign banks	84.1	80.4	80.8
All banks	60.4	62.7	63.1

The net NPLs [9] of all banks increased slightly by Rs 2.3 billion from Rs 98.2 billion in the last quarter to Rs 100.5 billion in the current quarter. The indicators measuring the asset quality displayed mixed picture (see **Table-3.4**). Net NPLs to

[9] Net of provision and mark-up in suspense account.

net loans ratio for all banks improved slightly from 12.2 percent in the last quarter to 11.7 percent in the current quarter. The local private banks brought about the major improvement in their ratio from 11.2 percent as of end of last quarter to 8.2 percent as of end of current quarter. The public sector banks, however, witnessed deterioration in the ratio from 15.8 percent in the last quarter to 19.6 percent in the current quarter. Again the single major element is the rise in the NPLs of ZTBs. Foreign banks saw a fractional improvement in this ratio.

The coverage ratio (provision to NPLs) of the banking system improved marginally from 62.7 percent in the last quarter to 63.1 percent in the current quarter. The ratio shows substantial improvement in case of local private banks that managed to increase it to 55.8 percent against 42.4 percent in the last quarter. The position in respect of public sector banks deteriorated as the ratio declined to 65 percent against 67.5 percent in the last quarter. The obvious reason is that provision against NPLs by ZTB did not change proportionately with the increase in its NPLs.

3.3 Profitability

Performance of the banking sector on profitability showed significant improvement, despite slack demand for credit for most of the period and ever-decreasing return on government papers (see **Table-3.5**). Year-to-date[10] provisional profit of the commercial banks was Rs 14.2 billion while specialized banks suffered a loss of Rs 1.1 billion[11]. Accordingly, return on assets and equity of commercial banks improved to 0.7 percent and 13 percent respectively in 2002 as compared to negative 0.01 percent and negative 0.3 percent respectively for the last year (see **Table-3.6**). The improvement in the profitability of commercial banks over the last year was the

Table 3.5: Profitability of Commercial Banks

billion rupees

	CY00	CY01	CY02
Profit before tax			
Public sector comm. banks	3.9	0.2	10.5
Local private banks	-0.6	5.0	10.8
Foreign banks	3.7	5.0	6.4
All Commercial banks	7.0	10.3	27.8
Profit after tax			
Public sector comm. banks	1.8	-4.6	4.8
Local private banks	-3.5	2.0	5.2
Foreign banks	1.4	2.4	4.1
All Commercial banks	-0.2	-0.2	14.2

[10] Calendar Year 2002.

[11] For the 1st two quarters (Sep. and Dec.02) of their financial year to be ended on 30th June, 2003.

result of increase in net interest income, non-interest income, effective control over administrative expenses and absence of extra ordinary expenses as in previous year in which one of the public sector banks provided heavy amount in respect of its non-recoverable assets.

Table 3.6: Earnings and Profitability Indicators

percent

	CY00	CY01	CY02
ROA			
Public sector comm. banks	0.2	-0.5	0.5
Local private banks	-0.7	0.4	0.7
Foreign banks	0.6	0.8	1.4
All Commercial banks	-0.01	-0.01	0.7
ROE			
Public sector comm. banks	4.9	-12.2	11.7
Local private banks	-17.4	10.2	13.4
Foreign banks	6.1	9.2	14.5
All Commercial banks	-0.3	-0.3	13.0
Net Interest Margin			
Public sector comm. banks	3.6	4.3	3.5
Local private banks	3.4	4.3	4.4
Foreign banks	3.2	3.3	3.0
All Commercial banks	3.5	4.2	3.8
Operating exp.to net interest income			
Public sector comm. banks	112.6	89.1	84.0
Local private banks	128.0	94.0	91.7
Foreign banks	109.9	94.0	78.7
All Commercial banks	117.0	91.4	87.0
Intermediation cost			
Public sector comm. banks	3.4	3.2	2.6
Local private banks	3.9	3.6	3.7
Foreign banks	2.9	2.5	2.1
All Commercial banks	3.4	3.2	2.9

The year 2002 experienced incessant decline in interest rates. This was punctuated by cuts in SBP discount rate twice during the year. In the last cut in the mid of the quarter under review, the rate was slashed by 150 basis points to a low level of 7.50 percent. Similarly return on government securities continued to slide. In response to this policy derive, lending rates came off significantly from 13.4 percent in Dec-01 to 10.3 percent in Dec-02, while lending spread shed to 6.7 percent (8.4 percent in Dec-01). Consequently, banks faced a significant decline in their interest income. However, they managed to post a higher net interest income on account of increased volume of earning assets. The availability of cheaper deposits also helped them reduce their cost of fund (deposits and borrowings) from 6 percent for the last year to 4.2 percent for 2002. Banks concentrated more on fixed income government securities that attracted the lion share of the increase in banking sector assets over the year. Since these assets fetched continually decreasing return, which coupled with lowered lending rates pulled down the NIM to 3.8 percent from 4.2 percent in Dec ember 2001.

As regards the non-interest income, the fee income increased by Rs 1.1 billion (9 percent) over the year. This fee based income formed 8.1 percent of total revenue

(6.8 percent in 2001). This improvement was, however, more than offset by decline of Rs 1.5 billion (17.9 percent) in income in dealing in foreign currency.

Marked decline in interest rates and upsurge in the capital market sentiment caused a significant appreciation in the values of securities. The situation enabled banks to record hefty capital gains on sale of investment. This gain contributed 2.4 percent of total revenues and 13.9 percent of profit before tax for the period.

Higher intermediation cost that is a cause of concern for banking industry has started to come down over the last few years (see **Table 3.6**). Banks managed to maintain this trend as intermediation cost came down to 2.9 percent in Dec 2002 (3.2 percent in Dec 2001).

Local private banks, which became the leader in terms of total assets after privatization of UBL during the quarter under review, were the major contributor towards total profit of banking sector with the figure of Rs 5.2 billion (ROA 0.7 percent). The sector not only managed to maintain the level of NIM but also improved upon non-interest income. However, their intermediation cost showed a slight deterioration that may be a corollary of expansion drives followed by some of the banks. Foreign banks with a net profit figure of Rs 4.1 billion and ROA of 1.4 percent continued to be impressive performer during this year also. Public sector commercial banks also showed positive results this year, and came up with a profit of Rs 4.8 billion (ROA 0.5 percent) as compared to loss of Rs 4.6 billion (ROA: -0.5 percent) in year 2001. This was made possible largely by better control on non-interest expenses and lower provisioning & extra ordinary expenses as compared to last year.

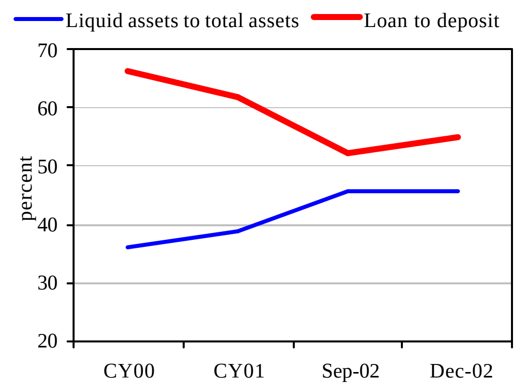
The financial year of specialized banks ends on June 30. During the 1st two quarters of their financial year 2002-3 they sustained a net loss of Rs 1.1 billion. However, this position shows improvement over their last year ended on June 30, 2002. During that year they suffered a huge loss of Rs 12.4 billion. The abnormal loss was the result of ongoing restructuring exercise at ZTBL resulting in a loss of Rs 10.4 billion to the bank in the form of fresh provisions provided against impaired assets.

The year 2003 is posing serious challenges to banking sector that is faced with altogether changed scenario. Banks are saddled with abundance of liquidity, while demand for credit from corporate sector is not so promising to absorb these funds. Investment in Govt. Securities that has so far been an easy and rewarding avenue for banks is also no more attractive, as the return of these securities has flattened. These developments are likely to squeeze the profit margin. Banking sector is left with no other options but to innovate and concentrate on non-fund based income and enterprise into new avenues of investments. Of late banks have started to venture into consumer finance, mortgage loans, leasing operations, and SMEs financing. This is a gradual and progressive process, as most of the banks have yet to develop expertise in these fields.

3.4 Liquidity and Sensitivity

Ample liquidity in the market is reflective of heavy inflows from abroad. During the quarter, though excessive over bidding pattern of the banks remained the market drift, heavy discounting from SBP window may reflect the tendency of the banks to lock in more into investments and encash the expected rate cut. However, with the rate cut of November 2002 market calmed down. However, a bit heavy discounting in the beginning of January 2003 may be on account of tax payments by the banks. Now, since mid of January 2003 market continued to be liquid whereby overnight rates came off substantially to the range of 0.5 -2.0 percent signifying more than double decline in the market rate as compared to discount rate. Consequently, latest issue of 6-months Tenor T-bill was traded at the lower levels of 1.65 - 1.85 percent, which gave a significant capital gain to the offering end of the trade. Likewise 12-months tenor T-bills were traded at the levels of 2.2 percent to 2.4 percent. In the bond market, 10-year PIB breached the level of 5 percent and activity was witnessed between levels of 4.65 to 4.80 percent. For PIBs of 3 and 5 years tenor rates ranged between 3.50 to 3.80 percent & 3.00 to 3.40 percent respectively. With the decline of more than 300 basis points in the market rate of Government securities as against a discount rate cut of 150 basis points, market may perceive further room for lowering the discount rate as an adjustment to cover the difference.

Figure 3.1: Liquidity Indicators



Liquidity indicators witnessed gradual improvement on account of liquidity influx (see **Figure-3.1**). Liquid assets as percentage of total assets improved considerably to 45.5 percent as against 38.8 percent in December 01. By the same token, loans as percentage of total deposits came off to 55 percent this quarter as against 61.7 percent of the corresponding quarter of last year. However, both the ratios recorded a slight deterioration over the last quarter. This, however, should be taken as a favourable development as banks have expanded their lending activities. The heavy investment in government securities increased the liquidity ratio of the banking system to 46.6 percent as of end current quarter against the required level of 20 percent as compared to 30.9 percent as of corresponding quarter of the last year.

The maturity profile of risk sensitive assets and risk sensitive liabilities show that banks are locking in their assets in longer term maturities and are running positive gaps except for the short period (three months) in the declining interest rate scenario. Sector-wise position shows that public sector banks are experiencing severe gaps for all the three periods, however cumulative gap remained within the acceptable range. By and large, local private banks and foreign banks managed to maintain the gaps within the acceptable range.