Quarterly
Performance Review of the Banking System
Quarter ended March - 2003

# STATE BANK OF PAKISTAN
## Banking Supervision Department

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## PERFORMANCE REVIEW OF THE BANKING SYSTEM
## For the Quarter Ended March 31, 2003

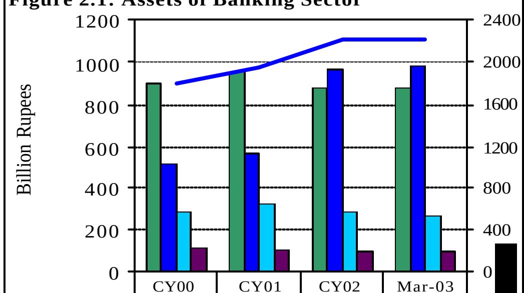
### 1 Overview

The banking sector remained on the profitability track even in the face of sharp decline in interest rates. This phenomenon is the reflection of banks' ability to pass on the effects of rate cuts to depositors and the ample liquidity that enabled the banks to finance increased level of earning assets at low costs. This development took place amid an incessant inflow of deposits - Rs 59.8 billion or 3.5 percent over the quarter that even surpassed the previous quarter's growth rate of 2.9 percent. Flush liquidity kept the inter-bank market calm with inter-bank spread coming down and a few visits to the SBP discount window. Loans that took an appreciable surge during previous quarter registered a marginal decline, while investment followed the increasing trend and left the asset base of the industry slightly higher than the previous quarter's level. The decline in the level of loans may be attributed to the seasonal retirement of commodity operation loans. Solvency of the banking sector shows signs of improvement, as equity support towards total asset base increased by 10 basis points to 4.9 percent, while the latest capital adequacy statistics show a marked improvement in market share of the banks with stronger adequacy ratios. Gradual amelioration in asset quality got a further push during the quarter in the form of improvement in NPLs indicators.

## 2 Sources and Uses of Funds

The swift expansion in the balance sheet of the banking system eased off during the quarter under review as the total assets increased marginally by Rs 1.9 billion or 0.1 percent to Rs 2,227.1 billion **(see Figure-2.1)**. Deposits, which were singularly responsible for the steep rise in the previous quarters, kept their upward momentum and increased by another Rs 59.8 billion. However, significant decline in borrowings by Rs 31.7 billion during the current quarter mainly accounted for this slow-down and dampened the effect of deposits growth. In fact the decrease in borrowings was more pronounced at Rs 46.6 billion for commercial banks. Specialized banks, however, contained the decline as they further increased their borrowings by Rs 14.9 billion. Unlike the last quarter, the increase in deposits went on to finance investments as loans witnessed a decline during this period.

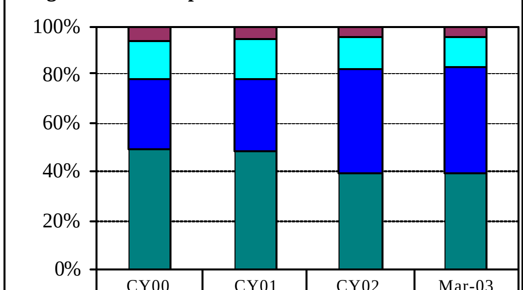
**Figure 2.1: Assets of Banking Sector**




| | CY00 | CY01 | CY02 | Mar-03 |
|---|---|---|---|---|
| PSCBs | 902.0 | 946.5 | 877.6 | 878.0 |
| LPBs | 513.5 | 565.9 | 968.3 | 983.1 |
| FBs | 280.6 | 323.7 | 280.9 | 265.9 |
| SBs | 111.5 | 106.2 | 98.5 | 100.2 |
| All | 1,807.6 | 1,942.3 | 2,225.2 | 2,227.1 |

The persistent increase in total assets of local private banks was the main determinant of the growth of total assets of the banking system. They captured market share from FBs as the latter experienced a reduction of Rs 15.1 billion in their asset base (**see Figure-2.2**). The other two groups recorded a marginal increase in their total assets.

**Figure 2.2: Group-wise Share in Total Assets**

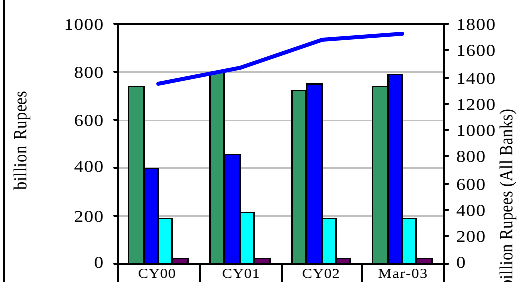



| | CY00 | CY01 | CY02 | Mar-03 |
|---|---|---|---|---|
| SBs | 6.2 | 5.5 | 4.4 | 4.5 |
| FBs | 15.5 | 16.7 | 12.6 | 11.9 |
| LPBs | 28.4 | 29.2 | 43.5 | 44.1 |
| PSCBs | 49.9 | 48.8 | 39.4 | 39.4 |

## 2.1 Deposits:

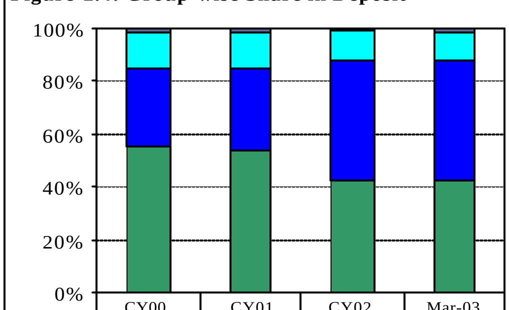
Amid the incessant inflow of funds an interesting development was going almost unnoticed - the decline in foreign currency deposits. Although foreign currency accounts were on the decline from the fourth quarter of 2001 but pace witnessed over last quarter was unprecedent i.e. a reduction of Rs 39.7 billion or 12.2 percent over the quarter. A combination of factors including repatriation of FE-45, reduction in both overseas and domestic FCY deposits portfolio went on to explain this decline. While FE-45 deposits were contractual, the fall in domestic foreign currency deposits was probably indicative of shifting of investors' preference to other avenues like stocks and real estate etc., as interest on these deposits came to naught in real terms (even negative). On this score, public sector commercial banks led the way with an overall reduction of Rs 29.9 billion followed by foreign banks by Rs 6.3 billion and LPBs by Rs 3.4 billion.

**Figure 2.3: Deposits of Banking Sector**




| | CY00 | CY01 | CY02 | Mar-03 |
|---|---|---|---|---|
| PSCBs | 743.7 | 795.2 | 721.9 | 742.2 |
| LPBs | 394.2 | 453.7 | 754.2 | 790.5 |
| FBs | 187.4 | 207.8 | 184.1 | 185.4 |
| SBs | 15.6 | 18.0 | 16.4 | 18.1 |
| All | 1,340.9 | 1,474.7 | 1,676.5 | 1,736.3 |

**Figure-2.4: Group-wise Share in Deposit**



| | CY00 | CY01 | CY02 | Mar-03 |
|---|---|---|---|---|
| SBs | 1.2 | 1.2 | 1.0 | 1.0 |
| FBs | 14.0 | 14.1 | 11.0 | 10.7 |
| LPBs | 29.4 | 30.8 | 45.0 | 45.5 |
| PSCBs | 55.5 | 53.9 | 43.1 | 42.7 |

On overall terms, deposit base went up by another Rs 59.8 billion or 3.5 percent, up from 2.9 percent growth in preceding quarter, which further aggravated the liquidity management problem for the banking sector **(see Figure-2.3)**. Local private banks spearheaded the increase by adding Rs 36.3 billion to their deposit base followed by PSCBs with an increase of Rs 20.3billion and foreign banks by Rs 1.3 billion.

Category-wise, saving and current accounts recorded an increase of Rs 82.1 billion and Rs 10.2 billion respectively. Fixed deposits came off by Rs 6.7 billion mainly because of decline in fixed deposits of foreign banks by Rs 15.5 billion or 25.3 percent which offset the increase in the fixed deposits of PCSBs and LPBs. Inter-bank deposits also decreased in a big way i.e. by Rs 28 billion, a logical consequence of flush liquidity in the banking system. As for the share, LPBs had a share of 45.5 percent, PSCBs 42.7 percent and the rest belonged to foreign banks and specialized banks

### 2.2 Borrowings

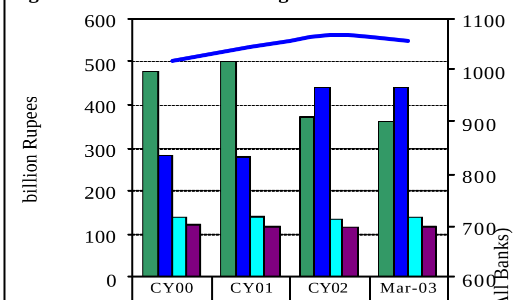
Borrowings had overall decline of Rs 31.7 billion or 11.4 percent to Rs 246.5 billion of all banks at the quarter end. Abrupt yield adjustment continued in this quarter as well although it failed to entice any speculative bidding from banks that seemingly carried a neutral outlook. A decrease of Rs 41.3 billion in repurchase borrowings to Rs 77.8 billion at the end of the quarter should be seen in this context. The decline was observed across all groups with the heaviest adjustment taking place in LPBs, a decline of Rs 19.6 billion or 31.5 percent. Call borrowings too came off by Rs 5.9 billion from Rs 27.4 billion a quarter ago so did export re-finance from Rs 45.7 billion to 41.6 billion. The said decline, however, has its root in banks' increasing appetite for substituting their own funds with that of SBP for trade financing.

### 2.3 Loans

Contrary to the expectations total loans of the banking system recorded a decline of around Rs 9 billion from Rs 1,065 billion in the previous quarter to Rs 1,056 billion as of end current quarter **(see Figure-2.5)**. On the face of it, this development may seem unusual considering the very low interest rate regime and attempts by the policy makers to give a boost to the economy. In fact the seasonal retirement of loans for commodity operations by Rs 18 billion as well as fall in lending to public sector enterprises by Rs

7 billion contributed largely to the decline, obscuring the improvement in lending to private sector by Rs 3.8 billion. The five largest banks mainly accounted for this decline as they finance most of these operations. The group-wise analysis reveals that public sector commercial banks and local private banks together saw a reduction of Rs 12.5 billion. However, it was largely by virtue of increase in loans of specialized banks, which restricted the decline to Rs 9 billion. Foreign banks fractionally increased their loans during the quarter.

**Figure 2.5: Loans of Banking Sector**




| | CY00 | CY01 | CY02 | Mar-03 |
|---|---|---|---|---|
| PSCBs | 475.7 | 501.0 | 374.2 | 362.1 |
| LPBs | 282.2 | 281.2 | 438.9 | 438.5 |
| FBs | 138.3 | 143.4 | 135.4 | 136.2 |
| SBs | 123.9 | 118.4 | 117.0 | 119.4 |
| All | 1,020.1 | 1,043.9 | 1,065.4 | 1,056.1 |

It may also be pertinent to point out that the private sector borrowers today have many alternative sources of funds i.e. their internal cash generation due to higher corporate earnings, capital markets funds (issuance of TFCs), repatriation of export proceeds previously kept abroad etc.

Banks are trying to fill the gap created by the low demand from traditional sources by venturing into hitherto untapped areas. Appreciable growth in consumer financing is testimony to this drive toward asset diversification. This has helped salvage the position to some degree as the loans to corporate sector increased modestly during the period under review (**Table 2.1**). The growth in consumer finance and agriculture finance is in

**Table- 2.1: Sector-wise Break Up of Loans**

Rs in billion

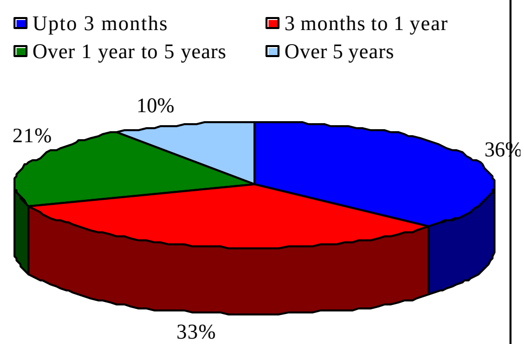
| | Dec-02 | Mar-03 | Change | Percent change |
|---|---|---|---|---|
| Corporate Sector | 542.5 | 549.4 | 6.9 | 1.3 |
| SMEs | 170.0 | 162.2 | -7.7 | -4.5 |
| Agriculture | 120.9 | 123.2 | 2.3 | 1.9 |
| Consumer Finance | 22.6 | 26.5 | 3.9 | 17.3 |
| *Credit Cards* | *6.1* | *6.0* | *-0.1* | -1.2 |
| *House Loans* | *1.9* | *2.1* | *0.2* | 10.5 |
| *Auto Loans* | *8.3* | *10.5* | *2.2* | 26.0 |
| *Other* | *6.3* | *7.9* | *1.6* | 26.4 |
| Others * | 209 | 195 | -14.42 | -6.7 |
| **Total** | **1,065** | **1,056** | **-9.0** | **-0.8** |

* Including Overseas Operations

line with the greater emphasis laid on these sectors in recent times. The decline in loans to SMEs may be because of low expertise of the banking system as well as asymmetrical information regarding this sector.

Among consumer financing, the housing finance increased by around 11 percent over the quarter. However, the level of housing finance so far is too low to have any significant impact on the maturity profile of loans (**see Figure 2.6**)

**Figure 2.6: Maturity Profile of Loans**




Following easy monetary policy SBP applied gradual cuts in its discount rates as well as return on MTBs and PIBs to induce the banks to reduce their lending rates for giving impetus to credit growth. The **table 2.2** shows the declining interest rate scenario since CY-00 on all instruments and schemes. The lending rates had started to reduce from the very first quarter of the CY-02 and during the current quarter weighted average lending rates of banks declined by another 205 basis points. All groups slashed their lending rates. However, privatized banks effected the largest cut by 270 basis points followed by private domestic banks by 198 basis points. Foreign banks still have the lowest weighted average lending rates at 6.9 percent as

**Table- 2.2: Interest Rate Structure** Percent

| | CY00 | CY01 | CY02 | Mar03 |
|---|---|---|---|---|
| Discount Rate | 13.00 | 10.00 | 7.50 | 7.50 |
| W. A. Lending Rates | 13.88 | 13.40 | 10.31 | 8.26 |
| W.A. Deposit Rates | 5.23 | 4.96 | 3.60 | 2.81 |
| Export Finance Rate | 8.00 | 10.00 | 7.00 | 5.00 |
| Export Refinance Rate | 6.00 | 8.50 | 5.50 | 3.50 |
| $ Export Rate | 0.00 | 5.65 | 3.84 | 3.84 |
| PIB rates | | | | |
| 3y | 12.50 | 10.50 | 7.00 | 7.00 |
| 5y | 13.00 | 11.00 | 8.00 | 8.00 |
| 10y | 14.00 | 12.00 | 9.00 | 9.00 |
| T. Bill Rate wt.avg | | | | |
| 3m | 10.23 | 7.65 | 3.90 | 1.96 |
| 6m | 10.96 | 7.93 | 4.32 | 2.09 |
| 12m | 11.49 | 8.40 | 4.36 | 2.66 |
| T. Bill Rate cut off | | | | |
| 3m | 10.23 | 7.65 | 3.90 | 2.00 |
| 6m | 10.96 | 7.93 | 4.32 | 2.16 |
| 12m | 11.49 | 8.40 | 4.36 | 2.75 |

compared to other sectors due to relatively lower intermediation cost. However, their focus on select customers prevents significant loans growth.

The relative share of different industries in total loans shows predominance of textile sector at 25 percent followed by agribusiness at 10 percent (**see Table-2.3**). The rest of the loan portfolio of the banking system is fairly diversified and apart from sporadic changes in some sectors the overall scenario exhibits little change.

**Table-2.3: Industry-wise exposure of banking system**

(Percent)

| **Industry** | **Exposure** |
|---|---|
| Textile | 25 |
| Agribusiness | 10 |
| Individuals | 8 |
| Public sector commodity operations | 5 |
| Chemical & Pharmaceuticals | 4 |
| Production & Transmission of energy, oil & gas | 4 |
| Trading & commerce | 4 |
| Automobile, transportation & communication | 3 |
| Sugar | 3 |
| Cement | 2 |
| Shoes & leather | 1 |
| Electronics & electrical appliances | 1 |
| Others | 32 |

## 2.4 Investments

Investments continue to be the focus of the banking system and increased by another Rs 51.7 billion **(see Table 2.4)**. The excess liquidity in the system forces banks to invest in government papers despite significant rate cuts. All the instruments recorded increase, however the Federal Government securities accounted for the most of the increase **(see Figure 2.7)**. The local private banks followed by public sector commercial banks had a dominant share in the total increase. Foreign banks, however, witnessed a decline apparently because of the shrinking size of their balance sheet.

A review of investment growth over the last few quarters shows that the investments are rising on a decelerated pace. The role of rate cuts notwithstanding, the low auction targets and amounts accepted by the SBP also restricted what otherwise would have been significant increase of investments.

A noticeable development of the quarter is comparatively lower investment in PIBs, which recorded a modest increase of Rs 5.6 billion as against the upsurge of Rs 17 billion in the last quarter. On the other hand, investment in MTBs swelled by Rs 43.9 billion constituting the bulk of the increase in investments in the government securities.

The sector-wise share in the growth of the government securities reveals that local private banks were chiefly responsible for the increase in PIBs and MTBs.

The **Table 2.5** indicates predicament of the banking system. A fractional increase in all banks' exposure to public sector during the

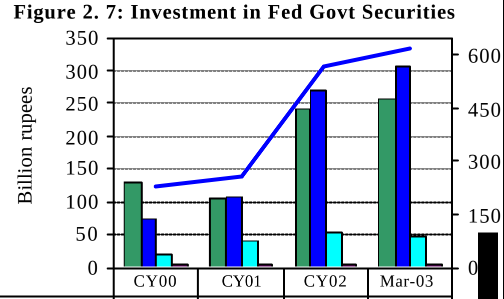
**Table-2.4: Total Investment of banking sector**

Billion rupees

| | CY00 | CY01 | CY02 | Mar03 |
|---|---|---|---|---|
| Government papers | | | | |
| MTBs | 95.8 | 126.6 | 373.9 | 417.8 |
| FIBs | 84.0 | 53.9 | 42.2 | 28.2 |
| PIBs | 2.0 | 42.0 | 116.7 | 122.3 |
| Provincial Govt. Securities | 1.7 | 1.6 | 1.4 | 1.5 |
| Others | 46.8 | 36.9 | 40.2 | 48.7 |
| Equity investment * | 16.0 | 25.4 | 29.0 | 33.9 |
| TFCs, bonds, debentures and PTCs | 40.7 | 49.0 | 55.5 | 59.5 |
| Others | 23.9 | 20.5 | 19.8 | 22.4 |
| Total investment | 311.0 | 356.0 | 678.6 | 734.4 |
| Provision/surplus/deficit | -6.6 | -5.0 | 22.9 | 18.8 |
| Total after provision/surplus/deficit | **304.3** | **351.1** | **701.5** | **753.2** |

*Including Investment in Subsidiaries and associate undertakings

**Figure 2. 7: Investment in Fed Govt Securities**




| | CY00 | CY01 | CY02 | Mar-03 |
|---|---|---|---|---|
| PSCBs | 129.8 | 106.2 | 242.7 | 256.5 |
| LPBs | 72.9 | 108.0 | 270.4 | 306.9 |
| FBs | 20.0 | 41.0 | 55.2 | 47.9 |
| SBs | 5.8 | 4.3 | 4.7 | 5.7 |
| All | 228.6 | 259.5 | 573.0 | 617.0 |

**Table- 2.5: Banks' Exposure to Public Sector** Percent

| | **Cy00** | **CY01** | **CY02** | **Mar-03** |
|---|---|---|---|---|
| Credit | 19.3 | 20.7 | 16.9 | 15.3 |
| Total (Credit+Govt. paper) | 36.6 | 35.5 | 44.3 | 45.0 |

Source: Weekly Statement

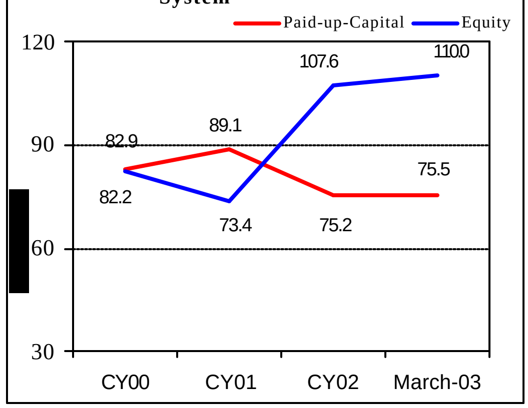
current quarter notwithstanding the fall in credit (loans + other investments) to public sector indicates insufficient niches to channel funds forcing banks to rest their excess liquidity in the government securities.

## 3 Performance of Banking System

### 3.1 Capital Adequacy

The banking system continued to strengthen its capital base during the quarter under review through fresh injection and profitable operations. Besides, merger and consolidation process is also going on. As a result, the number of banks deficient in meeting the minimum capital requirement of Rs 1 billion reduced to fourteen from sixteen as of end of last quarter.

**Figure-3.1: Capitalization of Banking System**




The equity of the banks grew by 2.2 percent to Rs 110 billion as of end of current quarter. The banking system had been experiencing negative gap between its paid-up capital and equity since long due to heavy accumulated losses particularly of government owned banks. During last year this gap turned into positive. The turnaround was achieved on the back of good operating results, substantial surplus on revaluation of securities and netting of large accumulated loss by UBL against its paid-up capital. During the quarter under review the positive gap between paid-up capital and equity further widened (see Figure-3.1).

The group-wise position shows that highest increase of around Rs 3 billion was made by local private banks in their equity followed by PSCBs. Both the foreign banks and specialized banks suffered contraction in their equity. However, their reasons were altogether different. The specialized banks had unprofitable operations whereas some of the foreign banks repatriated part of their surplus assigned capital and reserves. The shrinkage of Rs 1.8 billion in the equity of foreign banks will not impair their already high capital adequacy ratio as their asset base at the same time reduced by around eight times of decline in their equity.

Based on latest risk-adjusted capital position[2], the capital adequacy ratio of the banking system (excluding specialized banks) improved by 1.3 percentage points to 12.6 percent as of end December-02 **(see Table 3.1)**. The improvement, amidst strong growth in asset base during last year, was due to capital strengthening and change in risk profile of assets. Among assets, the major increase was witnessed in government papers, which attract zero risk weight. The highest improvement was made by the foreign banks followed by public sector commercial banks. On individual basis, most of the banks improved their capital adequacy ratio in a quest of strengthening their capital base. As a result, banks moved to higher buckets of CAR and the number of banks not meeting minimum threshold of 8 percent reduced to four **(see Table-3.2)**. The shifting of two large banks to the higher bucket of over 15 percent increased the market share of banks falling in this band to 46 percent from just 14 percent a year ago. The increase provided significant comfort to the solvency of the banking system. The non-

**Table3.1: Capital Adequacy Indicators**

Percent

| | CY00 | CY01 | CY02 |
|---|---|---|---|
| ***Capital Adequacy Ratio (CAR)*** | | | |
| Public Sector Commercial Banks | 10.4 | 9.6 | 12.3 |
| Specialized Banks | (3.3) | (13.9) | (31.7) |
| Local private banks | 9.2 | 9.5 | 9.7 |
| Foreign banks | 18.0 | 18.6 | 23.2 |
| All banks | 9.74 | 8.76 | 8.8 |
| All banks (excld. Spec.Banks) | 11.4 | 11.3 | 12.6 |
| ***Tier 1 Capital to Total Assets*** | | | |
| Public Sector Commercial Banks | 2.7 | 2.6 | 2.8 |
| Specialized Banks | (2.7) | (10.9) | (24.5) |
| Local private banks | 3.8 | 3.8 | 2.9 |
| Foreign banks | 8.5 | 8.1 | 10.0 |
| All banks | 3.6 | 3.1 | 2.5 |
| All banks (excld. Spec.Banks) | 4.0 | 3.9 | 3.8 |

**Table 3.2: Distribution of Banks According to Capital Adequacy Ratio with Market Share**

| Capital Adequacy Ratio | Below 8 percent | 8 percent to 10 percent | 10 percent to 15 percent | Over 15 percent |
|---|---|---|---|---|
| CY00 | 5 (13.4 %) | 6 (31.6 %) | 16 (45.0 %) | 17 (10.0 %) |
| CY01 | 5 (12.2 %) | 5 (38.7 %) | 11 (34.9 %) | 22 (14.2 %) |
| CY02 | 4 (10.1%) | 4 (31.1 %) | 9 (12.7 %) | 23 (46.2 %) |

[2] Capital Adequacy position is received on half-yearly basis.

compliant banks represented around 10 percent of the total assets of the banking system. One of them is in a process of raising its paid-up capital to meet the minimum requirement whereas other three are undergoing restructuring process.

To evaluate the capital adequacy as of end of current quarter, we can use the indicator of capital to total assets. The soundness ratio of the banking system worked out to 4.9 percent as of end of current quarter (**see Table-3.3**). The ratio is above the internationally accepted benchmark of 3 percent and also shows improvement over the last year's ratio of 4.8 percent and 3.8 percent in 2001.

**Table-3.3 Capital to Total Assets**

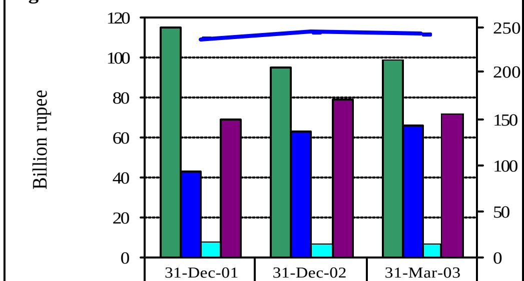
*Percent*

| | CY00 | CY01 | CY02 | Mar03 |
|---|---|---|---|---|
| Public Sector Comm. Banks | 4.6 | 3.7 | 5.6 | 5.8 |
| Specialized Banks | (1.1) | (10.3) | (23.0) | (22.6) |
| Local private banks | 3.5 | 3.8 | 5.3 | 5.5 |
| Foreign banks | 8.8 | 8.5 | 10.6 | 10.5 |
| All banks | 4.6 | 3.8 | 4.8 | 4.9 |
| All banks (excld. Spec.Banks) | 4.9 | 4.6 | 6.1 | 6.2 |

## 3.2 Non-performing Loans

Non-performing loans of the banking system recorded a decline of Rs 2 billion from Rs 244.2 billion as of December 31, 2002 to Rs 242.2 billion as of March 31, 2003 **(see Figure 3.2)**. The decline might have been greater had there been no increase in the NPLs of two banks, each from PSCBs and LPBs. The role of specialized banks was significant in the decline as they reduced their NPLs by Rs 7.5 billion not only because of cash recovery but also because of transfer of some of the NPLs to CIRC.

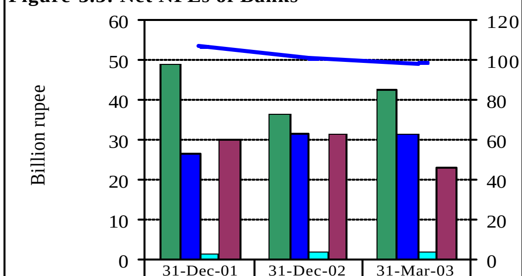
**Figure-3.2: Total NPLs of Banks**




| | 31-Dec-01 | 31-Dec-02 | 31-Mar-03 |
|---|---|---|---|
| PSCBs | 115.4 | 95.3 | 98.6 |
| LPBs | 43.4 | 63.1 | 65.5 |
| FBs | 7.8 | 7.1 | 6.9 |
| SBs | 69.6 | 78.8 | 71.3 |
| All (RHS) | 236.1 | 244.2 | 242.2 |

The net NPLs of the banks also showed a decrease of Rs 2.2 billion during the quarter from Rs 100.5 billion as of December 31, 2002 to Rs 98.3 billion as at the quarter ended on March 31, 2003 **(see Figure 3.3)**. Of course the specialized banks, here too, with Rs 7.9 billion reduction remained major contributor with fractional reduction by LPBs and FBs.

**Figure-3.3: Net NPLs of Banks**




| | 31-Dec-01 | 31-Dec-02 | 31-Mar-03 |
|---|---|---|---|
| PSCBs | 48.7 | 36.4 | 42.4 |
| LPBs | 26.7 | 31.5 | 31.4 |
| FBs | 1.4 | 1.6 | 1.5 |
| SBs | 29.8 | 31.0 | 23.1 |
| All (RHS) | 106.6 | 100.5 | 98.3 |

Naturally, the improvement in NPLs also translated positively into the corresponding asset quality indicators where infection ratios viz. (a) NPLs to total loans ratio declined marginally from 23.7 percent as of December 31, 2002 to 23.6 percent as at March 31, 2003 and (b) net NPLs to net loans ratio reduced marginally from 11.7 percent to 11.5 percent during the same period **(see Table-3.4).**

The coverage ratio (provisions to gross NPLs) of the banking sector hovers around 63 percent. However, in depth analysis shows that the ratio improved substantially in case of specialized banks, which increased from 63.7 percent as of December 31, 2002 to 70.4 percent as of end of current quarter. In case of PSCBs, however, the ratio deteriorated from 66.1 percent to 61.7 percent. This is mainly because of one of the public sector banks did not make adequate provisions against increased NPLs.

**Table-3.4: NPLs Indicators**

Percent

| | Dec01 | Dec02 | Mar03 |
|---|---|---|---|
| ***NPLs to total loans*** | | | |
| Public Sector Com. Banks | 23.3 | 28.0 | 29.1 |
| Specialized Banks | 81.0 | 61.1 | 56.6 |
| Local Private Banks | 15.3 | 14.9 | 15.4 |
| Foreign Banks | 5.3 | 5.1 | 5.0 |
| All Banks | 23.3 | 23.7 | 23.6 |
| ***Net NPLs to net loans*** | | | |
| Public Sector Com. Banks | 11.9 | 13.5 | 15.6 |
| Specialized Banks | 73.1 | 41.7 | 32.4 |
| Local Private Banks | 10.2 | 8.2 | 8.1 |
| Foreign Banks | 1.0 | 1.2 | 1.1 |
| All Banks | 12.6 | 11.7 | 11.5 |
| ***Provisions to NPLs*** | | | |
| Public Sector Com. Banks | 64.3 | 66.1 | 61.7 |
| Specialized Banks | 60.2 | 63.7 | 70.4 |
| Local Private Banks | 45.9 | 55.8 | 55.6 |
| Foreign Banks | 84.1 | 80.8 | 81.1 |
| All Banks | 60.4 | 63.1 | 63.2 |

The lower decline in the NPLs shows that the write-off guidelines are yet to have any sizable impact on the NPLs portfolio. The information as of end June 2003 shows settlement of 28,094 cases with outstanding amount of Rs 17.9 billion of all banks. Their impact would become visible once the operational time lag elapses, which would help reduce the NPLs of the banking system.

No doubt the decline in NPLs is somewhat sluggish, however the very fact there is no further rise is very encouraging. This is largely because of prudent lending with low NPL (5 percent) on a flow basis in recent years. The slow but steady decline, strict regulatory watch as well as restructuring process of the institutions that are mainly having massive portfolio of bad loans, creates optimism for further reduction not in a very distant future.

## 3.3 Profitability

After showing commendable operating performance in 2002, the commercial banks managed to keep the momentum in the first quarter (Jan-March) of 2003 as well. They posted an aggregate pre tax profit of Rs 10.6 billion (after tax profit of Rs 6.6 billion) that was 36.6 percent of the pre tax profit for last year. Accordingly Return on Assets (ROA) rose to 1.2 percent from 0.8 percent in 2002, while Return on Equity (ROE) surged to 20.0 percent from 13.8 percent in 2002 (**see Table 3.5 and 3.6**)[3].

**Table 3.5: Profitability of Commercial Banks**

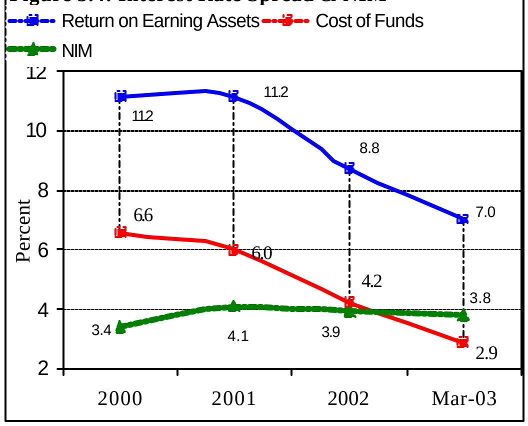
Billion rupees

| | CY00 | CY01 | CY02 | Mar03 |
|---|---|---|---|---|
| ***Profit before tax*** | | | | |
| Public sector comm. banks | 3.9 | 0.2 | 10.9 | 2.9 |
| Local private banks | -0.6 | 5.0 | 11.3 | 5.4 |
| Foreign banks | 3.7 | 5.0 | 6.6 | 2.2 |
| All Commercial banks | 7.0 | 10.3 | 28.9 | 10.6 |
| ***Profit after tax*** | | | | |
| Public sector comm. banks | 1.8 | -4.6 | 4.8 | 1.7 |
| Local private banks | -3.5 | 2.0 | 5.9 | 3.4 |
| Foreign banks | 1.4 | 2.4 | 4.2 | 1.5 |
| All Commercial banks | -0.3 | -0.2 | 14.8 | 6.6 |

The factors that contributed towards the improved profitability position remained the same as for the last year, namely higher level of earning assets and gains on sale of securities that started to emerge in the wake of low interest rate scenario from the last quarter of 2002.

The incessant-rate-decline phenomenon that set in during the last year and was further precipitated by SBP rate cut in November 2002 continued to affect the banking sector in the quarter under review as well. Return on earnings assets witnessed a sharp decline by 180 basis

**Figure 3.4: Interest Rate Spread & NIM**




[3] Profitability ratios for March-03 are annualized.

points to 7.0 percent as compared to 8.8 percent in 2002. However, this decline in return got some consolation from 130 basis points fall in cost of funds from 4.2 percent for 2002 to 2.9 percent that enabled the industry to withstand the adverse impact on net interest margin (NIM)[4] to some extent that came off by 10 basis points over the quarter to 3.8 percent (**see Figure - 3.4**).

Declined returns transpired into proportionally lower interest income that was 22.2 percent of the last year figure. This decrease was witnessed despite an appreciable rise in the level of average earning assets. Detailed analysis shows that depressing impact of lower returns was almost double i.e. 181 percent of the gain in interest income due to increased volume of earning assets. However, more than proportionate decrease in interest expense, mainly due to decline in cost of funds, left the net interest income (NII) for the quarter proportionally higher than that of last year i.e. 27.0 percent of 2002 NII. The share of NII in Gross Income (NII + Non-interest income) however decreased

**Table-3.6: Earnings and profitability indicators**
Percent

| | CY00 | CY01 | CY02 | Mar03 |
|---|---|---|---|---|
| ***Before Tax ROA*** | | | | |
| Public sector comm. banks | 0.5 | 0.02 | 1.3 | 1.3 |
| Local private banks | -0.1 | 0.9 | 1.3 | 2.2 |
| Foreign banks | 1.4 | 1.7 | 2.3 | 3.3 |
| All Commercial banks | 0.4 | 0.6 | 1.5 | 2.0 |
| ***Before Tax ROE*** *(based on Equity plus Surplus on Revaluation)* | | | | |
| Public sector comm. banks | 10.9 | 0.5 | 26.3 | 23.4 |
| Local private banks | -3.2 | 25.4 | 30.5 | 41.1 |
| Foreign banks | 15.6 | 19.3 | 24.2 | 31.1 |
| All Commercial banks | 8.8 | 12.2 | 26.9 | 32.2 |
| ***ROA*** | | | | |
| Public sector comm. banks | 0.2 | -0.5 | 0.6 | 0.8 |
| Local private banks | -0.7 | 0.4 | 0.7 | 1.4 |
| Foreign banks | 0.6 | 0.8 | 1.5 | 2.2 |
| All Commercial banks | -0.01 | -0.01 | 0.8 | 1.2 |
| ***ROE*** *(based on Equity plus Surplus on Revaluation)* | | | | |
| Public sector comm. banks | 4.9 | -12.2 | 11.5 | 13.3 |
| Local private banks | -17.6 | 10.3 | 15.9 | 26.0 |
| Foreign banks | 6.1 | 9.1 | 15.2 | 20.7 |
| All Commercial banks | -0.3 | -0.3 | 13.0 | 20.0 |
| ***Net Interest Margin*** | | | | |
| Public sector comm. banks | 3.6 | 4.3 | 4.1 | 3.6 |
| Local private banks | 3.4 | 4.3 | 4.0 | 4.0 |
| Foreign banks | 3.2 | 3.3 | 3.3 | 3.7 |
| All Commercial banks | 3.5 | 4.1 | 3.9 | 3.8 |
| ***Operating Exp. to Gross Income*** *(NII +Non-interest Income)* | | | | |
| Public sector comm. banks | 70.1 | 62.3 | 57.7 | 61.7 |
| Local private banks | 80.9 | 67.3 | 60.4 | 54.4 |
| Foreign banks | 59.4 | 54.5 | 45.4 | 39.5 |
| All Commercial banks | 71.6 | 62.7 | 57.3 | 54.7 |
| ***Intermediation cost*** | | | | |
| Public sector comm. banks | 3.4 | 3.2 | 2.9 | 2.7 |
| Local private banks | 3.9 | 3.6 | 3.3 | 3.3 |
| Foreign banks | 2.9 | 2.5 | 2.3 | 2.6 |
| All Commercial banks | 3.4 | 3.2 | 3.0 | 3.0 |

[4] Spread between actual return on earning assets and break even return on funds required to finance these assets i.e. net interest income to average earnings assets

to 65.2 percent (2002: 67.4 percent) due to appreciable increase in non-interest income.

The larger support to increasing share of non-interest income came from one time gains on sale of securities that contributed 9.1 percent of the quarter's gross income.

As a result of curtailment of overhead expenses through better controls and continued retrenchment policies commercial banks have been able to contain the operating expenses over the last few years. For the quarter under review these expenses improved further and now stood at 54.7 percent of Gross Income (57.3 percent in 2002).

Another major drag on the profitability of the banks is loan loss provision. Operating results for the quarter under review are subject to adjustment for these provisions as the banks provide relatively higher amounts at the end of year. These expenses as proportion of Gross Income have shown a declining trend over the last few years -- 15.4 percent for 2000, 12.6 percent for 2001, and 11.3 percent for 2002, while for the quarter under review this ratio was 4.2 percent. However, a number of factors viz. better loan-quality, improved NPLs coverage ratios, and sign of recovery in the economy suggest lower burden for the current year.

Sector wise analysis shows that foreign banks maintained the status of most efficient performer, as they posted the highest ROA i.e. 2.2 percent. Non-recurring gains on sale of investments, however, contributed a substantial part of these commendable operating results. Mainly due to shift in their mix of earning assets towards high return assets NIM of the sector showed the sign of improvement in contrast to the declining NIM for the industry.

Local Private Banks remained the volume leader in profits. They also posted a healthy ROA of 1.4 percent that owes a lot to non-recurring nature of gains on sale of investment; these gains account for 32.9 percent of their before tax profits.

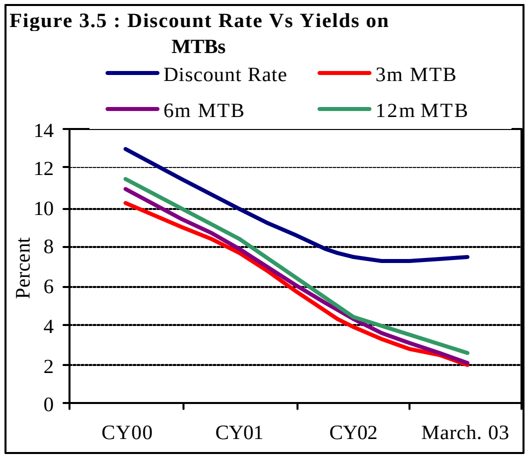
Public Sector Commercial Banks posted an annualized ROA of 0.8 percent that was though modest as compared to other sectors, however, was mainly based on recurring nature of core incomes. Share of capital gains in the pre tax profit of these banks' was only 3.0 percent. Decline in returns coupled with shift in assets mix from high yielding loans to low yielding assets pushed down the NIM by 50 basis points.

Performance of specialized banks has long been in red. These institutions are faced with high non-performing assets and excessively high overhead costs. The operating results of the quarter under review do not show any deviation from their past performance. Total year-to-date provisional loss of Rs 3.1 billion was mainly the result of loan loss provisions that were three times of the sector's year to date gross income. Non-interest expenses also presented a higher burden, as these expenses exceeded the quarter's gross income by 11.1percent.

Banking industry is faced with a declining return scenario. The returns on earning assets are already hovering around historically low levels. However, easy liquidity regime that continued to provide low cost funds for financing increased level of earnings assets enabled them to post higher margins for meeting operating expenses and post improved profits. Besides, low interest rates have enabled them to book capital gains on the sale of investments to further augment the profits. The ability of the banks to maintain and improve the operating performance for the remaining three quarters, however, depends upon the continued availability of funds to sustain and raise level of earnings assets and increase in fee based income.

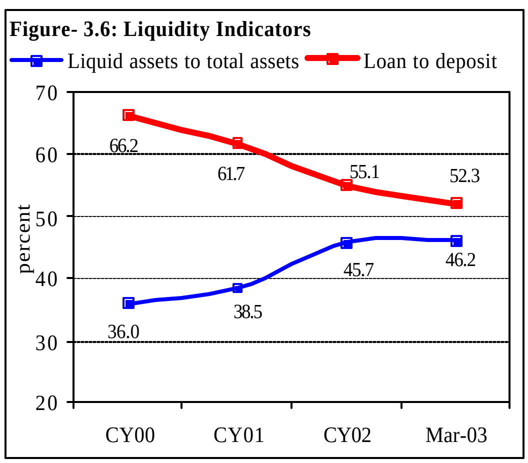
### 3.4 Liquidity and Sensitivity

March-03 quarter continued to have ample liquidity, falling interest rates and stronger Pak Rupee. Interbank bid – offer ends remained at the bottom level of 0.71 percent and 1 percent respectively with a spread of 0.29 percent in March-03 as against 3.75 percent and 4.12 percent with a spread of 0.37 percent in December 2002.Yields on Government papers continued to trickle down with the perseverance of historically low rates. Weighted average yields on 3- months, 6-months and 12- months tenor T-bills remained under pressure at 1.65 percent, 1.64 percent and 2.6 percent respectively. Chasing the same move, weighted average yields on 3- year, 5- year and 10- year bonds remained at 2.79 percent, 3.12 percent and 4.01 percent in March 2003 against 4.55 percent, 4.85 percent and 5.52 percent in December 2002 respectively. With no further cut since November 2002 discount rate, however, remained at its previous level of 7.5 percent. Growing spread between the market driven rates and the rate at SBP repo window facility signifies the excess liquidity position.




Present scenario is marked with a one-off rise in cut off rates in the latest issue of PIBs at the end of June 2003, the preferred strategy of the Government to contain a fall in NSS rates in the wake of moving towards meeting the conditionalities of the international donor agencies.

After a couple of weeks of vigorous activity on discount window in the beginning of the year 2003 SBP 3 day Repo facility was hardly availed by the banks for the next three months. Discounting of around Rs. 140 billion as against the overbidding of around Rs. 27 billion in the said period may be attributed to both the heavy tax payments and concentration of funds in the expectations of further fall in the rate.




Liquid assets maintained with the SBP exceeded the required level by 238 percent. Liquid assets as percentage of total assets increased by 63 basis points to 46.2 percent. Higher growth of deposits vis-à-vis decline in loans is well reflected in the drop of credit to deposit ratio by 283 basis points to 52.3 percent (**Figure -3.6**). Strengthening of Rupee persisted against

Dollar since the end of the year 2001. The continuous fall in the exchange rate because of desperate bidders in the market due to heavy inflows from abroad, settled at 57.72/74 at the end of April 2003.

Rate risk exposures are high due to significant mismatches between rate sensitive assets and liabilities. Cumulative negative GAP as percentage of total assets remained at 15.8 percent as it remained as high as negative 18 percent for the one-year bucket may be the banks' preferred stance in falling rates. Public sector commercial banks with large negative GAP for three months to one-year period at 21 percent are exposing to interest rate risk.