6 The Banking Sector

6.1 Overview

The banking industry turned in an exceptional performance for the second successive year in FY03, leveraging on a spectacular growth in deposits, aggressive marketing and investments, and increased efficiency, to counteract the impact of a sharp decline in interest rates. As a result, not only did the profitability of the sector increase, but selected industry indicators also depicted major improvements relative to the preceding year (see **Table 6.1**). In addition, the industry took important strides in improving governance, the furtherance of Islamic banking, and towards the privatization of government owned-banks.

Table 6.1: Changes in Selected Banking Sector Indicators

billion Rupees

	FY01	FY02	FY03
Deposit mobilization	112.2	173.5	275.1
Gross disbursements	105.9	199.3	387.3
Net credit	66.9	41.7	133.2
Credit to private sector	54.3	32.3	167.7
Stock of NPLs	18.8	14.0	-7.0
WA lending rates (basis points)	103	-185	-454
WA deposit rates (basis points)	-89	-83	-227

Note: Negative sign indicates decline over the previous year.

The deposit growth is particularly impressive given that it comes on the back of the already strong double-digit increases in the last two years. To put this in perspective, in absolute terms, the FY03 increase in deposits is almost equal to the *sum* of the rise in the preceding two years.

Not surprisingly, the strong deposit growth together with the easy monetary stance of the SBP contributed to a sharp decline in domestic interest rates. Two developments, in particular, marked a striking change from the recent past: (1) the November-2002 discount rate cut pushed T-bill yields to all-time lows; and (2) for once, lending rates responded strongly to the decline in T-bill rates, with the weighted average lending rate dropping into single digit for the first time in nearly thirty years.

This large reduction in interest rates finally initiated a resurgence of credit demand, taking the FY03 net credit expansion to a phenomenal Rs 133.2 billion, over three times higher than the corresponding FY02 figure. While a part of the higher FY03 credit probably reflects the exploitation of interest rate arbitrage available through NSS instruments, evidence clearly points to a strong contribution of increased economic activity as well as the aggressive marketing of consumer credit by the banks.

However, the pressure on banks' management to maintain profitability under the twin impact of falling return on assets and increasing liquidity has led to concerns over the quality of banks' asset portfolio and earnings for FY03. In particular, banks generated a substantial portion of their earnings through non-interest income, including capital gains on equity investments and fixed income securities.

6.2 Policy Environment

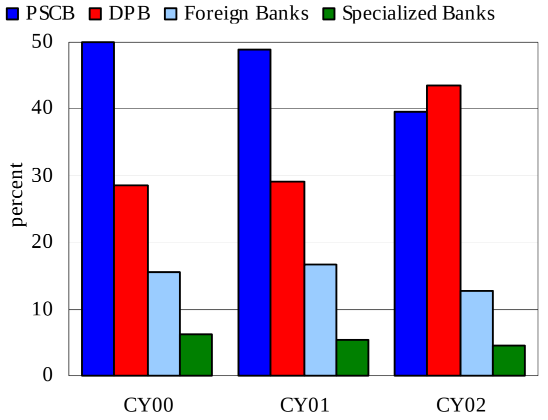
On policy issues, while the SBP focus remained unchanged at strengthening of the supervisory and regulatory framework, instilling a competitive business environment both by promoting the role of the private sector and liberalizing the financial markets, and to improve financial health of the banking sector; significant progress has been made during FY03. Key developments are analyzed below.

6.2.1 Privatization of Public Sector Banks

Privatization of public sector banks, which was initiated in the early 1990s, gathered pace during FY03. In particular, October 2002 saw the privatization of UBL, one of Pakistan's largest banks, as the government divested a 51 percent share in UBL to a consortium of investors, comprising the Abu

Dhabi Group & Bestway Group. Consequently, the share of domestic private sector banks in the aggregate banking assets has now risen to 43.5 percent (see **Figure 6.1**).

Figure 6.1: Asset Shares



In addition, the government divested yet another 10 percent stake in a second large bank, National Bank of Pakistan[1] during October 2002, as well as its remaining shares in a third large bank, Muslim Commercial Bank. Moreover, the process for the privatization of another large institution, Habib Bank Limited, is also well underway; the Privatization Commission has already received the Expression of Interest (EOI) from investors interested in the acquisition of minimum 26 percent stake.[2]

Finally, the Privatization Commission has also requested SBP to make arrangements for the dis-investment of the government's remaining 49 percent share in Allied Bank of Pakistan Limited. The SBP has received Expression of Interest (EOI) from 12 prospective bidders, of which nine have been short-listed and asked to provide Statements of Qualification.

6.2.2 Islamic Banking

In a bid to comply with the verdict of Shariah Appellant Bench of 1999, SBP had issued detailed guidelines for the establishment of Islamic Commercial Banks with effect from December 1, 2001. A license under these guidelines was issued to Meezan Bank Limited (as a model Islamic Bank in Pakistan) for the commencement of Islamic banking business in January 2002.

Additionally, in November 2002, the Banking Companies Ordinance (BCO) 1962 was amended to implement the process of Islamization of the financial system in parallel with conventional banking.[3] Following these amendments, detailed criteria for the establishment of Islamic Commercial Banks, and Islamic Banking Subsidiaries and/or Stand-alone branches for Islamic banking by the existing commercial banks was issued vide BPD Circular No. 1 dated January 1, 2003.

Following the issuance of these guidelines, five banks applied for permission to establish stand-alone branches for Islamic banking, leading to the issuance of the first Islamic Banking Branch License to MCB in May 2003; this branch has started commercial business, while applications of other banks are under consideration.

6.2.3 Strengthening of Supervisory System

In an effort to have a clear demarcation in supervisory responsibilities of SBP and SECP for the regulation of financial institutions, amendments in BCO 1962 were made in November 2002. Subsequently, the supervisory and regulatory responsibilities of all NBFIs, except DFIs, were transferred to SECP from SBP in December 2002. Since this demarcation calls for better coordination between SBP and SECP, quarterly meetings between senior management of the two regulatory authorities have been made mandatory.

[1] Earlier, 10 percent shares of NBP were floated through IPO during November 2001. The cumulative disinvestment in NBP now totals to 20 percent.

[2] Investors are currently working on the 'due diligence' for the transaction.

[3] A new sub-section (6) of section 9B was introduced with effect from November 4, 2002 vide ordinance No CX of 2002.

6.2.4 Prudential Regulations

The following FY03 changes in prudential regulations are particularly notable:

- To safeguard the interest of prospective investors, depositors and creditors, credit rating requirement for banks have been made mandatory vide a BPD circular No 9 dated May 3, 2002. Banks have been asked to get themselves rated by the SBP approved credit rating agencies; this is to be an on-going process and the rating is to be updated annually. The time period allowed for the process of credit rating has been increased from four months to six months.[4]
- To promote good corporate governance and to encourage senior management (Presidents/Chief Executives and Board of Directors) to play an active role in capacity building of the institutions, revised guidelines under "Fit & Proper Test" have been issued with effect from November 30, 2002.
- To prevent the possible use of banks for money laundering, terrorist financing and other illegal activities, the SBP has issued "Know Your Customer (KYC)" guidelines for the due diligence of customers with effect from March 29, 2003.

6.2.5 Non Performing Loans

Since 1997, SBP has been following a multi-pronged policy in order to manage the burden of NPLs of the banking sector. Major steps include clear guidelines for the classification of NPLs and provisions required there against; establishment of the Corporate and Industrial Restructuring Corporation (CIRC); Committee for Revival of Sick Industrial Units; and prosecution of defaulted cases under NAB Ordinance. Additionally, banks were pressured to accelerate recoveries.

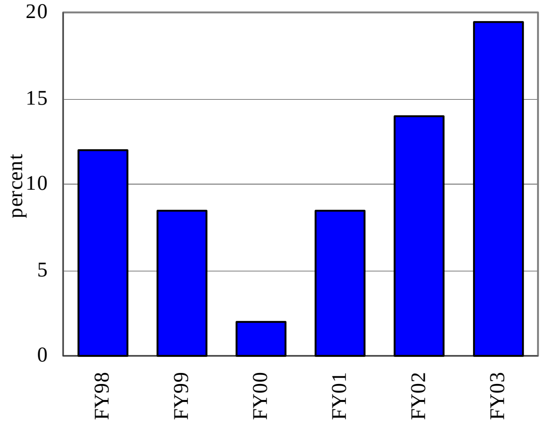
An important development in FY03, in this regard, was the release of new guidelines for the write-off of irrecoverable loans and advances.[5] These guidelines are designed to help banks to settle their old NPLs in an orderly and transparent manner. Write-offs/waivers under these guidelines force banks to account for the erosion in the values of assets carried on their balance sheets as a part of asset receivables (for details see **Box 6.1**).

6.3 Banking Sector Developments During FY03

6.3.1 Deposits of the Banking Sector

Despite offering negative real rate of returns on deposits, the banking sector recorded double-digit deposit growth for third year in a row, primarily on the back of a continuing improvement in the country's external account. Specifically, the remarkable 19.5 percent FY03 deposit growth, amounting to Rs 275.1 billion, was primarily driven by exceptional growth in remittances (see **Figure 6.2**). In fact, the bank-wise distribution of workers' remittances showed that around 80 percent of remittances were remitted through 10 banks, which also accounted for 70 percent of the aggregate deposit growth of the banking sector. However, unlike the preceding year, it appears that the FY03 deposits growth also incorporates a significant contribution from improvements in the domestic economy. The

Figure 6.2: Deposit Growth Rate



[4] For details, see BPD Circular No. 17 of May 9, 2003.

[5] Vide BPD Circular No. 29 dated October 15, 2002.

latter appears to stem from increased profitability of the corporate sector and impressive earnings of the agriculture sector.

Interestingly, it appears that increasing e-banking activities, use of ATM in particular, may have significantly affected the cash preferences of the public, as the cash holding in the economy has declined during FY03 (see **Special Section** on **e-Banking**). This is also evident from the fact that the rise in currency in circulation was substantially lower despite a substantial growth in reserve money. As a result, currency to deposit ratio has declined by one percentage point to 32.0 percent by end-FY03.

A distribution of the deposit growth by bank groups[6] reveals that domestic private banks led the field in FY03, mobilizing Rs 195.7 billion (see **Table 6.2**). A part of this performance is explained by the merger/acquisitions of some foreign banks with private banks, but even after adjusting for these, the aggregate growth in the deposits of private banks remains impressive at 28.3 percent. This robust deposit growth of private banks is probably driven by the relatively higher rate of return on deposits offered by these banks and increasing branch network.[7]

Table 6.2: Deposit Growth

percent

	FY02			FY03		
	Local	**Foreign**	**Total**	**Local**	**Foreign**	**Total**
PSCBs	18.1	-1.7	15.9	18.9	-21.9	15.0
DPBs	25.5	-4.3	21.2	35.7	-9.9	30.4
Foreign banks	6.3	-31.1	-7.7	8.0	-29.8	-2.6
Specialized banks	6.0	0.0	6.0	2.4	0.0	2.4
All banks	19.7	-13.7	14.0	25.2	-19.4	19.5

While deposit growth of public sector banks was also strong, the withdrawal of foreign currency deposits, shifting of deposits from foreign banks to private banks (on account of above-mentioned mergers/acquisitions) and comparatively larger exposure to the depleting forex deposits continued to depress the deposit growth of foreign banks for yet another year in FY03.[8]

The pattern of deposits by account holders also provides interesting insights (see **Table 6.3)**. While most of the sectors witnessed healthy growth in deposits during FY03, those recording significant movements include *manufacturing*, *other businesses*, *personal* and *government* deposits.

Table 6.3: Deposit Holdings of Selected Sectors

billion Rupees

			Change	
	FY02	**FY03**	**absolute**	**percent**
Government	127.3	155.4	28.1	22.1
Non financial PSEs	85.3	116.5	31.2	36.6
Private sector business	502.0	628.8	126.9	25.3
of which				
Agriculture	64.5	77.1	12.6	19.6
Manufacturing	112.4	136.5	24.1	21.4
Other business	108.4	150.1	41.7	38.5
Personal	363.5	490.1	126.6	35.0
	Percent share			
Government	9.1	9.4	-	-
Non financial PSEs	6.1	7.0	-	-
Private sector business	36	38	-	-
Personal	26	29.6	-	-

Looking at **Table 6.3**, the jump in deposits of the first three categories may simply reflect a general improvement in economic activity (i.e. profitability). On the other hand, the exceptional jump

[6] For meaningful comparison, UBL has been classified in DPBs for all years.

[7] Data on branch network provide interesting insights. While overall number of bank branches indicate decline of 72 branches during FY03, 125 new bank branches were opened during the same period largely by the private banks (103 out of 125). However, 197 branches were closed down primarily by big five banks (176) in an effort to rationalize their branch network. While opening up of new branches helped private banks to increase their business activities, closing down of bank branches by big five banks can hardly affect their business activities, as the deposits of these branches are usually shifted to another branches.

[8] Growth remained subdued, even if adjusted for shifting of deposits.

in p*ersonal* deposits, which account for a startling 46.0 percent of the aggregate FY03 deposits growth, very likely mirrors the sharp jump in remittances during the period.

The improvement in government deposits, on the other hand, is a function of better fiscal discipline, rising tax collections as well as a surge in defense receipts. Finally, non-financial public sector enterprises benefited from their improving financial health.

A break-up of the deposit profile by currency shows that the entire increase in aggregate banking sector deposits emanates from an unprecedented growth in rupee deposits, which comfortably absorbed the drag of a 19.4 percent drop (in rupee terms) in foreign currency deposits. A quick glance at **Figure 6.3** shows that the rupee deposits saw a steady rise throughout most of FY03, but most of decline in foreign currency deposits was largely concentrated in a few months (September 2002 to January 2003).

The fall in the rupee value of FCDs is attributable to the rupee encashment of frozen resident FCAs, payments of FE-45 deposits (institutional deposits), as well as the appreciation of the rupee against the US Dollar. By March 2003, however, FE-45 deposits had all been paid off and the exchange rate was relatively stable. Thus, the subsequent relative stability in the rupee equivalent of FCDs until end-June 2003 is simply because of the small increase in FE-25 deposits during Q4-FY03 (mainly due to the usage of these accounts by Exchange Companies for their operations)[9] that largely offset the continuing decline in other FCAs (see **Figure 6.4**).[10]

6.3.2 Net Credit Expansion by the Banking Sector

The exceptional rise in credit expansion evident by Q3-FY03 continued into the last quarter of the year as well. As a consequence, net credit of scheduled banks saw an

Figure 6.3: Deposits Trend During FY03

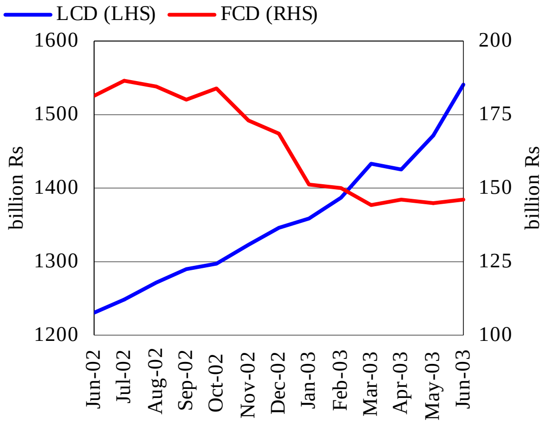


Figure 6.4: Cumulative FCAs Flows During FY03

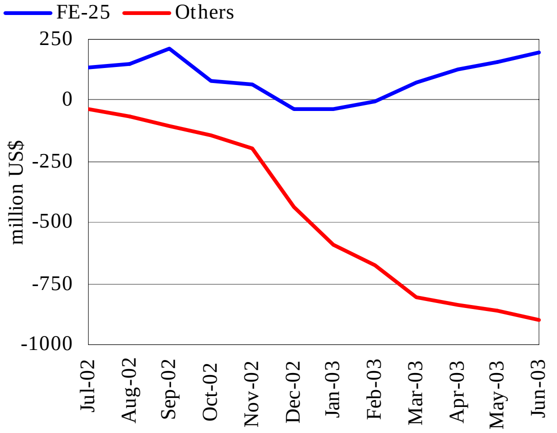
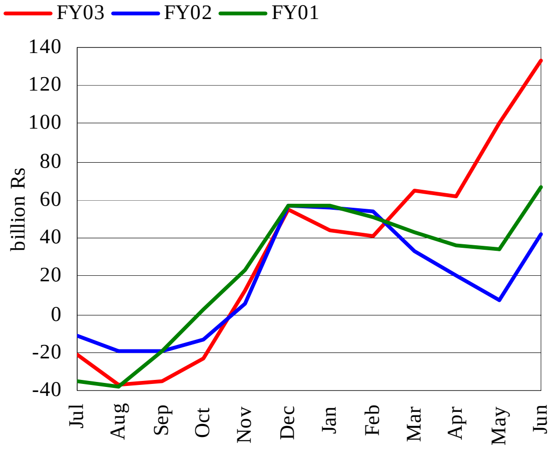


Figure 6.5: Net Credit: Cumulative Flows

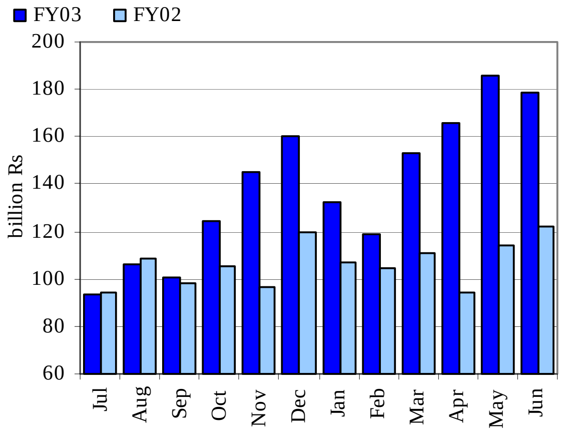


[9] Rise in FE-25 deposits is largely explainable by a decline in effective interest rate differential between the rupee and US$, particularly during Q4-FY03.

[10] These include the old (frozen) foreign currency deposits, as well as deposits of foreign individuals, embassies, etc.

expansion of Rs 133.2 billion during FY03; more than three times of change in net credit expansion recorded in FY02 (see **Figure 6.5**). This rise in net credit expansion was backed by an unprecedented increase in private sector credit demand, which expanded by Rs 167.7 billion during FY03 (see **Section 5.1.4** for detail).[11] More specifically, banks' increased investments in TFCs, (particularly issued by PIA)[12] and equities, aggressive entry into the consumer finance market (see **Box 6.2**), greater participation in foreign currency lending (trade loans), higher credit demand from textile sector and loans against NSS instruments were the major factors responsible for higher net credit extended during FY03.

Figure 6.6: Monthly Gross Disbursements



Looking at **Figure 6.5**, net credit expansion was quite weak before the November 2002 discount rate cut. This was intriguing given that macro variables were signaling a strong recovery of the economy at the time.[13] In fact, during this period, gross disbursements of loans were approximately at their corresponding FY02 level, reflecting re-pricing or short term borrowing in anticipation of interest rate decline. Once these were realized after the November 2002 discount rate cut; there was a massive rise in gross disbursements throughout the remaining period reflecting the true underlying demand (see **Figure 6.6**). In the end, credit disbursements for FY03 were Rs 387.3 billion higher as compared to FY02. Of this, Rs 321.4 billion (or 83.0 percent of total) rise in gross credit disbursements came after discount rate cut (during December 2002 to June 2003).

Contributing to the higher credit disbursements was the unusual rise during H2-FY03 that departed from seasonality patterns. This reflects increased consumer finance, trade loans and arbitrage against NSS instruments.

Disaggregating the net credit by banking groups, it is apparent that other than PSCBs and specialized banks, all groups witnessed higher net credit expansion during FY03 as compared to the preceding year. As customary, domestic private banks recorded the highest rise in net credit expansion of Rs 119.3 billion largely on account of their higher exposure toward trade related activities, consumer financing and equity investments (see **Table 6.4**).

Table 6.4: Net Credit Expansion

billion Rupees

	FY01	FY02	FY03
PSCBs	20.8	21.0	4.1
DPBs	35.6	18.2	119.3
Foreign Banks	8.8	-5.6	6.3
Specialized Banks	1.7	8.1	3.4
All Banks	66.9	41.7	133.2

However, the credit figures reported by PSCBs are little deceptive. It is the result of an unusually strong retirement of commodity operations loans stemming from the improvements in the fiscal

[11] Rise in overall net credit is considerably lower as compared to increase in net credit to private sector. This is the upshot of net credit retirement for commodity operations and credit to PSEs.

[12] Banks' investment in TFCs issued by PIA was Rs 10.8 billion as on June 30, 2003.

[13] However, credit numbers during H1-FY03, although slightly lower than H1-FY02, were not so disturbing in the presence of lower input cost, possibility of self-financing and availability of funds on account of higher tax refunds (see **SBP Quarterly Report for Q2-FY03**).

position of provincial governments. Adjusting for this it emerges that public sector banks actually registered an expansion of Rs 32.6 billion in net credit during FY03.

Composition of Credit

A broader de-composition of banks' aggregate net credit position also highlights some interesting developments (see **Table 6.5**).

Table 6.5: Composition of Credit

billion Rupees

			Change	
	FY02	**FY03**	**Absolute**	**Percent**
Advances	897.5	989.6	92.1	10.3
Of which				
FE-25 loans	20.4	61.0	40.6	199.3
Consumer credit	10.7	45.1	34.4	322.9
Bills	24.5	30.2	5.7	23.1
Other investment*	79.6	115.0	35.4	44.5
Total credit	1,001.5	1,134.7	133.2	13.3

*: Excluding bank's investment in the government securities (federal and provincial government and T-bills)

‘Other Investments’ grew very strongly

It appears that the relative attractive yields on offer in the domestic capital markets, together with declining profitability of banks in traditional business segments, led to a substantial increase of Rs 35.4 billion in *other investments* of the banking sector.[14] As a result, the share of investments in overall credit jumped up from 7.9 percent in FY02 to 10.1 percent by end FY03.

This change in composition of credit also yields interesting insights about the behavior of banks and corporate borrowers. While the latter borrowed medium to long term funds through the bond market to take advantage of all time low interest rates, the former channeled their funds to both bond and equity markets in an effort to protect their profitability in the presence of narrowing interest margins. However, the banks increased exposure towards equity investments is a matter of concern given the historic volatility of the Pakistani equity markets.

Banks exposure toward quoted share market was Rs 23.3 billion by end-FY03 (see **Table 6.6**). Of this, the larger portion consists of outright purchases of shares (more than 85 percent of total exposure to equity markets). Within the banking sector, it was the domestic banks, that were most active in the equity markets, increasing their stock portfolio as well as increasing loans for badla (COT) finance.

Table 6.6: Banks Exposure in Quoted Shares by end-FY03

million Rupees

	Purchases	Repo	Badla	Total
PSCBs	6851	0	8	6859
DPB	12909	353	2815	16077
Foreign banks	81	0	0	81
Specialized	302	0	0	302
All banks	20143	353	2823	23319

The roots of this sharp contrasting behavior of domestic and foreign banks may be traced to the investment policies of the banks; the large foreign banks' typically have more stringent investment guidelines and better risk management practices. Another plausible explanation may come from the liquidity position of the banks. Since domestic banks have seen much stronger deposit growth compared to foreign banks, the temptation to invest in the relative high yielding opportunities in the local equity market was therefore greater for these institutions.

FE-25 loans comprised one third of FY03 net credit

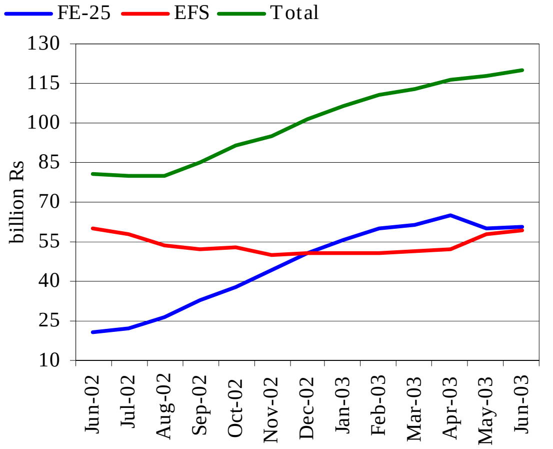
The foreign currency loans were a significant component of the record FY03 net credit expansion. Although banks had been allowed to use their FE-25 deposits for trade financing since March 2001, the demand for such loans grew strongly only after the increased expectations of a continued appreciation of the rupee, and the issuance of clear guidelines by SBP for trade loans against FE-25 deposits in August 2002 (see **Figure 6.7**).[15]

[14] Other investment includes investment in TFCs, debentures, equity investment etc.

[15] FE Circular No 5 dated August 2002.

As explained in **Section 5.1.4** these loans were attractive substitutes for EFS loans because of their lower cost (especially as the rupee appreciated) and easier terms. Consequently, the demand for such loans grew until April 2003, when the falling rupee interest rate (the EFS rates dropped to 2 percent, compared to the 3-4 percent cost for FE-25 loans) and the stability of the exchange rate rendered them relatively unattractive.

Figure 6.7: Trade Financing



6.3.3 NPLs of the Banking Sector

NPLs of the banking sector have witnessed substantial improvement during the year under review as: (1) the stock of NPLs declined to Rs 227.7 billion by end-FY03 with a reduction of Rs 7.0 billion; (2) additions of fresh NPLs to existing stock were Rs 10.1 billion lower during FY03 as compared to the preceding year; (3) banking sector recovered Rs 32.1 billion despite an increasing amount of irrecoverable loans in total NPLs; and (4) banks were able to restructure 32,051 cases worth of Rs 18.8 billion under new guidelines for write-off of irrecoverable loans (see **Box 6.1**). These heartening developments are primarily attributed to a comprehensive multi-pronged policy followed over the past four years.[16]

Within the banking sector, all groups registered a decline in outstanding amount of NPLs, except domestic private banks. Their NPLs rose by Rs 1.6 billion during FY03. This rise is the upshot of a jump in NPLs of one of the financially weak privatized institution. Public sector banks took the lead by reducing their NPLs by Rs 6.1 billion over the same period (see **Table 6.7**).

Table 6.7: NPLs of the banking Sector

billion Rupees

	FY02	FY03	Change
PSCBs	100.1	94.1	-6.1
DPBs	59.8	61.4	1.6
Foreign banks	7.8	6.9	-0.9
Specialized banks	66.9	65.2	-1.7
All banks	234.7	227.7	-7.0

These changes in outstanding stocks of NPLs at two points of times must be interpreted with some caution, since this figure alone does not reflect the true burden on the banks.[17] Outstanding stocks are useful only in determining aggregate changes in NPLs, therefore must be seen in relation to advances for meaningful analysis. In this backdrop, a quick glance at **Table 6.8** reveals that the

Table 6.8: Burden of NPLs

	NPLs/GA	Net NPLs/NA	Coverage ratio
Jun-02	24.6	12.84	61.6
Sep-02	24.0	12.20	62.7
Dec-02	23.7	11.69	63.1
Mar-03	23.6	11.45	63.2
Jun-03	20.7	9.46	65.7

GA: Gross Advances; NA: Net Advances

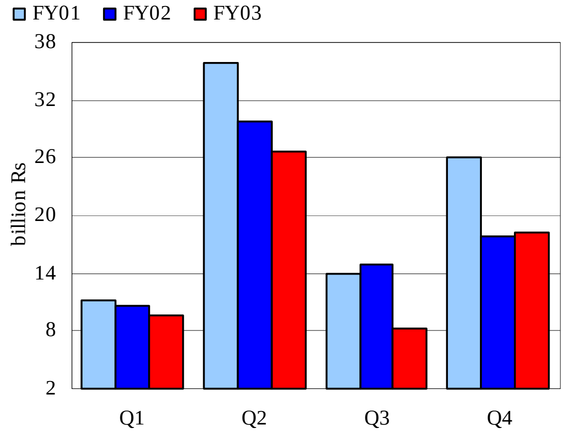
[16] Realizing the negative repercussions of this hefty amount of NPLs, the SBP together with its allied government institutions chalked out a comprehensive multi-pronged policy to tackle the issue of NPLs. The policy focus was to: (1) improve reporting and coverage of NPLs; (2) actively manage the existing stock of NPLs; (3) improve policy and regulatory environment; and (4) contain the flow of fresh NPLs.

[17] Outstanding stock of NPLs will continue to rise even in the absence of any new additions. This change will come from accounting method, as accrued interest on outstanding principal will continue to rise with the passage of time until or unless the case is settled.

NPLs to gross advances ratio has witnessed persistent decline during all quarters of FY03, indicating an improved position of NPLs. The point is reinforced by the net NPLs to net advances ratio, which has also witnessed a similar declining trend.

Moreover, a notable gap between NPLs to gross advances and net NPLs to net advances ratio suggests that either a substantial amount of NPLs have been provided for and/or the accumulated mark up on outstanding principal constitutes a considerable portion of NPLs. Further analysis suggests that a substantial amount of NPLs has been provided for, as the coverage ratio (provisions to NPLs ratio) not only remained over 60 percent, but also witnessed a rise during FY03. However, the share of accumulated mark up on outstanding principal is also 20.7 percent of NPLs.

Figure 6.8: Quarterly Fresh NPLs



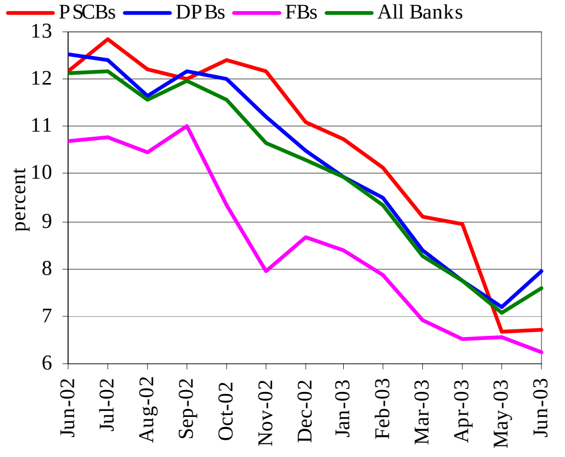
In sum, stricter classification criteria and provisioning requirements are helping the banking sector to mitigate the risk posed by their large NPL portfolio. Finally, there has clearly been a welcome improvement in the asset quality of the banking sector reflected by declining amount of fresh NPLs (see **Figure 6.8**). The decline in fresh NPLs is quite visible over the years, and the distinct quarterly variations are explained by: (1) internal loan portfolio reviewing policy of few big banks (usually practiced half yearly); and (2) seasonality in private sector credit;[18] particularly of specialized banks.

6.3.4 Lending and Deposit Rates

An easy monetary policy stance kept rupee-lending rates under pressure throughout the FY03. As a consequence, weighted average lending rate on fresh loans and advances, which slipped down to single digit during Q3-FY03 for the first time since 1974, saw a further slide of 68 basis points during Q4-FY03, taking the overall decline in weighted average lending rate to an unprecedented level of 454 basis points during FY03 (see **Figure 6.9**).

However, there was considerable variation in the rates of various banking groups. While the weighted average lending rates of PSCBs and DPBs plummeted by over 544 and 455 basis points respectively during FY03, specialized banks witnessed a decline of a mere 84 basis points. Excluding specialized bank, the gap in lending rates of foreign banks and other groups, which substantially increased during Q2-FY03,[19] has narrowed down to around 217 basis points in the remaining period (see **Figure 6.10**). This dispersion in lending rates

Figure 6.9: Weighted Average Lending Rates

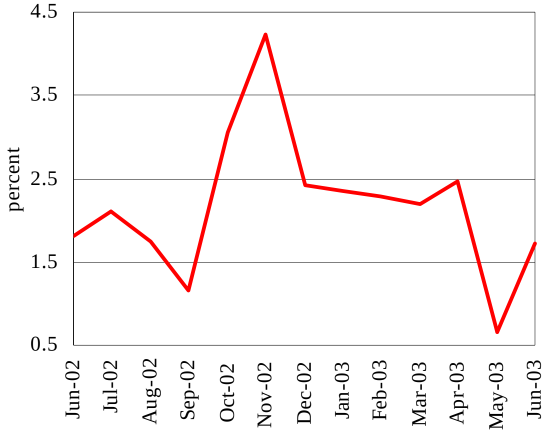


[18] For details on seasonality in private sector credit, see **Section 5.1**.

[19] This sharp rise in difference was the upshot of changing banking environment in response of expected discount rate cut during Q2-FY03, which were realized in November 2002. Another possible reason could be the slower credit growth of foreign banks during H1-FY03, which may have forced these banks to lower their lending rates.

of the banks is primarily attributable to blue-chip client base of foreign banks and relatively greater intermediation cost of domestic banks.[20]

Figure 6.10: Gap in Lending Rates (Max-Min)



Following the steep slide in the weighted average lending rates, banks rushed to curtail their deposit rates in an effort to preserve their net interest margins. Weighted average deposits rates of the banking sector, therefore edged down by 227 basis points during FY03.

The relatively smaller decline in weighted average deposits rates as compared to unprecedented slide of lending rates squeezed the banking spread by 227 basis points. This visible decline in banking spread could potentially have negative implications for the banking sector profitability. Unfortunately, the real impact of the narrowing spread cannot be observed due to: (1) definition problems that could be masking the true movement of the spread,[21] and (2) banks ability to reduce profits paid on PLS deposits.

6.4 Financial Performance of Scheduled Banks During CY02[22]

The financial health of scheduled banks has witnessed substantial improvement during CY02. This was primarily supported by increased business activities, a welcome reduction in the intermediation cost, lower burden of NPLs and a cut in the tax rate. This turn around looks more impressive in the presence of a narrowing average interest rate spread.

Assets of the banking sector registered an impressive rise of 14.6 percent in CY02 as compared to a rise of 7.4 percent in CY01, primarily on the back of strong growth in investment activities. A decomposition of the assets showed that while investments of the banking sector almost doubled by end-CY02 as compared to CY01, advances could manage a rise of merely 1.4 percent in the same period. This surge in the former is a logical consequence of declining interest rates, as banks were striving to book assets at higher returns.[23]

The overall banking sector Capital Adequacy Ratio (CAR) reached at 8.8 percent by end-CY02 despite a visible shortfall in the equity of specialized banks. The ratio is well above the minimum requirement of 8.0 percent. Adjusting for specialized banks, CAR for commercial banks improves to 12.6 percent by end-CY02 as compared to 11.3 percent in CY01.[24] This improvement was driven both by a rise of Rs 45.9 billion in overall equity of commercial banks[25] and an increase in the share of zero risk-weighted assets in total assets. The former was caused by relatively lower provisions,

[20] Intermediation cost of domestic banks is relatively higher than the foreign banks mainly due to their higher NPLs and problems of advance taxes.

[21] For details, see **Third Quarterly Report for FY03**.

[22] This section is based on annual audited balance sheets of banks. Since banks closing date is usually December 31, hence it is according to Calendar year (CY), instead of financial year (from July to June). For more detailed analysis, see forthcoming issues of **Financial Sector Assessment 2001-02** *and* **Banking Sector Review 2002**.

[23] Share of government securities in total investment climbed up to 80.8 percent by end-CY02, as compared to 68.1 percent over a year before.

[24]This also indicates that improvement shown by commercial banks was eclipsed by heavy provisions against NPLs of specialized banks.

[25] This surge in equity was the upshot of massive rise in surplus (deficit) on revaluation of assets and substantially lower un-appropriated losses.

surplus on revaluation of securities and SBP requirement to raise minimum paid up capital.[26] Similarly, the banks massive investment in government securities helped fall in the latter (investment in government securities carry zero credit risk).

Asset quality indicators have been improving for the last three years due to the implementation of measures such as strict classification criteria, pressure on banks to accelerate recovery, investigation of cases through NAB, establishment of CIRC, and guidelines for write-off of NPLs, taken by the SBP and allied government institutions. As a result, not only have infection and coverage ratios[27] started showing improvement, the absolute amount of NPLs has also declined, even in the presence of substantially high ratios for specialized banks. Such an improvement in the asset quality will not only helped the banking sector in increasing earning assets of the banking sector and easing pressure on profitability through lower provisions, but also indicates a decline in the threat to the capital base of the banking sector.[28]

The profitability of the banking sector witnessed a significant rise during CY02, despite substantial losses incurred by the specialized banks. Although, the average interest rate spread has narrowed and net interest margin has been squeezed, after tax returns on average assets have turned out to be positive. This turnaround in profitability is derived from: (1) higher net interest income (2) increased business activities of the banking sector;[29] (3) lower burden of provisioning due to improved positions of NPLs; (4) substantial capital gains; (5) reducing burden of taxes;[30] and (6) lower borrowing requirements due to ease of liquidity.

Indicators for the management performance of the banking sector also depict positive trends. In particular, the expense to income ratio and intermediation cost have recorded notable positive changes during CY02. However, the specialized banks did not share this improvement, as their expense to income ratio and intermediation cost both deteriorated further. The increasing intermediation cost of these banks is primarily explainable by heavy provisions made to provide for outstanding stock of NPLs. Adjusting for this group, intermediation cost (including provisions) of all commercial banks fell to 3.6 percent by end-CY02 against 4.0 percent in CY01. This lower adjusted intermediation cost coupled with higher income (despite squeezing interest rate spread) and improvement in asset quality indicators reflects better management of the banking sector, particularly of commercial banks.

Liquidity indicators were also no exception to the positive trends, as the strong deposit growth along with weak credit-off take kept the banking sector liquid during FY03[31]. Moreover, heavy investment in government securities also pushed liquid assets of the banking sector up. As a result, the liquid assets to total assets ratio surged to 47.0 percent by end-CY02 against 39.9 percent in comparable period last year.

[26] In first phase, banks were required to raise their minimum paid up capital to Rs 750 million by end-December 2001 and in second phase meet the requirement of Rs 1.0 billion by end-December 2002.

[27] Infection ratios include NPLs to gross advances and to net advances, whereas, coverage ratios indicate that how much non-performing loans have provided for.

[28] Net NPLs to net advances declined from 10.2 percent in CY01 to 8.4 percent in CY02. Whereas, the coverage ratio has gone up from 53.2 percent in CY01 to 58.3 percent in CY02.

[29] Earning assets to total assets ratio of the banking sector spiked up to 84.1 percent by end CY02 and compared to 77.6 percent in CY01.

[30] In Pakistan, banking sector is not only highly regulated sectors (obviously because of its risky business), but heavily taxed sector also. Advance nature of taxes and dispute between the banks and Central Board of Revenue on taxable base (specifically treatment of accrued interest on NPLs transferred to suspense account) aggravated the problem of banking taxation. As a part of on going reform process in the country, efforts were also geared to do away with this problem. Tax rate has been brought down from 64 percent in FY95 to 47 percent by end-FY03, and is planned to cut down to 35 percent by end-FY07, equalizing with the corporate sector. Furthermore, the government issued PIBs of worth Rs 22 billion in FY02 to settle the issues outstanding taxes.

[31] Loans to deposit ratio plummeted to 55.1 percent over the period under review.

Furthermore, within banking sector, while liquid assets to total ratios of PSCBs, DPBs and specialized banks increased, it declined for foreign banks. This reinforced the view that the foreign banks were relatively quicker to adjust to the changing business environment.

Box 6.1: Write-off of Irrecoverable Loans and Advances

An important policy measure in FY03 was the issuance of new guidelines for the write-off of irrecoverable loans and advances.[32] These guidelines were aimed at providing banks' an opportunity to clear irrecoverable NPLs from their balance sheets, in accordance with the global norms.

There are three key elements of the global norms: (1) banks are in the business of taking and managing risk, and inevitably, not all risks pay-off; (2) similarly, borrowers may face losses due to economic shocks, which are beyond their control and therefore banks could end up with bad loans even with the best management; and finally, (3) it is important that banks' balance sheets incorporate the erosion in their asset portfolios by pruning the irrecoverable values.

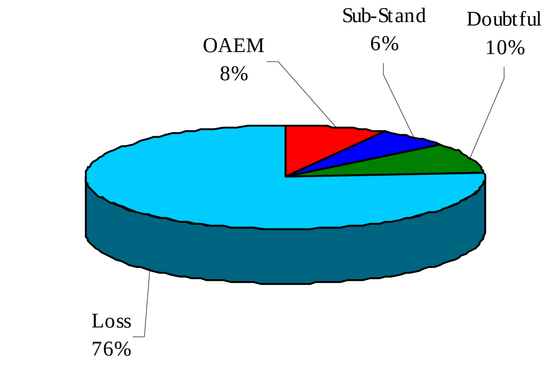
However, the SBP guidelines attracted considerable public concerns that the guidelines might help only big borrowers and willful defaulters. The following analysis focuses on these issues in detail.

Table 6.1.1: Classification of NPLs

	Principal/Interest over due from due date		Provision required
	Short Term Loans	Long Term Loans	
OAEM	90 days or more	90 days or more	0%
Sub-standard	180 days or more	One year or more	20%
Doubtful	One year or more	Two years or more	50%
Loss	Two years or more	Three years or more	100%

A break down of banks' non-performing loans (NPLs) by the categories defined in **Table 6.1.1** shows that over 75 percent of NPLs (outstanding principal only) fall in the loss category, i.e., these loans are not performing for at least last two years and that full provisioning has been made against these loans (see **Figure 6.1.1**). Typically, such loans have poor chances of being recovered, and therefore, if banks continue to carry these loans on their balance sheets, their balance sheets would appear to be inflated.

Figure 6.1.1: NPLs Categories FY03



It is these loans that are targeted by the new guidelines, which enable banks to undertake timely restructuring of problem loans, in a transparent manner, by waiving some of accrued mark up and/or by writing-off a portion of the principal amount.

For the purposes of the guidelines, NPLs that have been in the "loss" category for at least three years (i.e., non-performing for at least 5 years) are further divided into three categories according to the outstanding amount,[33] as separate guidelines are applicable for each sub-category (**Table 6.1.2**).

Table 6.1.2: Performance and Beneficiaries of the Write-off Scheme

end-June 2003

	Category			
	A	B	C	Total
Number of applicants	38480	648	1205	40333
Amount involved (Rs mln)	6488	708	72659	79856
Performance				
Number of cases settled	31513	206	332	32051
Amount involved (Rs mln)	1600	215	17023	18838
Cash recovered (Rs mln)	567	65	699	1330

Under this scheme, the banks received 40,333 applications for the settlement of Rs 79.9 billion loans by end-June 2003 (see **Table 6.1.2**). Of this, 38,480 applicants fall in category A, which implies that the small borrower rushed for the settlement of loans. Of course, outstanding amount against these loans was substantially lower (Rs 6.5 billion) due to small amount of loans.

By end-FY03, the banks have not only settled 32,051 cases involving amount of Rs 18.8 billion, but also recovered amount of Rs 1.3 billion. This shows that both banks and borrowers are benefiting from this scheme, as the banks turned a portion of their NPLs into performing loans and borrowers received a partial waiver in their outstanding liability. Furthermore, the category wise loan settlements strongly refute the concerns raised earlier that only big borrower would be able to get their loans settled.

[32] BPD Circular No.29 dated October 15, 2002.

[33] Loans having outstanding amount (principal and interest) upto Rs 0.5 million are classified in category A; more than Rs 0.5 million and upto Rs 2.5 million in category B; and from over Rs 2.5 million in category C.

Box 6.2: Consumer Financing

Consumer financing means " any financing allowed to individuals for meeting their personal, family or household needs". It specifically includes credit cards, auto loans, housing finance and personal loans (other than for business purposes). This, (other than personal loans) is a relatively new area for Pakistani banks, as the earlier ban on housing finance and lease finance kept the banks away from this market segment. However, banks were allowed to establish separate subsidiaries for housing finance and lease finance. This is why many banks established their own leasing, modaraba and housing finance companies. As a result, consumer finance activities were largely falling in the purview of Non-Bank Financial Institution (NBFIs).

With the emergence of the concept of universal banking and in a bid to pool existing fragmented resources, financial sector has witnessed substantial changes since 1997. Banks were encouraged to develop in-house systems to deal in consumer financing products. The SBP, in consultation with stakeholders, has helped banking sector by making relevant changes in the prudential regulations.

However, in general, banks generally did not focus on consumer credit until 2000 due to a variety of reasons, including: (1) lack of expertise and supporting infrastructure for consumer financing; (2) high start-up costs of certain activities like credit cards; (3) reluctance to extend long-term loans; and (4) ample availability of alternative assets offering attractive (risk-adjusted) returns.

It was only 2001, when banking sector faced a liquidity glut and declining yields in their traditional business lines that banks began to focus more strongly on the potential offered by this relatively untapped and higher yielding market segment. As a consequence, Pakistan witnessed remarkable growth in consumer finance over the last two years. Specifically, banks' exposure toward consumer financing increased to Rs 45.1 billion by end-June 2003, up a spectacular 639 percent as compared to the mere Rs 6.1 billion by end-June 2000 (see **Figure 6.2.1**).

A break up of the consumer financing by category shows that, by end-June FY03, personal loans (others) accounted for more than 40 percent of total credit, followed by the auto finance (see **Figure 6.2.2**).[34] While other products are still in their infancy, these too appear to be growing strongly.

Credit Cards

History of credit cards dates back to 1966, when the Habib Bank Limited introduced its credit card for the first time. However, the credit card market was quite insignificant, until the mid-1990s, when a foreign bank began actively marketing its credit cards. Outstanding financing through credit cards reached to Rs 6.7 billion by end-FY03.[35]

Auto Loans

Although a few banks had been extending auto loans since the mid-1990s, the business segment remained largely in the domain of leasing companies until recently. Over the last two years many banks have launched car financing schemes[36] and marketing aggressively. Combined net credit of all banks for auto-financing reached at Rs 15.8 billion by end FY03. This is substantially higher as compared to the aggregate total of only Rs 3.5 billion in FY01 (see **Figure 6.2.3**).

Figure 6.2.1: Trend in Consumer Financing

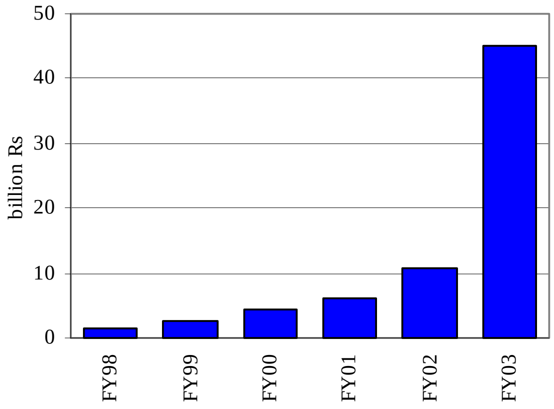
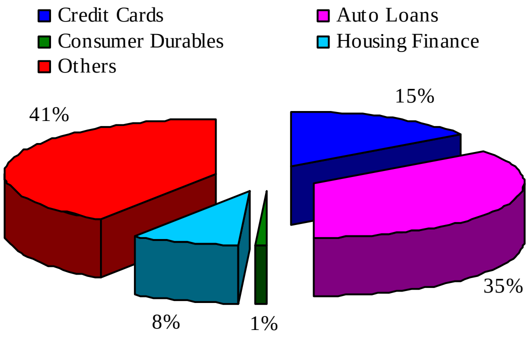


Figure 6.2.2: FY03 Composition of Consumer Financing



[34] In fact, approximately two-thirds of the *growth* in consumer finance loans during FY03 is accounted for by these two categories.

[35] For a more detailed discussion on Credit cards, see Special Section on **E-Banking**.

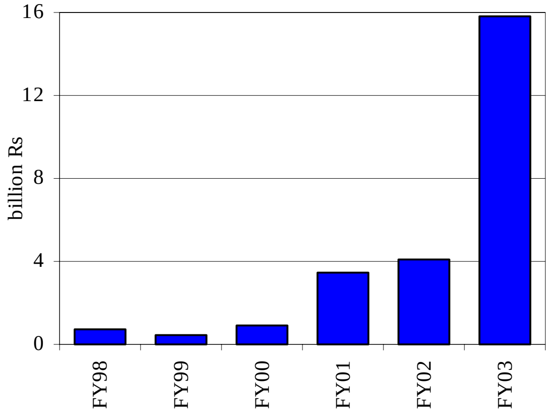
[36] Askari Bank, Union Bank, Bank Alfalah, Meezan, Citi Bank, and Habib Bank have introduced their car financing schemes.

Housing Finance

In sharp contrast to the credit cards and auto loans market where banks were free to undertake these business activities, housing finance by banks was barred until the May 5, 1998, prior to the issuance of a National Housing Policy.[37] Policy guidelines first issued in July 2001 were further liberalized in June 2003 keeping requirements of stakeholders and risk managing capacity of the banks in mind. Another very important development was the Financial Institutions (Recovery of Finance) Ordinance, 2001, which empower banks to recovery collateral without recourse to potentially lengthy and expensive court proceedings.

The main characteristics of the credit policy for housing finance are summarized in **Table 6.2.1**. As a result of these policy initiatives and increasing banks' interest in housing finance, net credit to this sector reached at Rs 3.8 by end-FY03.

Figure 6.2.3: Auto Loans



This activity is likely to flourish as various banks have tailored their housing finance products according to the targeted groups. The banks are also encouraged to float long-term housing bonds having maturity of 10 year or more (but not less than 10 years) to ensure asset-liability matching.

Table 6.2.1: Credit Policy-Housing Finance

	Jul-02	Jun-03
Maximum limit (million Rs)	5	7.5
Maximum maturity (years)	15	20
Debt equity ratio	70:30	80:20
Financing to be commensurate with cash flows	Yes	Yes
Exposure under housing finance as % of net advances	5	10

Personal Loans

Another important area of consumer finance is the personal loans, which has witnessed tremendous growth over the past two years, with net outstanding credit reaching Rs 18.4 billion by end-FY03. Although banks were already allowed to "clean" (uncollateralized) lending upto Rs 0.1 million and Rs 0.5 million (in case of credit cards) to individuals, the real impetus to such loans came during FY02 and FY03, when banks aggressively marketed their tailored products for personal loans.

In sum, besides other factors, this impressive growth in consumer financing played an important role in exceptional net credit expansion by the banking sector during FY03. Furthermore, these activities are likely to record higher growth in future, as the banks build required infrastructure and human resource capacity for this relatively new business area. In this regard, SBP is also playing an active role by making required policy changes to facilitate consumer finance activities on sustainable basis and for prudent risk management. Specifically, the SBP has drafted a set of Prudential Regulations for consumer financing, which is expected to be implemented soon after extensive consultation with stakeholders.

[37] Before May 1998, only housing finance companies were allowed to undertake housing finance, and House Building Finance Corporation was enjoying near monopoly position until 1998, as the business activities of private housing finance companies were quite limited. The banks were allowed vide a BPRD Circular No 10 dated May 5, 1998.

Special Section: e-Banking

"In the 21st Century there will be a lot of banking but there will be no banks"
Bill Gates

In recent years, Automated Teller Machines (ATM), Tele Banking, Internet Banking, Credit and Debit Cards, etc. have emerged as effective delivery channels for traditional banking products in Pakistan.

Foreign banks took the lead by re-introducing credit cards to the Pakistani mass market in mid-1990s. This was followed by the domestic banks, which introduced ATM facility in late 1990s. However, this delayed entry in e-banking may be largely explainable by regulatory hurdles, higher start-up costs,[38] on-going banking sector reforms, and lack of technical skills.

At present, a number of commercial banks have set up their own standalone ATM networks, issuing credit and debit cards, offering round the clock phone banking, and maintain comprehensive websites providing detailed information on their conventional and e-banking products. Furthermore, all banks have joined one of the two operating ATM Switch Networks and these two switches are in process of linkage with each other. Have linked these two switches, customers will have access to over four hundreds ATMs throughout Pakistan.[39] However, other e-banking activities are yet to establish. In this backdrop, the following discussion is restricted to these two e-banking products.

ATM Cards

In Pakistan, the ATMs generally allow cash withdrawals, balance information, PIN change, and to print mini-statement. A few banks also provide fund transfers, check book request, and utility bill payment facilities through their ATM networks. A quick glance at **Table 1** shows that the number of ATMs, cardholders and cash withdrawals have sharply increased since CY00. As a result, the value of ATM transactions has also recorded strong growth over the same period.

Table 1: Position of ATM

	CY00	CY01	CY02	Jun-03
No. of on-line branches	322	450	777	994
No. of ATMs	206	259	399	445
No. of card holders (000)	240	415	736	838
No. of transactions (000)	3624	5923	9319	6450
Value of transactions (million)	12507	22108	37786	28052
Value per transaction (Rupees)	3451	3733	4055	4349

The usage of ATM facilities other than for cash withdrawals is currently quite limited, but increasing (see **Table 2**). Lower number of balance inquiries and mini statement generated may be attributable to high service charges, i.e. Rs 2 for balance inquiry and Rs 5 for mini statement, and due to the fact that every transaction statement contains this information.

Table 2: Facilities Availed through ATM
thousands

	CY00	CY01	CY02	Mar-03
No. of fund transfer trans.	0.7	2.5	3.4	0.9
No. of mini statement	84.7	135.5	180.8	67.1
No. of balance inquiry	198.1	318.8	429.3	258.7

Within the banking sector, MCB has established the largest ATM network with 155 ATMs and owns an ATM Switch Network", while all other banks are lagging far behind. Its nearest competitors are

[38] Although start up cost of e-banking is very high, as it involves the purchase of costly technology (security and privacy), trusted brand (which are generally very costly), and require significant advertising expenditure. However, transaction cost is substantially lower as compared with the traditional banking.

[39] Stand-alone ATM networks mean the depositors of one specific bank, say bank X, having account in the on-line branch and holds ATM card, can use ATM facility only on the ATMs of that specific bank. While if that bank is linked with one of two operating switches, say M-net of MCB, that depositors can utilize ATM facilities on all those ATMs which are linked to that switch. Similarly, the connectivity of two switches will allow the depositors of any bank maintaining account in on-line branch and holds ATM card to utilize ATM facilities at any ATM through out Pakistan.

HBL, NBP, and Askari Commercial Bank having networks of only 66, 34 and 25 ATMs, respectively (see **Table 3**). These developments also indicate that private domestic banks are major suppliers of ATM facility. Although ABN AMRO, a foreign bank, has established an ATM Switch Network named "Shared ATM Switch Net Work", it has only 16 ATMs. However, this situation is likely to change in near future, as the number of on-line branches of various banks (particularly of UBL, HBL and few private banks) is increasing. The pace of expansion can be gauged from the fact that during H1-FY03, 217 branches have gained the status of on-line branches.[40]

Table 3: Number of ATMs

	CY00	CY01	CY02	Jun-03
MCB	75	103	151	155
HBL	33	50	60	66
NBP	15	16	29	34
Askari	13	14	18	25
S & C	14	15	24	24
Others	56	61	117	141
Total	206	259	399	445

It is hoped that the usage of ATM will substantially increase in near future as the banks have already connected their stand-alone ATM networks with one of two operating Switch Links by end-June 2003.[41] In addition, these two switch links will be connected to each other, which will allow the cardholders to have excess to over 400 ATMs throughout the Pakistan. Furthermore, SBP has allowed banks to extend deposit of cash or cheques facility through ATMs within branch (on site) premises. This will help in promoting banking activities in the country by reducing transaction times. Furthermore, banks have also been allowed to install off-site ATMs for the dispensation of cash only.[42]

Credit Cards

Table 4: Use of Credit Cards

	CY00	CY01	CY02	Mar-03
No. of card holders (000)	217	292	369	397
No. of transactions (000)	3351	4224	5248	1340
Value of transactions (million)	8486	10834	14161	3828
Value per transaction	2532	2565	2698	2857

Financing through credit cards is another well-established e-banking activity in Pakistan, and it has witnessed remarkable growth since CY00. The number of credit card holders and volume of transaction have both significantly increased during last three years (see **Table 4**). This sharp rise was facilitated by improving e-banking infrastructure and rising banks' interest in the area of consumer financing. While the total number of POS terminals has increased to 8616 by the end of March 2003, net credit expansion to consumer financing surged to Rs 59.3 billion by end-June 2003.

Table 5: Number of Card Holders
thousands

	CY00	CY01	CY02	Mar-03
Citibank	107.3	132.8	153.1	152.8
Standard Charted	93.7	121.7	145.4	149.8
Askari	5.3	17.7	38.6	48.4
Union	0.0	8.0	13.3	16.5
Others	10.7	11.3	18.7	30.0
Total	216.9	291.6	369.1	397.3

In sharp contrast to ATMs, two foreign banks have dominated the credit card business in Pakistan; accounting over 95 percent of total amount is transacted during CY02 (see **Table 5**). However, few private sector banks have emerged as serious competitors through aggressive marketing.[43] This will not only help in promoting credit card facility, but will also help consumers by providing better services at competitive rates.

[40] An on-line branch means that customer records on that branch are computerized and is also linked with a central hub generally at head office.

[41] At present, two ATM Switch Networks are in operation, managed by MCB (M-net) and ABN AMRO Bank (Shared ATM Switch Net Work). The mandatory requirement for banks to link their ATMs networks with one of the two existing Switch-Links, may help MCB and ABN AMERO (owner of Switch Links) to recover their cost earlier, as other banks will pay an annual fee to these banks for utilizing their services.

[42] For details, see BPD Circular Letter No. 21 dated June 27, 2003.

[43] These banks are offering credit at relatively lower interest rates and providing annual fee waivers, etc.