6 Banking Sector[1]

The banking sector recorded a robust performance during Jan-May 2004. This was led mainly by the continuation of an exceptionally strong H1-FY04 net credit expansion.[2] Deposits too, recorded a significant rise of Rs 144.2 billion during Jan-May 2004, compared with Rs 102.6 billion during Jan-May 2003. The strong deposit growth is particularly interesting given the sharp reduction in the external account surplus relative to the preceding period, which suggests that the deposit growth during the period was increasingly driven by exceptionally strong domestic credit growth and the portfolio shift away from investments in the National Saving Schemes (NSS).

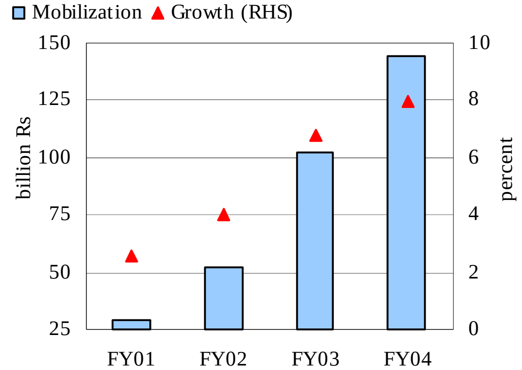
Other significant developments in the banking sector include: (1) the introduction of separate Prudential Regulations for Corporate and Commercial Banking, SME Financing and Consumer Financing;[3] and (2) the inter-switch connectivity of two ATM switches in the country (see **Section 6.4** for details).

Finally, a proactive multi-pronged policy to deal with outstanding stock of NPLs and to stem new additions continued to lessen the burden of NPLs. The outstanding stock of NPLs of the banking sector saw a decline of Rs 3.1 billion to Rs 207 billion during Q3-FY04. Correspondingly, the *NPLs to total advances* and *net NPLs to net advances* ratios also saw visible improvement during the period.

6.1 Deposit Mobilization

Despite a strong base-effect (a rise of Rs 117.0 billion during (H1-FY04), Jan-May deposits witnessed a spectacular rise of 8.0 percent YoY compared with a 6.8 percent increase during the same period of FY03. As evident from **Figure 6.1**, the growth in banking sector deposits has surged strongly since FY03, which appears to be principally due to a

Figure 6.1: Deposit Mobilization during Jan-May



[1] For a detailed analysis of the aggregate balance sheets of the banking sector, please refer to the *SBP Quarterly Performance of the Banking System for March-2004*.
[2] In fact, this rise is in contrast to the long-term credit cycle, in which the third quarter of a fiscal year typically witnesses a net *retirement* of credit.
[3] For details please refer to the *SBP Banking System Review 2003*.

corresponding exceptional rise in external account surpluses. In this context, the narrowing external account surpluses during Jan-May 2004 would have suggested a slowdown in deposit growth. However, the rise in deposits appears to have been insulated by: (1) the re-intermediation of NSS investments;[4] (2) the record growth in credit off-take (for the third quarter of a fiscal year); and (3) rising incomes due to increasing economic activity.

Table 6.1: Deposit Mobilization

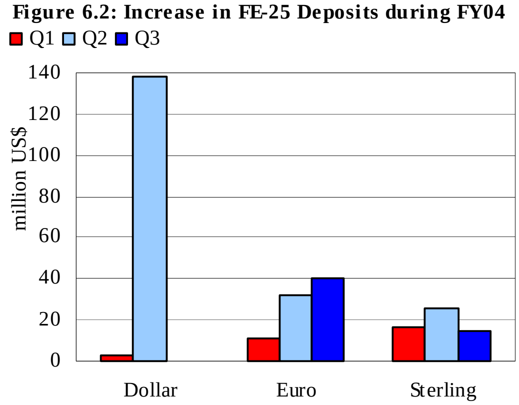
billion Rupees

	LCDs		FCDs		Total Deposits	
	FY03	**FY04**	**FY03**	**FY04**	**FY03**	**FY04**
			During Jan-May			
PSCBs	23.3	36.9	-14.4	2.6	8.9	39.5
DPBs	99.4	92.8	-3.7	5.4	95.7	98.1
FBs	2.8	5.6	-5.3	2.5	-2.5	8.1
SBs	0.6	-1.5	0.0	0.0	0.6	-1.5
All Banks	126.1	133.8	-23.5	10.5	102.6	144.2
			During Jul-Mar			
PSCBs	31.6	57.4	-8.2	4.0	23.4	61.4
DPBs	202.5	175.5	-12.0	7.4	190.5	182.9
FBs	5.4	13.0	-16.1	4.6	-10.7	17.6
SBs	1.5	-1.2	0.0	0.0	1.5	-1.2
All Banks	241.1	244.7	-36.4	16.0	204.7	260.8

HBL is included in Domestic Private Banks

However, the relative weakness in the external account does appear to have influenced the currency composition of the deposit growth. During Jan-May 2003, the strengthening rupee had led to a substitution of funds from forex to Rupee deposits, thereby contributing to net reduction in forex deposits. This phenomenon appears to have ended amidst some expectations of a weakening Rupee, allowing for a rise in forex deposits during Jan-May 2004 (see **Table 6.1**).

Figure 6.2: Increase in FE-25 Deposits during FY04



Other factors contributing to the relative improvement in FCDs during Q3-FY04 include: (1) the absence of hefty withdrawals[5] related to temporary deposits of Privatization Commission;

[4] During Q3-FY04, mobilization in NSS declined by Rs 4.05 billion against mobilization of Rs 22 billion during Q3-FY03.

[5] During Q3-FY03, privatization proceeds of UBL and Pakistan Oil Fields were transferred to government account with SBP from National Bank.

(2) inflows during Q3-FY04[6] in some of the government institutions, and (3) the rise in non-US$ forex deposits reflecting the strengthening of the Euro against the Rupee (see **Figure 6.2**).

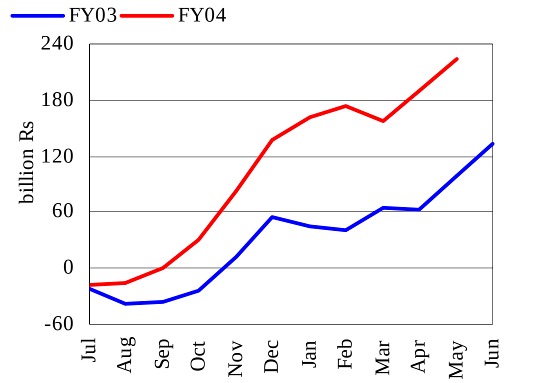
Although dollar deposits witnessed net withdrawals of US$ 0.67 million during Q3-FY04, this mainly represents the transfer of 'earnest money' placed with NBP to the government account with the SBP. Adjusting for this outflow, dollar deposits have actually increased during the quarter.

6.2 Credit Expansion

As mentioned in the **Money and Credit section**, net credit disbursements to the private sector increased significantly, particularly during Q3-FY04, on account of the growing trade volume and strong credit demand for personal credit. This was partially offset by the continuing retirement of liabilities by the pubic sector to banks.

As a result, overall credit of the banking sector increased by Rs 19.5 billion during Q3-FY04, bringing the cumulative Jul-May expansion to Rs 224 billion. To put this in perspective, this growth is more than twice that seen in Jul-May 2003. Moreover, this has taken place despite a Rs 23 billion downward adjustment by a specialized bank that reduced aggregate stock of net credit outstanding during Q3-FY04, thereby depressing the net credit growth figure for the period (see **Figure 6.3**).

Figure 6.3: Overall Credit Expansion-Cumulative

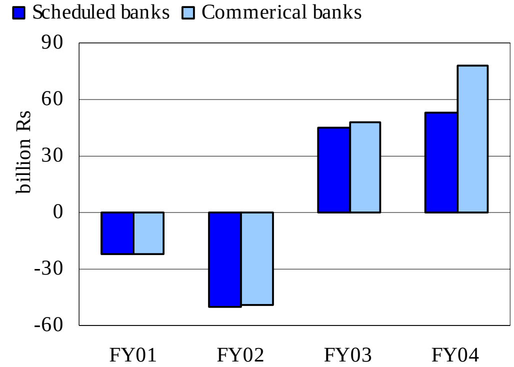


Viewing the figures for commercial banks only, overall credit increased by Rs 78.2 billion during Jan-May 2004, which is significantly higher than the increase witnessed during the same period last year (see **Figure 6.4**).

[6] The quarter saw a large deposit by a government institution, which was withdrawn during April 2004. Similarly, the proceeds of the privatization of Pakistan Oil Fields were temporarily deposited with a DPB before being withdrawn in the succeeding quarter.

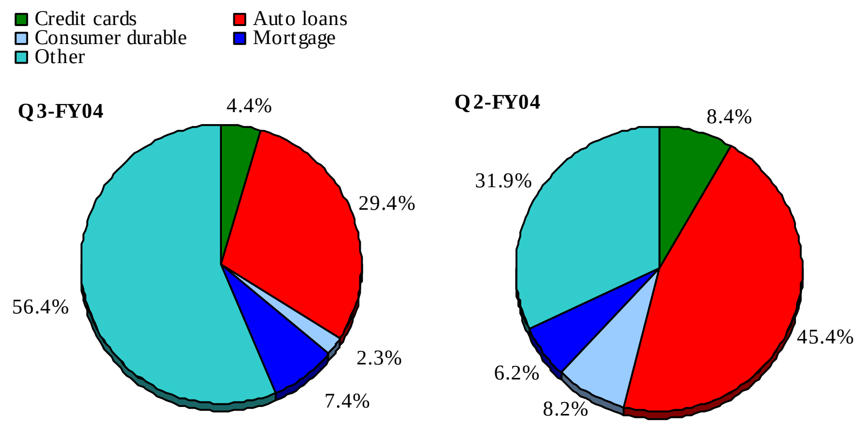
The sectoral distribution of the net credit growth shows that it is not only the newly developed market segments (consumer and SMEs) that have contributed to the change in the cyclical movements of credit expansion; the corporate sector also contributed towards the unseasonal credit off-take. In fact, the corporate sector accounts for 54 percent of overall net credit expansion.[7]

Figure 6.4: Overall Credit Expansion in Jan-May



The sectoral composition of the increase in consumer credit has changed significantly during Q3-FY04 as compared with Q2-FY04 (see **Figure 6.5**).

Figure 6.5: Composition of Rise in Consumer Financing



During Q2-FY04, most of the consumer credit was directed to finance automobile purchases. In contrast, during Q3-FY04, the unclassified sector (which mainly

[7] Sector wise distribution of credit within the business sector is already discussed in **Section 4 Money and Credit**.

constitutes the personal finance and balance transfer facilities) registered the largest expansion.[8]

Auto loans, nonetheless saw an increase, rising by Rs 5.4 billion during Q3-FY04 as against the Rs 5.3 billion increase seen in Q3-FY03. In addition, mortgage loans showed the highest expansion for the last three quarters, probably reflecting the aggressive marketing of these loans, and launch of schemes by some of the large domestic banks (that have greater outreach).

Bank wise data for consumer credit shows that the big five banks[9] contributed 32.6 percent of the total consumer credit (see **Table 6.2**), with one bank accounting for 20 percent of total consumer credit. In fact, this bank has been aggressively marketing its 'personal loan' product over the last few quarters, which is reflected in the 41 percent share of this bank in total 'other' loans of the banking sector.

Table 6.2: Banks' Share in Consumer Credit (end-Mar 04)

percent

	Big Five	Domestic	Foreign
Credit cards	1.6	43.6	54.8
Auto loans	16.9	62.6	20.5
Consumer durable	14.9	85.1	0.0
Mortgage loan	7.0	51.5	41.5
Other	55.5	13.1	31.5
Total Consumer Credit	**32.6**	**36.7**	**30.8**

Foreign banks account for 30.8 percent of outstanding consumer credit as on end Q3-FY04, of which 78.5 percent was held by only two banks. These two banks appear to be particularly strong in credit card business; enjoying 55 percent share in this market segment. Foreign banks are also competing aggressively in personal and mortgage loans markets.

However, it is domestic banks (excluding big five banks) that have captured the major share of the consumer credit market especially in auto finance, mortgage loans and loans for the purchase of consumer durables. This is the outcome of their faster shift in market strategy to take advantage of rising liquidity within the banking system.

6.3 Microfinance Institutions

Microfinance institutions (MFIs) continued to gradually enhance their outreach during Q3-FY04, as evident from an increase in number of branches, borrowers

[8] Other loans increased by Rs 10.3 billion against Rs 3.7 billion in Q2-FY04.

[9] These include, HBL, UBL, NBP, MCB and ABL.

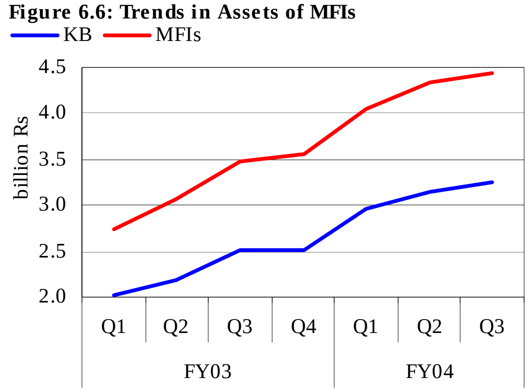
and depositors (see **Table 6.3**). Corresponding to this increasing outreach, gradual changes are also visible in the financial accounts of the MFIs, as the assets reached to Rs 4.4 billion, with a rise of 2.4 percent during the quarter under review (see **Figure 6.6**).

Table 6.3: Outreach of MFIs

	Dec-02	Dec-03	Mar-04
No. of branches	39	56	60
No. of borrowers "000"	57.0	96.4	102.1
No. of depositors "000"	2.8	10.1	12.1
Net advances million Rupees	493.1	736.3	796.2
Average loan size - Rupees	9000.8	8093.9	8253.1

However, the distribution of financial assets between the two operating MFIs remained highly skewed towards Khushhali bank, which accounts for 73.3 percent of the total assets as on end Q3-FY04. This simply reflects the larger size of the latter institution as well as the fact that it began operations earlier than the other institution.

Figure 6.6: Trends in Assets of MFIs

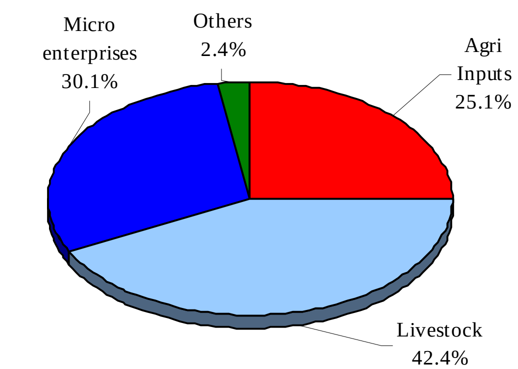


The asset composition of MFIs paints an interesting picture, as investments account for 46.8 percent of overall assets, followed by advances with a share of only 17.9 percent. The substantially lower share of advances (relative to commercial banks) is attributed to: (1) the limited (though gradually rising) retail capacity of MFIs during early periods of operations; and, (2) the smaller average loan size which renders difficult a sharp rise in advances.

A break up of the advances suggests that the aggregate loan portfolio of MFIs is diversified (see **Figure 6.7**). This is deceptive, and owes to the diversified portfolio of the Khushhali bank that accounts for 88.8 percent of the loans. In contrast, the FMFB has greater exposure towards the micro-enterprises (80.6 percent of total loans).

While the expanding outreach and overall asset composition bode well, increasing amount of NPLs seems to be a major point of concern. Specifically, NPLs of MFIs have reached Rs 86.7 million by end Q3-FY04. Both, *NPLs to total advances* and *net NPLs to net advances* ratios are 10.5 and 5.1 percent respectively. The visible gap between these two ratios reflects that a substantial portion of NPLs has been provided for, and the outstanding stock does not, as yet, pose a serious threat to the well-capitalized MFIs at this stage. However, it does suggest the need for vigilant monitoring.

Figure 6.7: Distribution of Advances

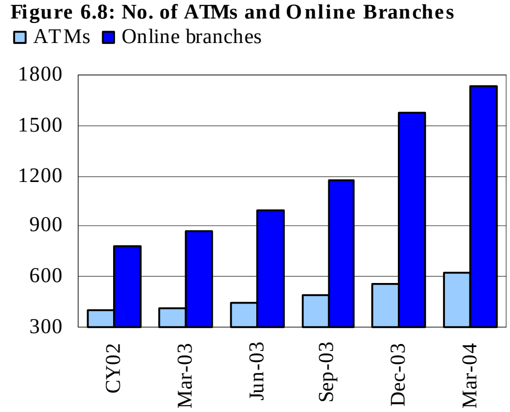


6.4 Automated Retail Transactions

The e-banking infrastructure continued to improve during Q3-FY04. The number of on-line branches reached to 1738 by end Q3-FY04, with an impressive rise of 157 during Q3-FY04, while the number of ATMs rose by 78 during the quarter to 630 (see **Figure 6.8**).

The use of e-banking has been helped by the advent of the ATM *inter-switch connectivity* during Q3-FY04. Most of the banks in Pakistan were already linked to either of the two operating ATM switch-links (M-net and 1-Link), and the connectivity between the two now allows consumers access to their accounts from over 600 ATMs across the country. The convenience of the inter-switch connectivity is underlined by the fact that over 4000 transactions were executed between the two switch-links during the initial two weeks[10] alone. Moreover, the share of inter-bank transactions in total ATM transactions on both switch-links before connectivity reached 6.7 percent by end Q3-FY04, as compared to only 1.5 percent in CY02.

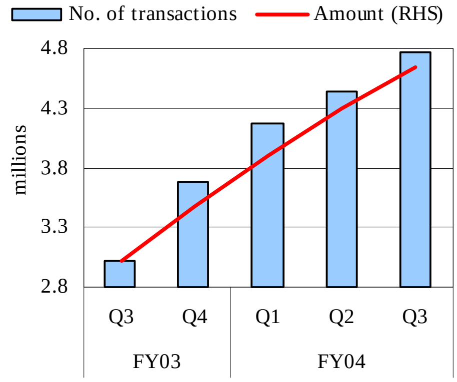
Figure 6.8: No. of ATMs and Online Branches



[10] Both switch links were connected with effect from March 16, 2004.

The impact of the increase in the number of ATMs, connectivity of banks with one of the two switch-links and inter-switch connectivity, is quite visible in the number of ATM transactions and amount withdrawals through ATMs (see **Figure 6.9**).

Figure 6.9: Trends in ATM Transactions



Further, 58.2 percent of overall branches (6869) have been computerized up to Q3-FY04 and the number of on-line branches constitutes only 43.5 percent of computerized branches. This suggests there is yet substantial opportunity for further acceleration in e-banking activities by increasing the ATM network.

6.5 Non-Performing Loans[11]

The NPLs of the banking sector saw a decline of Rs 3.1 billion during Q3-FY04, bringing down the outstanding stock of NPLs to Rs 207.0 billion (see **Table 6.4**).[12] A breakup of NPLs into major banking groups according to the ownership structure indicates that the decline in NPLs was not evident across the banking sector. It was the specialized banking group (SBs) that drove the outstanding stock of NPLs down. One the other hand, NPLs of the commercial banks saw a marginal rise of

Table 6.4: Outstanding NPLs during FY04

billion Rupees

	Q1	Q2	Q3
PSCBs	43.2	43.6	44.0
DPBs	115.1	108.7	108.8
FBs	4.3	3.7	3.7
All CBs	162.6	156.0	156.6
SBs	53.1	54.1	50.4
All Banks	215.7	210.1	207.0

Note: HBL has been classified in DPBs for all quarters

[11] The SBP has taken various far-reaching steps to deal with the accumulated stock of non-performing loans and stem the new flows. These include the SBP Incentive Scheme of 1997, Promulgation of NAB Ordinance, establishment of CIRC, the Financial Institutions (Recovery of Finance) Ordinance 2001, and guidelines for the write-off of irrecoverable loans.

[12] The SBP has revised and updated the accounting/reporting methodology of NPLs inline with best international practices since Q2-FY04. As a result, the past data of NPLs is no more comparable with recent NPLs figures.

0.6 billion. However, this is not worrisome. This is because the NPLs of all but four banks actually declined. Moreover, even the rise in NPLs of these four banks appears to be a consequence of one-time factors, i.e. either a change in management or restructuring/mergers.

Although overall NPLs of the banking sector have declined during Q3-FY04, it is instructive to analyze them in terms of the overall portfolio as proxied by total advances. Two important ratios widely used to measure portfolio infection are the *NPLs to gross advances* and *net NPLs to net advances*.[13] A quick glance at **Table 6.5** shows that both ratios have significantly declined for all the banking groups except for PSCBs. Also, the large difference between the *NPLs to total advances* and the *net NPLs to net advances* ratios indicates that a significant portion of NPLs have been provided for, which is also evident from the high coverage ratio (provisions to NPLs ratio).

Table 6.5: Relative position of NPLs during FY04

percent

	NPLs/gross advances		Net NPLs to net advances		Coverage ratio	
	Q2	**Q3**	**Q2**	**Q3**	**Q2**	**Q3**
PSCBs	20.2	20.6	7.4	7.8	68.4	67.2
DPBs	13.5	13.0	5.4	5.0	63.8	64.8
FBs	2.9	2.8	0.4	0.3	86.1	90.4
All CBs	13.6	13.2	5.2	4.9	65.6	66.1
SBs	55.0	51.6	34.2	26.4	57.5	66.2
All Banks	16.9	16.1	6.9	6.1	63.5	66.1

Furthermore, the high coverage ratio coupled with progressive nature of provision specification criteria suggests that the banks' expense on provision is likely to decline in future, if the existing portfolio is of better quality.

The break up of NPLs into various categories defined for provisioning shows that 78.3 percent of NPLs fall in loss category by end Q3-FY04;[14] this high share of NPLs in the "loss" category suggests that existing portfolio of the overall banking sector is of relatively better quality as compared to the past. The declining trend in fresh NPLs (evident from FY00) of the banking sector also highlights the fact that fresh lending is of relatively better quality (see **Figure 6.10**). [15]

[13] Net NPLs =NPLs less provisions, net advances = total advances less provisions.
[14] Loss category includes all those advances, which have not been performing at least form the last two years for short-term loans and three years for the long-term loans.
[15] Data for the last two quarter also takes into account the fresh NPLs of the banking sector from its overseas operations, while all other figures are related to domestic operations of the banking sector.

The accumulated Rs 42.9 billion rise in fresh NPLs upto Q3-FY04, primarily on account of surge in one of specialized banks during the first quarter of the year, is lower than Rs 44.6 billion over the same period last year. In this backdrop, it seems that the asset quality of the banking sector is improving and risk posed to banking solvency is mitigating with the passage of time.

Figure 6.10: Fresh NPLs