6 The Banking System

6.1 Performance of Scheduled Banks[1]

The banking sector has been undergoing a complex, painful but comprehensive phase of restructuring since 1997, with a view to make it sound, efficient, and at the same time forging its links firmly with the real sector for promotion of savings, investment and growth. Although a complete turnaround in banking sector performance is not expected till the completion of reforms, signs of improvement are visible in some indicators under the CAMEL framework (see **Box 6.1**). Furthermore, this improvement has to be seen in the context, not only of the restructuring undertaken so far, but also the negative fallout of freezing Foreign Currency Accounts (FCAs) in May 1998.

Banks had to withstand several distinct types of pressures since 1997. First, the wave of multipronged reforms, introduced by SBP, required banks to enhance capital adequacy, strengthen asset quality, improve management, increase earnings and reduce sensitivity to various financial risks. At the same time, on-site as well as off-site surveillance by SBP has assumed greater importance. Second, the unfortunate freeze of FCAs set into motion a process of weakening, erosion and disintermediation in the financial system. Third, the continued stagnation in economic activity and low growth, have also affected the demand for credit provided by banking system. Fourth, the drive for accountability and loan recovery since October 1999 have also brought about behavioral change both among the borrower as well as lenders. Risk aversion has been more pronounced than is warranted. The almost simultaneous nature of these developments makes it difficult to disentangle the positive impact of reform measures. Keeping this in mind, signs of improvements and deteriorations are discussed for the five groups of scheduled banks in the following sections.[2]

6.1.1 Capital Adequacy

In order to protect the interest of depositors and shareholders of banks, SBP introduced the risk-based system for capital adequacy in November 1998[3] and asked banks to maintain 8 percent[4] Capital to Risk Weighted Assets (CRWA) ratio. Additionally, banks were required to achieve a minimum paid-up capital of Rs 500 million by December 31, 1998. Recently, this requirement has been revised to Rs 1 billion as on January 1, 2003.[5]

Accordingly, capital base of scheduled banks has improved significantly since December 1997. As shown in **Table 6.1**, CRWA of the banking system was less than the required level in CY97, mainly due to the poor performance by Nationalized Commercial Banks (NCBs) and specialized banks. In NCBs, though

Table 6.1: Capital Adequacy Indicators

	CY97	CY98	CY99	CY00
CRWA ratio				
Nationalized commercial banks	-2.1	11.4	10.4	10.1
Privatized commercial banks	8.0	8.2	7.9	6.9
Specialized banks	-6.2	-1.4	0.3	-3.3
Private banks	15.8	15.0	13.6	11.5
Foreign banks	14.6	15.6	18.6	18.0
All banks	**4.5**	**10.9**	**10.9**	**9.7**
No. of banks below 8% CRWA				
Nationalized commercial banks	3	0	0	0
Privatized commercial banks	1	0	1	1
Specialized banks	2	2	2	2
Private banks	0	0	0	2
Foreign banks	1	0	0	0
All banks	**7**	**2**	**3**	**5**

[1] All the data in this chapter is based on annual (audited) balance sheets of banks, ending December. Hence, data is for calendar year, where CY00 means calendar year 2000. Furthermore, it includes the operations of both domestic and overseas branches and may, therefore, differ from the data given in Statistical Annexure, based only on domestic operations.

[2] See **Statistical Annexure** for group-wise list of banks (Annexure **6.12**).

[3] Vide BPRD circular No. 36, November 4, 1997, w.e.f. December 31, 1997.

[4] This is the benchmark set by the BASLE committee.

[5] Vide BSD circular No. 31 dated December 6, 2000.

the three major banks were not meeting the benchmark, huge losses suffered by one of them, resulted in negative CRWA for the entire group.

Capital injection of Rs 30.7 billion and revaluation of fixed assets, helped in bringing the group's ratio to 11.4 percent at end-December 1998, which remained above 10 percent in the following two years. Furthermore, it is important to note that after CY97, all NCBs were showing CRWA more than the 8 percent level.[6] In terms of private and foreign banks, this ratio was well above the benchmark.

Box 6.1: CAMELS Framework

Supervisory framework of SBP, consistent with international norms, covers risk-monitoring factors for evaluating the performance of banks. Specifically, CAMELS framework is in place since end December 1997 for *on-site* and *off-site surveillance*. This framework involves the analyses of six groups of indicators reflecting the health of financial institutions.

Capital Adequacy: Capital base of financial institutions facilitates depositors in forming their risk perception about the institutions. Also, it is the key parameter for financial managers to maintain adequate levels of capitalization. Moreover, besides absorbing unanticipated shocks, it signals that the institution will continue to honor its obligations. The most widely used indicator of capital adequacy is capital to risk-weighted assets ratio (CRWA). According to Bank Supervision Regulation Committee (The Basle Committee) of Bank for International Settlements, a minimum 8 percent CRWA is required.

Asset Quality: Asset quality determines the robustness of financial institutions against loss of value in the assets. The deteriorating value of assets, being prime source of banking problems, directly pour into other areas, as losses are eventually written-off against capital, which ultimately jeopardizes the earning capacity of the institution. With this backdrop, the asset quality is gauged in relation to the level and severity of non-performing assets, adequacy of provisions, recoveries, distribution of assets etc. Popular indicators include non-performing loans to advances, loan default to total advances, and recoveries to loan default ratios.

Management Soundness: Management of financial institution is generally evaluated in terms of capital adequacy, asset quality, earnings and profitability, liquidity and risk sensitivity ratings. In addition, performance evaluation includes compliance with set norms, ability to plan and react to changing circumstances, technical competence, leadership and administrative ability. In effect, management rating is just an amalgam of performance in the above-mentioned areas.

Earnings and Profitability: Earnings and profitability, the prime source of increase in capital base, is examined with regards to interest rate policies and adequacy of provisioning. In addition, it also helps to support present and future operations of the institutions. The single best indicator used to gauge earning is the Return on Assets (ROA), which is net income after taxes to total asset ratio.

Liquidity: An adequate liquidity position refers to a situation, where institution can obtain sufficient funds, either by increasing liabilities or by converting its assets quickly at a reasonable cost. It is, therefore, generally assessed in terms of overall assets and liability management, as mismatching gives rise to liquidity risk. Efficient fund management refers to a situation where a spread between rate sensitive assets (RSA) and rate sensitive liabilities (RSL) is maintained. The most commonly used tool to evaluate interest rate exposure is the Gap between RSA and RSL, while liquidity is gauged by liquid to total asset ratio.

Sensitivity to Market Risk: The diversified nature of bank operations make them vulnerable to various kinds of financial risks. Sensitivity analysis reflects institution's exposure to interest rate risk, foreign exchange volatility and equity price risks (these risks are summed in market risk). Risk sensitivity is mostly evaluated in terms of management's ability to monitor and control market risk.

The improvement in CRWA seems to deteriorate after CY98. However, this has to be seen in the context of the post-detonation scenario, where a monetary ease resulted in a fall in yield of government securities, and hence banks' investment. Being zero-risk weighted, disinvestments of government securities inevitably led to a slight fall in capital adequacy ratio. Nevertheless, this ratio

[6] However, during FY01, SBP again injected Rs 8 billion in one of the major state run bank.

is still above the required level and helped the banks to divert their investments toward more productive private sector advances. In addition, higher provisioning against NPLs, which affects the capital base through profit/loss accounts, has further contributed to this decline. In essence, this may be considered a positive development.

6.1.2 Asset Quality[7]

Asset quality is generally measured in relation to the level and severity of non-performing assets, recoveries, the adequacy of provisions, distribution of assets, etc. Although, the banking system is infected with a large volume of Non-Performing Loans (NPLs), its severity has stabilized to some extent. This is not to say that the problem of NPLs has taken a secondary position. Unfortunately, it still remains the most dominant factor affecting the earning capacity of banks. However, marginal improvements in various ratios indicate that this problem is manageable, and continues to be addressed with more vigor, using stringent requirements for provisioning and disclosure.[8]

Table 6.2: Asset Quality Indicators

	CY97	CY98	CY99	CY00
Gross NPLs to gross advances ratio				
Nationalized commercial banks	31.3	29.6	31.2	26.5
Privatized commercial banks	12.8	14.2	18.2	18.4
Specialized banks	50.6	47.2	51.6	51.2
Private banks	7.0	7.2	12.2	11.6
Foreign banks	5.0	5.3	5.1	5.1
All banks	**23.5**	**23.1**	**25.9**	**23.3**
Net NPLs to net advances ratio				
Nationalized commercial banks	17.5	15.6	18.7	12.7
Privatized commercial banks	6.2	8.6	13.5	13.6
Specialized banks	44.1	23.6	32.8	30.1
Private banks	3.1	2.0	7.3	6.9
Foreign banks	1.8	1.4	1.9	2.0
All banks	**14.1**	**11.1**	**15.3**	**12.1**
Loan default to gross advances[1]				
Nationalized commercial banks	29.4	25.6	17.8	16.1
Privatized commercial banks	11.3	13.4	11.0	11.0
Specialized banks	17.4	16.2	10.8	12.9
Private banks	5.7	6.8	11.2	8.9
Foreign banks	4.1	5.7	5.0	3.7
All banks	**16.7**	**16.7**	**13.3**	**12.3**
Cash recovery to loan default[1]				
Nationalized commercial banks	9.5	6.6	8.1	7.5
Privatized commercial banks	9.2	5.0	7.1	11.6
Specialized banks	2.8	0.9	1.9	7.0
Private banks	9.5	3.3	4.5	9.5
Foreign banks	8.4	1.3	2.9	12.2
All banks	**8.6**	**5.3**	**6.6**	**8.3**
Gross NPLs (billion Rupees)	173.0	183.0	230.8	236.7
As percent of GDP	6.5	6.2	7.2	6.8

[1] Both cash recovery and defaults are against domestic operations

Improvements, slight or significant, can be discerned from **Table 6.2**. Ratio of gross NPLs to total loans has gone down slightly from 23.5 percent in CY97 to 23.3 percent in CY00, albeit rising first to 25.9 percent in CY99. This temporal rise was due to increase in volume of NPLs following enforcement of more vigorous standards for classifying loans, improved reporting and disclosure requirements adopted by SBP in recent years.[9] Prior to that, some of the specialized banks were reporting only default or overdue portion of their NPLs instead of total outstanding amounts of such loans. This adjustment alone has added to the volume of non-performing loans.

In case of NCBs, this improvement is much more pronounced, given their share in total NPLs. This shows that fresh loans are being extended much more prudently than was the case earlier. In the case of private and privatized banks, this ratio has gone up considerably and is a cause for concern. For private banks, this is largely due to a rapid rise in their loan books, reflecting their increasingly aggressive approach toward credit extension. However, the level of infection in foreign banks is not only the lowest but also close to constant, showing their prudence.

[7] It is important to mention again that NPLs used here are global, including those against domestic as well as overseas advances.
[8] Vide BSD circular No. 31, August 13, 1997.
[9] Vide BSD circular No. 27, July 8, 1997.

The ratio of net NPLs to net advances, another indicator of asset quality, for all scheduled banks has declined significantly from 14.1 percent in CY97 to 12.1 percent in CY00 (see **Table 6.2**).[10] In the case of specialized banks, this fall is entirely due to provisioning.

Marked improvement is visible in recovery efforts of almost all groups of scheduled banks. This is remarkable in the case of NCBs, in terms of reduction in the ratio of loan defaults to gross advances, from 29.4 percent in CY97 to 16.1 percent in CY00. Although privatized banks do not show significant improvement, their ratio is much lower than that of NCBs. Specialized banks also show improvement and so do foreign banks. Only exception is the group of private banks for which the ratio has gone up from 5.7 percent in CY97 to 8.9 percent in CY00. This ratio includes some of the weak banks against which actions have recently been taken (see **Section 6.6**). However, it is still lower, except when compared with that of foreign banks. Nevertheless, it indicates that private banks need to focus on recoveries, side by side with aggressive credit extension.

6.1.3 Management Soundness

Sound management is one of the most important factors behind financial institutions' performance. Indicators of quality of management, however, are primarily applicable to individual institutions, and cannot be easily aggregated across the sector. Furthermore, given the qualitative nature of management, it is difficult to judge its soundness just by looking at financial accounts of the banks. Nevertheless, total expenditure to total income and operating expense to total expense helps in gauging the management quality of the banking institutions.

Management indicators are reported in **Table 6.3**. At first glance, expenditure to income ratio seems to show an improvement from CY97 to CY00. Unfortunately, this is not the case. Very large ratio for NCBs in CY97 was the result of losses suffered by UBL due to provisioning against bad loans, implemented for the first time. Therefore, subsequent decline for the following two years can hardly be called an improvement. However, it is visible in CY00.

Pressures on earnings and profitability of foreign and private banks due to FCA freeze, caused their expenditure to income ratios to rise first in CY98. However, it started tempering down as they adjusted their portfolios to meet the liquidation of FCAs. An across the board increase in administrative expenses to total expenditure is visible from CY99 onwards. Surprisingly, the worst performers in this regard are the privatized banks, mostly because of high salaries and allowances (see **Table 6.3**).

Table 6.3: Management Soundness Indicators

	CY97	CY98	CY99	CY00
Expenditure to income ratio				
Nationalized commercial banks	134.4	104.2	104.5	95.4
Privatized commercial banks	95.5	96.1	95.6	101.6
Specialized banks	101.8	171.1	85.0	119.5
Private banks	82.8	90.4	89.0	89.8
Foreign banks	81.2	88.6	86.8	87.2
All banks	**106.5**	**102.3**	**96.1**	**95.8**
Administrative expenses to total expenditures				
Nationalized commercial banks	24.2	25.8	30.0	33.2
Privatized commercial banks	33.7	34.2	39.4	40.5
Specialized banks	25.0	11.3	25.0	20.2
Private banks	21.5	19.0	21.2	22.8
Foreign banks	19.1	19.3	22.0	25.6
All banks	**24.5**	**23.3**	**28.7**	**30.6**
Salaries, allowances etc to total expenditure				
Nationalized commercial banks	16.6	17.0	19.8	22.6
Privatized commercial banks	23.7	24.2	26.7	28.3
Specialized banks	19.9	8.4	19.1	15.9
Private banks	9.1	8.4	9.4	10.1
Foreign banks	7.0	7.7	8.7	9.9
All banks	**15.3**	**14.2**	**17.6**	**19.2**
Provisioning to total expenditure				
Nationalized commercial banks	15.8	6.6	10.0	3.6
Privatized commercial banks	8.9	0.7	1.0	8.8
Specialized banks	10.9	68.6	0.5	26.1
Private banks	5.9	7.3	2.6	7.3
Foreign banks	2.8	3.2	2.6	3.4
All banks	**11.1**	**12.4**	**5.7**	**6.9**

[10] Net NPLs are gross NPLs minus provisioning.

6.1.4 Earnings and Profitability

Strong earnings and profitability profile of banks reflects the ability to support present and future operations. More specifically, this determines the capacity to absorb losses, finance its expansion, pay dividends to its shareholders, and build up an adequate level of capital. Being front line of defense against erosion of capital base from losses, the need for high earnings and profitability can hardly be overemphasized. Although different indicators are used to serve the purpose, the best and most widely used indicator is Return on Assets (ROA). However, for in-depth analysis, another indicator Net Interest Margins (NIM) is also used (see **Table 6.4)**.[11]

Table 6.4: Earnings & Profitability Indicators

	CY97	CY98	CY99	CY00
Return on assets (after tax)				
Nationalized commercial banks	-3.3	0.7	-1.1	0.2
Privatized commercial banks	0.1	0.2	0.2	-0.2
Specialized banks	-0.2	-9.4	1.7	-2.3
Private banks	1.1	0.6	0.6	0.3
Foreign banks	1.4	0.4	0.7	0.6
All banks	**-1.2**	**-0.1**	**-0.2**	**0.1**
Net interest margin				
Nationalized commercial banks	1.5	3.3	3.3	3.4
Privatized commercial banks	4.3	3.8	3.4	3.3
Specialized banks	3.6	9.3	4.1	4.2
Private banks	3.3	3.0	2.7	2.8
Foreign banks	4.4	3.3	3.5	3.4
All banks	**2.8**	**3.7**	**3.3**	**3.3**

ROA of banking industry remained negative during CY97-99, primarily on account of heavy losses suffered by nationalized and specialized banks. Since NCBs have significantly large share in the banking industry, their performance overshadows the other banks. Hence, profit earned by this group resulted in positive value of ROA of banking industry during CY00, despite losses suffered by privatized (ABL) and specialized banks.

Post-freeze stress on earnings and profitability is visible most in the case of foreign and specialized banks (see **Table 6.4)**. Stress in NCBs is also present but not visible in CY98 due to heavy losses declared by one of the large NCBs a year earlier on account of first time provisioning of bad loans undertaken immediately after the banking reform process. ROA also declined for domestic private banks during CY97-00.

Net interest margins also declined across the board as shown in **Table 6.4** except for NCBs, which rose from 1.5 percent in CY97 to 3.3 percent in CY98. The stress on earnings and profitability was inevitable despite the steps taken to provide liquidity to banks during the peak period when FCAs were being liquidated. Not only did the liquid assets to total asset ratio decline sharply, earning assets to total assets also fell. The portfolio of government securities fell on account of the steps taken by SBP (to provide liquidity comfort) but also became T-bills became less remunerative.

Banks seemed to have taken the hit on their profitability from almost every side during this period. After the freeze, long-term Federal Investment Bonds (FIBs) became highly attractive due to sharp declines in short-term yields. However, auctions of FIBs were suspended after June 1998. Scheduled banks holdings of FIBs started to decline thereafter, despite a drastic increase in their market prices, which at certain periods reached up to Rs 125-130 compared with their par values of Rs 100. T-bill portfolio of scheduled banks declined considerably, as they were less remunerative. FCAs also became less attractive due to the rise in forward cover charged by SBP, while advances continued to rise. It is not surprising that banks reduced deposit rates to maintain their earning spreads. However, despite maintaining, or even increasing their spreads, banks were not able to contain the decline in ROA due to declining stock and remuneration of their earning assets.

[11] NIM is the net yield, which the earnings from interest represent on net earning assets. It is calculated as the difference between net earning asset yield and break even yield, where net earning asset yield equals total interest income / net earning assets, and break even yield equals total interest expenses / net earning assets

6.1.5 Liquidity

Movement in liquidity indicators since CY97 captures the painful adjustment process triggered by the freezing of FCAs. Ratio of liquid assets to total assets has gone down from 41.4 percent in CY97 to 34.9 percent in CY00 (see **Table 6.5**). This was consciously brought about by the monetary policy changes by SBP to manage the crisis-like situation created after the freeze. Both the cash reserve requirement (CRR) and the statutory liquidity requirement (SLR) were reduced during FY99. This was done to avoid the liquidity crunch facing banks on account of Rupee withdrawals from frozen FCAs. These steps were reinforced by declines in SBP's discount rate and T-bill yields, which helped banks manage Rupee withdrawals and still meet the credit requirements of the private sector.

Table 6.5: Liquidity & Sensitivity Indicators

	CY97	CY98	CY99	CY00
Liquid assets to total assets				
Nationalized commercial banks	39.2	40.4	38.7	36.1
Privatized commercial banks	40.9	39.0	37.4	27.8
Private banks	40.5	41.7	38.3	34.0
Foreign banks	47.6	46.0	40.3	39.3
All banks	**41.4**	**41.3**	**38.7**	**34.9**
Loan to deposit				
Nationalized commercial banks	48.7	46.7	50.1	54.4
Privatized commercial banks	53.6	54.0	54.9	61.9
Private banks	58.1	58.2	64.3	69.5
Foreign banks	54.3	56.7	68.2	71.6
All banks	**51.8**	**51.2**	**55.9**	**60.3**
Gap= RSA -RSL (billion Rupees)				
Nationalized commercial banks	-131.6	-146.5	-171.8	-166.8
Privatized commercial banks	-22.3	-24.4	-34.6	-32.1
Private banks	-9.4	-20.7	-25.1	-25.5
Foreign banks	-35.4	-36.3	-55.2	-30.2
All banks	**-198.7**	**-227.8**	**-286.7**	**-254.5**
RSA/RSL				
Nationalized commercial banks	78.4	78.1	76.4	77.9
Privatized commercial banks	89.0	88.6	85.5	86.9
Private banks	94.0	88.4	86.8	89.0
Foreign banks	85.0	84.2	74.8	86.6
All banks	**83.5**	**82.3**	**79.2**	**82.5**

Increase in loan to deposit ratio of banks during this period is a direct consequence of steps described above. One can see from **Table 6.5** that foreign banks have gone through this adjustment much more quickly than other groups. Their decline in liquid assets to total asset ratio, as well as the rise in loan to deposit ratio, are also much steeper than other groups. However, these signs of stress have to be interpreted with caution as they were brought about deliberately in order to tackle the problem created by the liquidation of FCAs. Trend in growth of deposits is already showing that the most painful part of the adjustment is over, and scheduled banks are poised for financial intermediation in the future. This is amply reflected in the reversal of decelerating deposit growth into an accelerating one in CY00 (see **Table 6.6**).

6.1.6 Sensitivity to Market Risk

Rate sensitive assets (RSA) have diverged from rate sensitive liabilities (RSL), in absolute terms, since CY97 as shown in **Table 6.5**. The negative gap has stretched from Rs 199 billion in CY97 to Rs 255 billion in CY00. Negative value indicates comparatively higher risk sensitivity towards liability side than the asset side. It also shows that increase in interest rates may affect banks negatively, while decline in interest rates may prove beneficial. Negative stretching indicates the rising trend of this sensitivity towards liability side.

Higher sensitivity towards liabilities is also reflected in less than 100 value of ratio between RSA and RSL, as shown in **Table 6.5**. Decline in this ratio from 83.5 percent in CY97 to 79.2 percent in CY99 indicates the rise in this sensitivity. However, this trend has reversed in CY00.

6.2 Deposit Mobilization

Deposit mobilization has dwindled considerably after CY97. Deposits as a proportion of GDP have gone down from 42.4 percent in CY97 to 38.5 percent in CY00. Growth rate of overall deposits of scheduled banks have gone down from 10.1 percent in CY97 to 6.7 percent in CY00. However, the

slowdown seems to have been arrested and reversed in CY00 with growth increasing from 3.6 percent in CY99.

Group-wise performance of deposit mobilization, reported in **Table 6.6** is a reflection of the varying degree with which each group has been affected as a result of FCA freeze. Foreign banks were affected the most, given their high reliance on FCAs. They experienced deposit erosion of 3.8 percent in CY98 and 14.0 percent in CY99. However, they were able to successfully turn it around to show a deposit build up of 2.1 percent in CY00. Similar recovery is shown by private domestic banks.

Table 6.6: Deposits Structure of Scheduled Banks

	CY97	CY98	CY99	CY00
Deposits (billion Rs)	1,135.5	1,209.9	1,253.8	1,338.3
(as % of GDP)	42.4	41.2	39.4	38.5
Deposits share (percentage)				
Nationalized commercial banks	50.6	52.3	53.9	53.4
Privatized banks	16.5	16.6	17.8	17.2
Specialized banks	1.2	0.9	1.2	1.2
Private banks	12.1	12.7	12.5	14.2
Foreign banks	19.5	17.6	14.6	14.0
Deposits growth (percentage)				
Nationalized commercial banks	3.0	9.9	6.9	5.7
Privatized banks	11.2	6.7	11.5	3.2
Specialized banks	8.2	-20.3	35.9	7.8
Private banks	35.1	11.4	1.9	21.7
Foreign banks	16.8	-3.8	-14.0	2.1
Overall	10.1	6.6	3.6	6.7

Deposit mobilization efforts of NCBs seem to be waning, after closure of their successful Rupee deposit schemes linked through lottery prizes. Growth in NCB deposits is declining continuously since CY98. However, even before the freezing of FCAs, their growth was only 3.0 percent in CY97 showing lethargic performance. Despite the slowdown, NCBs captured a larger share of deposits. Aggressive posture of private domestic banks in mobilizing more deposits in CY00 is clearly reflected in their growth going up from only 1.9 percent in CY99 to 21.7 percent in CY00. This has enabled them to increase their share in deposits to 14.2 percent in CY00.

Foreign currency deposits had been the prime factor causing around double-digit growth in the deposits of the banking system till the freeze. Either through institutional deposits or resident deposits, the banks especially foreign banks were very comfortable in accumulating these deposits, which not only provided the counterpart Rupee for their intermediation, but also provided very high returns by simply placing these Rupee funds in government papers.

With the freeze, the whole scenario changed. FCA schemes has been revised and now banks are neither required nor have the option to place their FCAs with the SBP. Although, the growth in FCAs increases the deposit base of banks, it does not add to their Rupee liquidity. In this respect the increasing share of foreign currency deposits in total deposit base is a worrying development. In order to check this trend, SBP made it compulsory for the banks not to allow FCAs to exceed 20 percent of their Rupee deposits effective from January 1, 2002. This will ensure that the Rupee-Dollar deposit mix remains manageable.

6.3 Credit Extension

Bulk of the advances extended by scheduled banks is for working capital financing and, therefore, of self-liquidating nature. Growth in advances slowed down to 7.8 percent in CY98, from 11.1 percent a year earlier. However, due to an easing in SBP's monetary stance, credit extension not only exceeded deposit mobilization in CY98, but also accelerated afterwards. This is reflected in advances growing from 7.8 percent to 12.3 percent in CY99 and 14.0 percent in CY00 as shown in **Table 6.7**. Advances, in terms of GDP, have also gone up marginally to 29.2 percent in CY00 after declining first in CY98 to 27.0 percent from 27.4 percent a year earlier.

Group-wise performance of banks in credit extension, shown in **Table 6.7**, reveals three distinct features. First, foreign banks had to curtail their loaning activities significantly, due to the crunch

faced by them following their high exposure to FCAs. Second, the continued dominance of NCBs, as they were able to maintain their share in total advances. Third, the aggressive approach of private domestic banks in capturing the credit market, reflected in their rising share from 11.4 percent in CY97 to 13.8 percent in CY00. Private domestic banks were the only group that not only maintained their growth in double-digit level but also pushed it to 31.5 percent in CY00. With this high growth, they have surpassed foreign banks, in terms of share of advances in CY00, whereas three years ago their share was 5.5 percentage points lower than that of foreign banks.

Table 6.7: Advances Structure of Scheduled Banks

	CY97	CY98	CY99	CY00
Advances (billion Rs)[1]	735.0	792.1	889.8	1,014.6
(as % of GDP)	27.4	27.0	28.0	29.2
Advances share (percentage)				
Nationalized commercial banks	45.7	44.7	45.7	45.5
Privatized banks	14.7	14.6	14.6	14.9
Specialized banks	11.3	13.0	13.2	12.2
Private banks	11.4	11.9	11.9	13.8
Foreign banks	16.9	15.9	14.5	13.6
Advances growth (percentage)				
Nationalized commercial banks	5.0	5.3	15.0	13.5
Privatized banks	8.4	6.4	12.5	16.6
Specialized banks	2.4	24.0	14.2	4.8
Private banks	40.2	13.0	12.6	31.5
Foreign banks	23.2	1.2	2.8	7.0
Overall	11.1	7.8	12.3	14.0

[1] Represent gross advances.

6.4 Banking Spreads

Trend in weighted average lending and deposit rates, and the spread in between, is shown in **Table 6.8**. Declining trend in both lending and deposits rates is clearly visible. Downward pressure in lending rates was brought about by the loosening of monetary stance by SBP. Therefore, realized trend in lending rates was in line with monetary objectives, although achieved with lags following the sharp reductions in T-bill yields during FY99, needed to induce required investment portfolio changes by scheduled banks.

Table 6.8: Weighted Average Lending & Deposit Rates

	Deposit rates[1]	Lending rates	Spread
Jun-97	6.80	14.55	7.75
Dec-97	6.38	14.71	8.33
Jun-98	6.81	15.64	8.83
Dec-98	6.69	15.42	8.73
Jun-99	6.49	14.80	8.31
Dec-99	5.83	14.46	8.63
Jun-00	5.47	13.52	8.05
Dec-00	5.39	13.55	8.16

[1] Including zero rates

Downward trend in deposit rates was almost inevitable, keeping in view the pace of Rupee withdrawals from FCAs witnessed after the freeze in May 1998. One can argue that banks should have maintained (if not increased) their deposit rates to arrest the declining growth in total deposits. However, this was not possible because at times of eroding balance sheets, steady earnings are of paramount importance. Consequently, banks tried to find creative ways of mobilizing deposits at low returns. A case in point was the lottery deposit schemes initiated by HBL and adopted by other large banks as well. These schemes successfully mobilized additional deposits at considerably lower rates of returns. However, they were closed down following the concerns that these schemes were not consistent with the principles of Islamic finance.

Due to inefficiencies of the large banks, the interest rate spread was very large at 7.8 percent in June 1997. Subsequently, the decline in deposit rates became larger (at 141 basis points) compared with a decline of 100 basis points in lending rates between June 1997 and December 2000. This upward trend is unlikely to persist in the future. In fact, preliminary rates for selected banks show that term deposit rates are moving up. However, as a larger share of term deposits is still locked up at old lower rates, it may take some time for the weighted average deposit rates to reflect this upward trend. Rising spread can further be explained by the fact that term lending constitutes a smaller proportion compared with term deposit mobilization by banks. Hence, the increase in deposit rates take longer to be translated into weighted average deposit rates than lending rates. This also explains the higher lag of transmission of monetary policy to deposit rates compared with lending rates.

6.5 Asset Composition

Assets of banking sector, as percent of GDP, have been declining since CY97. Slowdown in asset growth was also accompanied by changing shares of different groups. As expected, foreign banks were affected the most by the developments described earlier. As shown in **Table 6.9**, negative growth in their assets during CY98 and CY99 was the prime reason behind declining growth in overall assets of the banking industry. Share of NCBs have been decreasing since the new private banks were allowed to operate in 1992. However, the large branch network of NCBs coupled with attractive lottery schemes introduced by these banks to attract outflows from frozen FCAs, helped improve their share in assets. The most important and positive change during this period was the rising share of private domestic banks. In term of asset share, private domestic banks are now as large as foreign banks.

Table 6.9: Asset Structure of Schedule Banks

	CY97	CY98	CY99	CY00
Assets (billion Rs)[1]	1,436.5	1,556.1	1,653.9	1,752.2
(as % of GDP)	53.6	53.0	52.0	50.5
Assets share (percentage)				
Nationalized commercial banks	46.7	48.7	49.1	48.5
Privatized banks	15.5	15.4	16.1	15.6
Specialized banks	6.8	6.3	6.6	6.4
Private banks	12.3	12.7	13.0	14.7
Foreign banks	18.7	16.9	15.3	14.8
Assets growth (percentage)				
Nationalized commercial banks	4.1	13.0	7.3	4.7
Privatized banks	11.9	7.5	11.1	2.6
Specialized banks	5.1	0.9	10.6	2.8
Private banks	32.4	11.8	8.2	20.3
Foreign banks	17.9	-2.1	-4.1	2.7
Overall	10.7	8.3	6.3	5.9

[1] Represent assets net of provisions.

6.6 Problem Bank Management by SBP

State Bank of Pakistan is the sole authority in Pakistan to supervise, monitor and regulate financial institutions in order to safeguard the interest of depositors and shareholders of the institutions. During FY01, SBP took actions against two private domestic banks, which began to undermine the financial viability of the system.

Indus Bank Limited (IBL): On-site and off-site surveillance system of SBP reported unsatisfactory state of affairs in Indus Bank Limited. The bank was involved in misusing the export refinance facility, in addition to unauthorized and fraudulent release of foreign exchange. It also failed to elect fresh directors and appoint chief executive in accordance with the law for over a year and a half. It also showed reluctance in providing information to the inspection teams of SBP. On the basis of these findings, the license of IBL was cancelled on September 21, 2000. IBL is now being liquidated after getting permission from Peshawar High Court.

Prudential Commercial Bank Limited (PCBL): PCBL was found operating in a highly questionable and non-transparent manner. The affairs of PCBL revealed that the board and management of the bank indulged in self-serving and unscrupulous practices that were resulting in the erosion of their capital base, deterioration in asset quality and reduction in the earning capacity of the bank. More specifically, the following irregularities were found in the affairs of PCBL:

- Concentrated lending (to specific groups) in violation of prudential regulations and established banking norms.
- Funds drawn from SBP under export refinance were placed with other banks in lucrative deposit schemes. Furthermore, it allowed export finance to certain parties, which had already defaulted in repatriation of full export proceeds.
- Examination of treasury operations indicated a number of grave irregularities in money market deals. Further, bank also failed in meeting the SLR requirements on a number of occasions.

In view of this imprudent management, the federal government issued 180 days moratorium order against the bank on SBP's request, which was effected from March 19, 2001. After successful negotiations, management and control of PCBL was handed over to Saudi-Pak group.[12]

[12] The group commenced operation with a new name 'Saudi Pak Commercial Bank' on September 20, 2001.