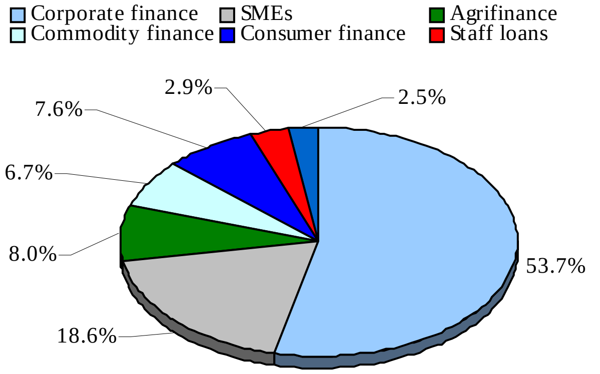
2 Financial System Credit

As mentioned in **Section 1.1.4**, there was a tremendous growth of credit to the private sector during the last two years. This was supported by favorable demand and supply conditions in the credit market. Specifically, with the objective of utilizing the ample liquidity available with them, banks had to move beyond their traditional lending practices, by diversifying the clientele and product mix. In recognition of this factor, State Bank identified various sectors and provided guidelines for their financing with the objective of giving a boost to the overall economy and ensure better returns for banks while maintaining prudential norms. These included agriculture, small and medium enterprises (SMEs) and consumer financing. This resulted in a healthy competition within the banking sector in the form of aggressive marketing to capture a sizeable share of the expanding credit market. Moreover, due to the historically low interest rates and a surge in the overall economic activities, credit demand from the more traditional sectors was also positive.

All this led not only to a sharp rise in credit off-take but also a much diversified loan portfolio for banks. As shown in **Figure 2.1**, the share of corporate sector is now limited only to 53.7 percent of the total credit which once used to dominate the credit market. More encouragingly, the share of SME financing has reached a substantial level at around 18.6 percent. However, keeping in view the financial health of SMEs and their role in the overall economy, there is a considerable scope for banks to increase the pace of their lending activities, especially in the area of fixed investment.

Figure 2.1: Sectoral Distribution of Bank Credit at end-June 2004



Source: Banking Supervision Department, SBP

Consumer financing currently has a share of around 7.6 percent in overall credit. But the way banks are marketing their products and the interest exhibited by the consumer sector, it is likely that there will be a sizeable increase in the share of consumer loans in the years to come. Among the consumer financing products, while auto financing and personal loans have already attracted a large number of customers, mortgage financing is a relatively new product and has yet to create a significant market.

The share of agriculture finance is projected to reach a double-digit figure in the near future. This is due to the fact that now it is not only ZTBL which is focusing on the development of the agriculture sector, commercial banks are also geared up to finance agriculture activities. In fact, these banks with their large branch network and outreach provide a greater accessibility to their products in the far-flung areas of the country.

A more detailed discussion on the various segments of banks' financing is given below:

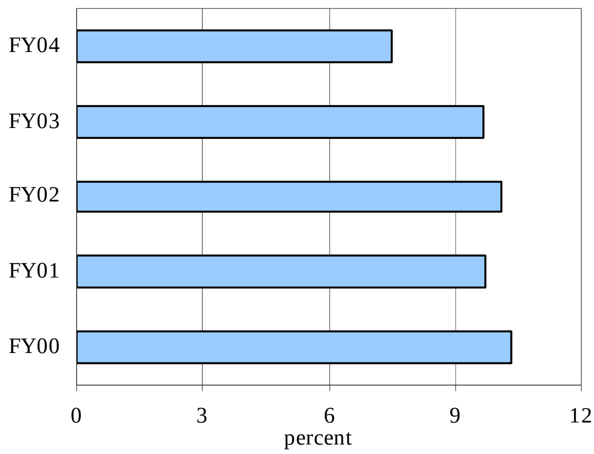
2.1 Agricultural Credit

The growth of agri-credit in Pakistan has increased manifold since independence. Agricultural Development Bank of Pakistan (ADBP), now known as Zarai Taraqiati Bank Limited (ZTBL), enjoyed the status of the single largest provider of agri-credit since its inception in 1961 (through the merger of Agricultural Development Finance Corporation and the Agricultural Bank of Pakistan). In the past, investment or development lending to agriculture was done exclusively by ADBP, in addition to lending for production purposes, while cooperatives and commercial banks dealt mainly in production loans i.e. lending for the purchase of seasonal inputs like seeds, pesticides, fertilizers, etc. Big five commercial banks[1] effectively joined this course in 1973 however an increased pace of agricultural lending has been witnessed only since FY00 and now they have the largest share in total agri-credit.

Overall agri-credit has registered an increase both with respect to disbursements as well as recovery due to the special efforts made by SBP through its encouraging and supporting policies, by fixing targets for different banks, and continuous surveillance. SBP's policies to enhance the scope and coverage of agricultural credit have greatly helped in maintaining the share of agri-credit in total credit disbursement (see **Figure 2.2**).

The major developmental shift is the enhanced role of commercial banks and PPCBL[2] in agri financing. SBP greatly facilitated commercial banks in advancing agri loans in order to benefit from their extended branch network and outreach.

Figure 2.2: Share of Agri Credit in Total Credit



Source: Statistics Department, SBP

Another important policy measure in this respect was the introduction of "Revolving Credit Scheme"[3] in FY03 to facilitate the farmers in availing timely credit by avoiding unnecessary documentations and bank visits. The Revolving Credit Scheme offers automatic renewal and the added convenience of full repayment (principal and mark-up) by the borrowers once in a year, at a time of their convenience.

SBP has also increased the limit of credit against personal security from Rs 50,000 to Rs 100,000 and there is no restriction on providing credit on provision of proper collateral. Commercial banks lend directly to farmers but they can also utilize the channel of ZTBL, microfinance institutions and NGOs,[4] and this lending is considered as part of their mandatory targets.

SBP has also revised indicative per acre credit limit[5] for various crops for meeting the increased credit requirement of the farmers. Another important development pertaining to agri-credit is the restructuring of ZTBL and the reduced mark-up rate from 14 percent to 9 percent (with a further 1 percent reduction in mark-up rate in case of timely or early payment of installments).

Disbursements

The total agri-credit disbursement registered a remarkable improvement in volume, by increasing from Rs 39.7 billion in FY00 to Rs 70.9 billion in FY04, a growth of 77.7 percent as compared to FY00 (see **Figure 2.3**). Commercial Banks, ZTBL and PPCBL are the major partners responsible for this improvement in total disbursements since the beginning of the 2000s.

1 Including: i) Allied Bank of Pakistan Ltd., ii) Habib Bank Ltd., iii) Muslim Commercial Bank Ltd., iv) National Bank of Pakistan, v) United Bank Ltd.
2 Punjab Provincial Cooperative Bank Ltd.
3 ACD Circular No /1035-1039/PD (P)–08/2001, April 25, 2001.
4 To avail the outreach of ZTBL and NGOs, in case of absence of their own direct access to certain areas.
5 ACD Circular No.ACD/2014-2034/PD (P)-08/2004, August 04, 2004.

An institutional breakup of total agri-credit disbursements reveals that since FY00, a visible shift of activity from ZTBL to commercial banks has taken place. Commercial banks have increased their share from 23 percent in FY00 to 45 percent of total agri-credit in FY04 while ZTBL's share shrank from 62 percent in FY00 to 41 percent in FY04 (see **Figure 2.4**). Domestic Private Banks are the new entrants in this field and they have been contributing a smaller but increasing amount since FY02. They have increased their share of total disbursement from 1 percent in FY02 to 4 percent in FY04.

Subsequent to the liquidation of the Federal Bank of Cooperatives (FBC) in FY02, PPBCL was the only cooperative bank active in agri-credit. The share of PPCBL in total disbursements varies between 10 to 15 percent of total agri lending over the period of assessment, as it was 15 percent in FY00 and 11 percent in FY04.

Recoveries

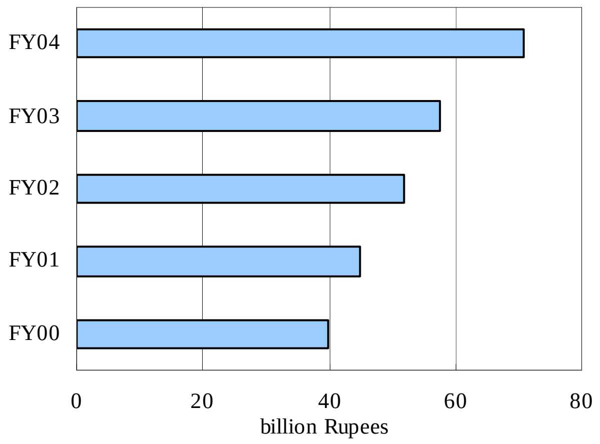
The amount of outstanding loans has registered an increase of 23 percent, from Rs 86.9 billion in FY99 to Rs 107.2 billion in FY04. Recoveries followed a similar pattern and it is clear from **Figure 2.5** that commercial banks continue to provide a major contribution to the total volume of improved recovery.

In terms of increase in the outstanding amount, commercial banks have the highest share. Cooperatives and DPBs are two other players proving their presence in meeting the credit demand of the agriculture sector although with a smaller share as compared to the commercial banks (see **Figure 2.6**).

The fall in ZTBL's outstanding credit in FY02 is due to exclusion of mark-up on NPLs and performing loans. Earlier it was used to be the part of outstanding amount. Otherwise its outstanding amount is showing an increasing trend.

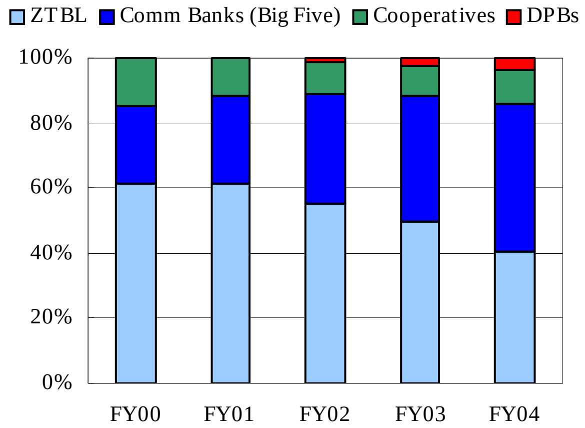
Although improved farm income and prudent lending by ZTBL has contributed to the timprovement of the recovery to outstanding

Figure 2.3: Agri Credit Disbursement during the year



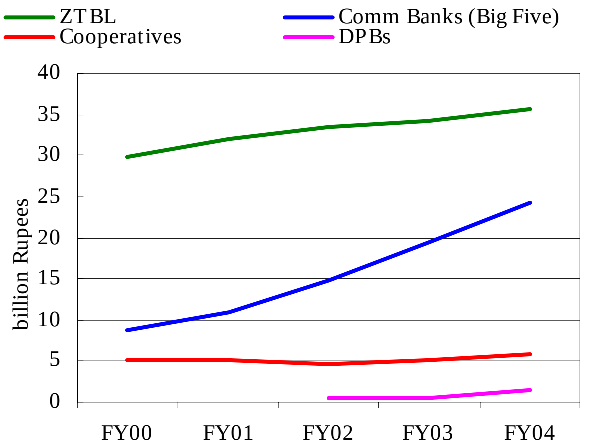
Source: Agricultural Credit Department, SBP

Figure 2.4: Share in Disbursement



Source: Agricultural Credit Department, SBP

Figure 2.5: Recovery of Agri Credit*



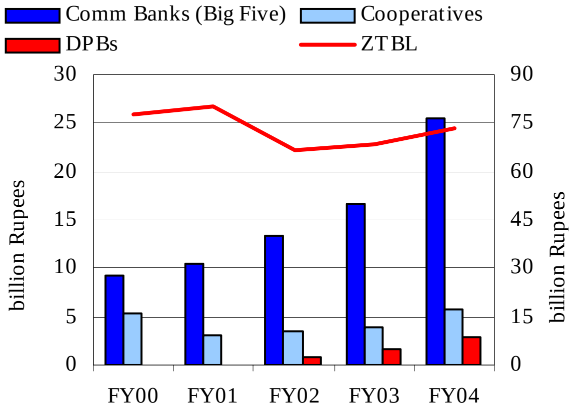
*: Recovery against all due loans except bonafide losses

Source: Agricultural Credit Department, SBP ratio (see **Figure 2.7**), but the main factors responsible for improved ratio is the exclusion of mark-up from outstanding credit as mentioned earlier

Efficiency in Target Meeting
Commercial banks' agri-credit disbursement was 148.4 percent of the mandatory target for FY04 as compared to 121.6 percent for FY03. . After commercial banks, PPCBL is the only institution approximately meeting its target, as its disbursement was 2.4 percent higher than the fixed target for FY04.

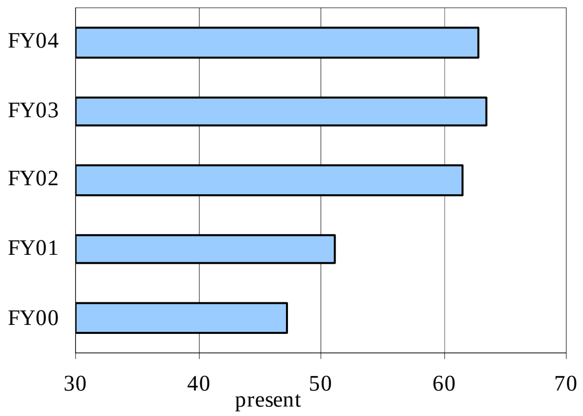
The share of ZTBL has gradually been taken over by commercial banks and it has not been successful in meeting its targets in the past few years. DPBs are relatively new in this area and are striving to improve their efficiency in target meeting and recovery performance (see **Figure 2.8**).

Figure 2.6: Outstanding Agri Credit



Source: Agricultural Credit department, SBP

Figure 2.7: Ratio of Recovery to Outstanding



Source: Agricultural Credit Department, SBP

2.2 Consumer Finance

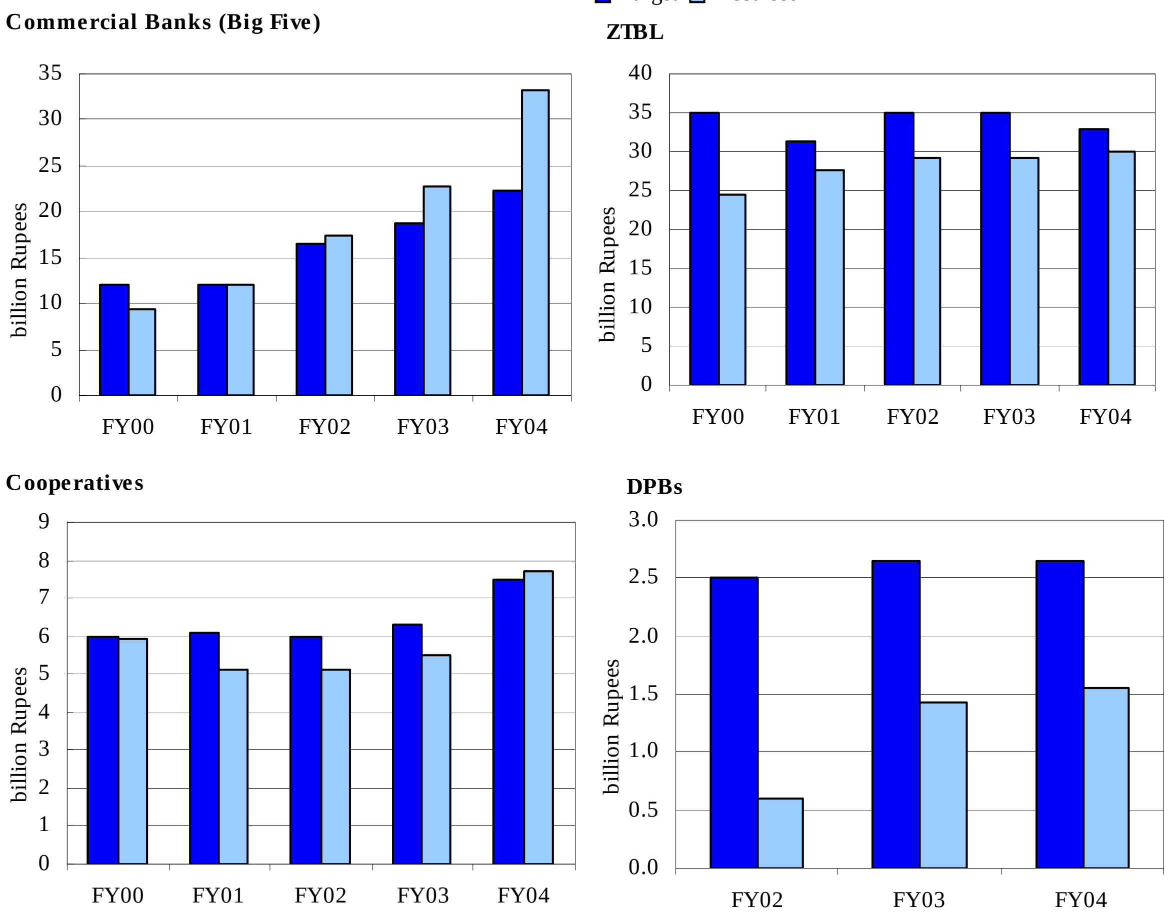
Consumer financing refers to any financing allowed to individuals by financial institutions to meet their personal needs. It gives individuals the ability to generate funds for their personal consumption by borrowing against future income. It can range from financing a vacation, to buying a car or a house, etc.

Commercial banks in the Pakistan financial sector have traditionally focused on meeting the financing needs of the corporate sector in their normal course of business, and until the recent past, it had remained their bread and butter at the neglect of the needs of the household sector. Whereas individuals did avail revolving financing facilities from banks, this activity remained confined to fully secured loans against tangible liquid securities (usually government securities, bank deposits etc.) in line with SBP's margin requirements on such collateral. Consumer financing in a broader sense remained a relatively less explored avenue (due to its high risk nature) for revenue generation for banks until a few years ago, when surplus liquidity and slow credit growth from the corporate sector forced the banks to focus their attention on previously ignored areas for the growth of their asset base.

Consumer finance has now gained accelerated momentum. SBP has also recognized the need to promote economic growth through the viable avenue of consumer loans as part of its demand inducement policies and has made requisite provisions in its regulatory framework to guide financial institutions accordingly. As a result of these measures consumer financing consumption stands at around 7.6 percent of the total credit off-take, as at end-June 04.

Initially, Credit Cards were introduced by Citibank in 1994, and since then a variety of products have inundated the market in the form of auto financing, mortgage loans, personal loans (both secured and unsecured). Offshoots and variants of such products include co-branding services being offered by banks in collaboration with leading Oil Marketing Companies, manufacturers of consumer durables, etc.

Figure 2.8: Performance of Banks in Agri Financing



Source: Agricultural Credit Department, SBP

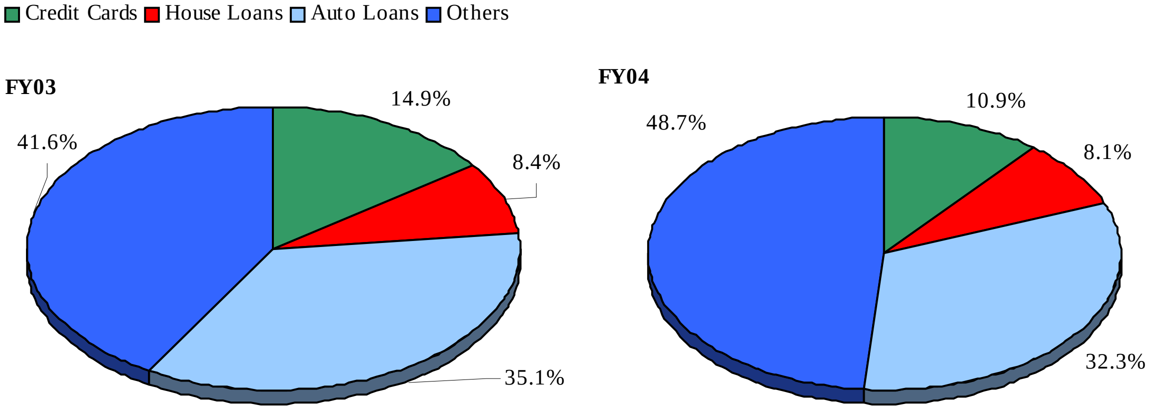
Table 2.1 shows that consumer financing has grown at a rapid pace since June 2003, with an increase of 128 percent up to June 2004. Whereas the pace of growth has stabilized from quarter-ending September 2003 onwards, the largest share belongs to the 'others' category which consists of personal loans, both secured and unsecured, as well as financing for consumer durables. The largest contribution (around 41.6 percent of all loans in this category, as at June 2004) is that of a large local bank which has successfully designed and marketed a separate product for personal loans for government employees, and other salaried individuals.

billions Rupees

	Jun-03	Sep-03	Dec-03	Mar-04	Jun-04
Credit cards	6.7	8.0	8.9	9.7	11.2
House loans	3.8	3.4	4.1	5.5	8.3
Auto loans	15.8	16.9	22.2	27.6	33.1
Others	18.7	25.6	30.3	40.2	50.0
Total consumer finance	45.0	53.9	65.5	83.0	102.6
Growth rate (percent)	69.8	19.8	21.5	26.7	23.6
Total loans	1,043.1	1,040.2	1,152.0	1,205.4	1,350.9
CF as percent of total	4.3	5.2	5.7	6.9	7.6

The auto loans have the second largest share in outstanding loans, with credit cards at third place (see **Figure 2.9**). Mortgage financing is a relatively new area for banks and an increased market share is expected in the near future with an increase in the total size of the pie.

Figure 2.9: Break-up of Consumer Finance



Source: Banking Supervision Department, SBP

A comparative analysis of the consumer finance portfolio of end-FY03 and FY04 shows that the share of credit cards has been taken over by Personal Loans in the 'Others' category, which currently has the largest share at 48.7 percent of total consumer financing.

Target Market and Product Branding

Consumer Financing products are designed to cater to the middle class segment, both salaried and self-employed people, who can demonstrate an ability to service the loan facility in line with their recorded cash flows. These financing opportunities have gradually changed the mindset of the target market regarding ‘debt’, which was previously considered taboo. With the availability of such products, the average consumer can now fulfill his/her immediate financing requirements instead of first saving up the requisite amount.

Due to increased competition in the area of Consumer Finance, banks have resorted to product branding tactics to gain a competitive edge and have committed substantial amount of resources to aggressive marketing and advertising campaigns. These marketing techniques have also helped in creating and building consumer awareness of the wide variety of products available to choose from in addition to educating the consumer in the various benefits offered by each financial institution offering such products. Some banks are also offering these products within the framework of Islamic Financing.

Existing players in consumer financing include commercial banks, DFIs, Leasing Companies and Modarabas. This section however takes into account consumer financing activities pertaining to the banking sector only.

Consumer Financing Products

<u>Credit Cards</u>

One of the prominent foreign banks operating in the country was the first to introduce this product in the market on a mass scale in 1994. In 1996, another leading foreign bank introduced its card facility as well, and currently these two banks hold the largest share of the credit card market (51.3 percent as at end June 2004). Given their successful experience as well as the increasing popularity of this product, domestic banks have also become increasingly active in providing credit card facilities. Besides these two foreign banks, private banks are the other operators in this area.

<u>Auto Loans</u>

Prudential Regulations allow these loans for the purchase of vehicles for personal use only.

As mentioned in 'Pakistan: Financial Sector Assessment 2001-2002', auto loans were largely the domain of the leasing companies in the early 1990s, whereas foreign banks entered this market in the late 1990s. Currently this area of consumer financing is very popular for both lenders and borrowers, and the auto demand thus created has been the driving force behind the strong growth of the Automobile industry.

Housing Finance

The property market has witnessed a boom in the last few years, with an excess flow of funds from increased remittances, as well as opportunities of investment with lucrative gains. Moreover with the advent of the National Housing Policy 2001, an enabling environment has been created by the government to promote this product, as well as by the legal system in terms of foreclosure laws, recovery ordinance etc.

House Building Finance Corporation (HBFC) was the sole player in this market since 1952,[6] given that the banking sector was not allowed to undertake such financing until 1998. Commercial banks have also been hesitant about this product due to the unclear nature of the title of property prevalent across the country, as well as the linked problem of the legal infrastructure, which made recovery of dues through disposal of collateral a time-consuming and cumbersome process, often not worth the cost in terms of time and effort. However with the advent of foreclosure laws and Recovery of Finance Ordinance 2001 which facilitate this process, banks have been encouraged to come up with suitable products. Reduction in stamp-duty is also one of the factors which have encouraged home-ownership among people instead of rental options.

In order to address the problem of asset / liability mismatch with respect to these longer tenor loans, banks are encouraged to issue long-term housing bonds with a minimum maturity of 10 years, and also to develop floating rate products in order to prudently manage interest rate risk.

Housing finance has around 40 other industries linked to it and increased activity in this sector is directly proportional to an increased activity in these industries. According to the Ministry of Finance, the cement industry is working at 77.8 percent capacity in March 2004, compared to 67.4 percent in June 2003. Most of this increase is attributed to increased construction activity in the country.

Personal Loans

These are classified into Secured and Unsecured, and are not usually linked to a specific purpose for utilization of funds.

a) Unsecured

These are generally balloon disbursement installment loans. SBP's currently permissible clean limit for such loans upto Rs 500,000. Higher amounts can be financed on the basis of security coverage.

These loans do not assign a specific purpose for the utilization of the loan; loan is either disbursed as cash into the customer's Personal Loan account or paid directly to the seller of a consumer durable depending on the purpose for which the loan is being utilized. In case of a durable good, the same are hypothecated as security to the bank.

b) Secured Overdrafts

These are in the form of Running Finance / Revolving Finance secured against government securities, lien on deposits and other such liquid, tangible securities and have historically been the

[6] Besides HBFC, 3 more housing finance companies came up in the 1990s in the NBFIs sector, in the wake of financial liberalization reforms. For details, please see section 4.6

only or rather the only 'popular' mode of consumer financing available with individuals through which they can manage their personal needs, household requirements, etc.

Given the prevalent interest rate structure on government securities vis a vis the rates being charged on these facilities, considerable arbitrage opportunities existed and were exploited in the recent past where the proceeds of these loans were utilized for further investment in government securities in order to benefit from the interest rate differential.

Steps were taken from the regulatory perspective to correct this anomaly and rates on existing facilities were revised. With the gradual rationalization of the NSS interest rate structure the arbitrage opportunity has all but disappeared.

Potential Risks, Mitigants & Future Outlook

1. <u>General provisions against consumer financing</u>
   Banks are required to maintain a general reserve at least equivalent to 3 percent of their consumer finance portfolio. This provision is in place to protect banks from the risks associated with the consumer finance business.

2. <u>Appropriate Risk Management Policies</u>
   Consumer financing has given a boost to the aspect of consumerism in the country. Whereas well-managed consumerism is a healthy aspect of the economy, banks need to be careful about devising and maintaining prudent risk management policies with respect to consumer loans. The adverse affect of increased consumerism is an increased risk of default if economic activity slides to the extent that it results in unemployment and affects consumer's ability to repay. In this respect banks need to chalk out prudent lending and credit assessment policies in line with SBP's Prudential Regulations.

3. <u>Training of staff involved in Consumer Financing</u>
   Due to a lack of previous experience and expertise in consumer credit analysis, banks also need to have adequate training facilities in place to impart ongoing training to the staff directly involved with various aspects of consumer financing

4. <u>Role of Consumer Credit information bureau</u>
   Another factor which has hindered the development of consumer finance in Pakistan is the absence of a centralized Credit Information Bureau which maintains the credit history of all individuals availing such loans from the banking sector. The risk here is that individuals can over-leverage themselves by taking several loans from various banks where each bank calculates the debt-burden profile based on its own loans, hence there is a higher risk of willful as well as circumstantial default.

   SBP has made it mandatory for all banks engaged in consumer financing to become a member of at least one Consumer Credit Information Bureau. Apart from the credit data maintained by the Credit Information Bureau at SBP itself (for all facilities of Rs 500,000 and above), a few efforts have been made in the private sector to establish such databases. A company by the name of 'Data Check' started operations a few years ago for which banks have to take membership in order to obtain default data on individuals. This then becomes one of the mandatory checks for all applications, before they are put up for approval. If a default status is detected, the application is not processed any further. Moreover, banks are also encouraged to share data amongst themselves.

Whereas the significance of the above-mentioned databases cannot be ignored in credit analysis, in order to fully protect banks from accommodating habitual defaulters, a centralized database for all loans sizes, with details of both the default and regular status, needs to be developed given the increased reliance on consumer financing by both lenders and borrowers.

5. Portfolio Management through the generation of periodic reports
   This is another important area which has been emphasized in the Prudential Regulations as well, without which the survival of a consumer finance structure is questionable. It is important to monitor the booked portfolio on the basis of delinquency reports which can be further categorised into demographic and other details in order to establish cause and effect relationships between the defaulters and their profiles. These reports also serve the purpose of establishing necessary triggers for the management to take pre-emptive action against potential loan defaults.

6. Collections (and Recovery) Systems
   Support of a well-functioning Collections unit is an essential infrastructural requirement for any Consumer Finance unit.

   Strong collection expertise in terms of trained resources and computer systems are very important back-office components of a Consumer Finance business. A collection unit is responsible for monitoring ongoing periodic payments by individuals in addition to tracking and classifying defaults and initiating repossession and recovery activities.

7. Credit cycle impact
   Given that Consumer Financing is a relatively new area, and most of the banks are relatively new entrants in this business, the full impact of the Credit cycle on the outstanding portfolio will only becoming evident with the passage of time.

8. Asset Liability matching in case of Housing Finance
   Given the longer tenors associated with housing finance, it is important for the lending institutions to match the tenors of their assets and liabilities in order to avoid any problems in case of default on these loans.

Given that the total consumer financing portfolio currently forms around 7.6 percent of the total loans and advances of the banking sector, concerns voiced by financial analysts regarding the possibility of excessive consumer financing leading to the downfall of the banking system are not entirely justified.

However given the pace of growth of Consumer Financing and its increasing popularity, financial institutions need to carefully plan the expansion of their respective portfolios by minimizing the impact of the above-mentioned risks with adequate systems and resource support, in order to be able to sustain and positively avail the benefits of this growth.

2.3 Working Capital and Project Financing

Working capital loans provide an essential ingredient to carry out business operations. Generally working capital loans are bridge finance loans used to finance the business cycle of a company, as well as its short-term expenses. Hence working capital finance helps firms in managing its cash flows. On the other hand, project financing is connected with specific investment plans of a firm, which are generally long-term in nature. This type of financing is required when firms expand their businesses. In general, the long-term financing requirements of an economy increase when its investment climate improves, along with greater possibilities of realizing the potential output of the economy.

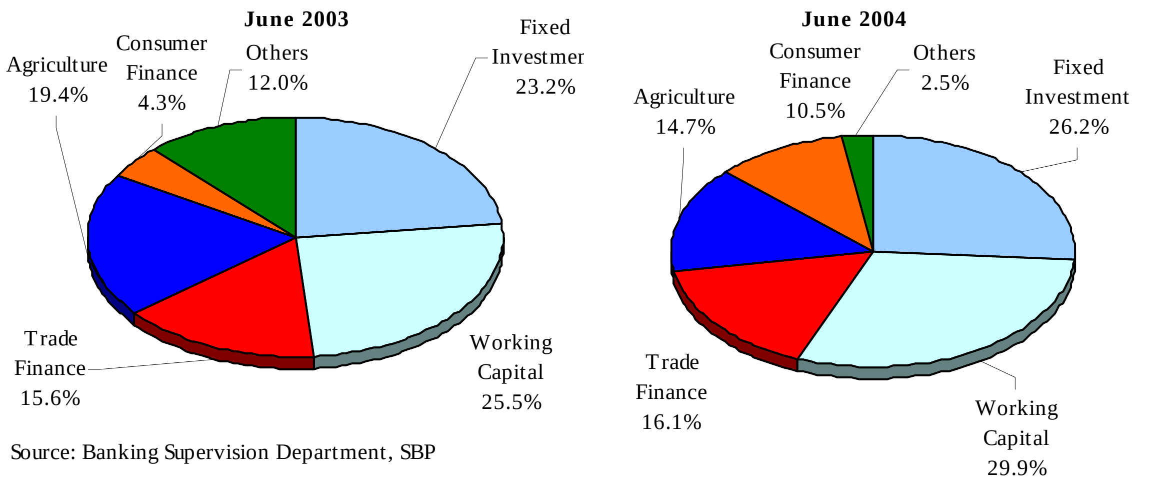
More importantly, real investment may depend on financial factors. The financing needs of the business firms may be fulfilled through either domestic or external sources. External finance, if available, may be costlier than domestic finance because of transaction costs, agency problems and/or asymmetric information. From domestic sources, besides raising long-terms funds through the issuance of TFCs, private sector business firms route their financing needs to scheduled banks and non-bank financial institutions (NBFIs). Whereas scheduled banks largely cater to the working capital needs of the private sector, however they also extend fixed investment financing. The NBFIs in contrast, are an essential source of project financing albeit they also provide short-term finance.

Scheduled Banks

During the last few years, scheduled banks have had surplus rupee liquidity in excess of their routine volume of lending. On one hand, this higher availability of funds served to reduce the interest rates which led to an increase in credit demand from the private sector. On the other hand, this excess liquidity forced banks to broaden their activity base. Besides focusing on consumer financing, scheduled banks also concentrated on fixed investment finance.

As a result, not only the overall credit extended by the scheduled banks increased from Rs 1,042.2 billion at the end of FY03 to Rs 1,350.9 billion at the end of FY04, but the diversification of credit also increased the share of fixed investment finance during FY04 (see **Figure 2.10**).

Figure 2.10: Structure of Scheduled Banks Credit



Source: Banking Supervision Department, SBP

The possible explanation of this increase in the share of fixed investment finance is the increasing capacity building and BMR activities in the manufacturing sector particularly in the textile industry. The share of working capital and consumer finance provided by the scheduled banks in overall credit increased during FY04. This increasing share of working capital finance probably represents the increasing capacity utilization by many segments of the economy as the domestic economy performed well beyond the target. Moreover, commercial banks' clientele in the area of consumer finance is rising on the back of low interest rate scenario.[7] On other hand, the decline in the share of agricultural credit[8] perhaps mirrors a reduction in public sector commodity procurement operations.

Sectoral Distribution

The break-up of fixed investment data shows that share of SME sector has shown a tremendous

[7] However, a significant portion of jump in the share of consumer finance is probably due to the better data reporting by end-June 2004 as the size of 'Others' category declined considerably in this period.

[8] Including commodity procurement loans taken by the government.

growth during FY04, which marginally increased its share in fixed investment (see **Table 2.2**). The possible explanation of this phenomenon is the increasing economy wide recognition of this sector that led to rising commercial banks focus on financing the growing needs of SMEs.[9]

Table 2.2: Distribution of Scheduled Banks Credit
billion Rupees

	As on		Change during FY04	
	Jun-03	Jun-04	Absolute	Percent
Fixed investment	241.8	354.5	112.7	46.6
Corporate sector	220.8	313.7	92.9	42.1
SMEs	21	40.8	19.8	94.1
Working capital	265.7	403.5	137.8	51.8
Corporate sector	190.9	247.9	57	29.9
SMEs	74.9	155.6	80.7	107.8
Trade finance	162.3	218	55.7	34.3
Corporate sector	112.7	163.8	51.1	45.3
SMEs	49.6	54.2	4.6	9.3
Agriculture[1]	202.2	198.7	-3.5	-1.7
Consumer credit[2]	45.1	142.3	97.2	215.4
Others	125	33.9	-91.1	-72.9
Total	1,042.2	1,350.9	308.7	29.6

[1] Includes commodity loans
[2] Includes staff loans

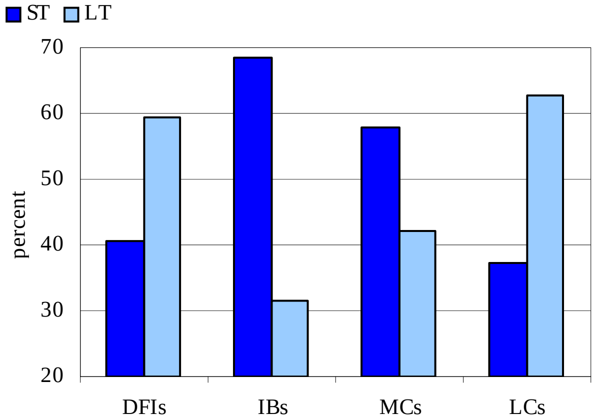
The aggregate of working capital and trade financing[10] data reveals that the share of SME sector in the working capital finance grew from 29.1 percent at the end-June 2003 to 33.8 percent at the end-June 2004. Moreover, the share of agri credit, a part of which may be treated as working capital finance, declined during FY04.

NBFIs[11]

In terms of advances and investments, DFIs have the largest share followed by Mutual Funds and Leasing Companies at end-June 2003 (see **Table 4.1**). With respect to outstanding advances, the share of DFIs has increase from 25.3 percent to 29.0 percent during the last four years while the share of mutual funds jumped sharply from 18.0 percent to 27.4 percent in the same period. However, the composition of advances and investment of these institutions is somewhat different. DFIs have around 70 percent investments whereas mutual funds are entirely in the form of investments. In contrast, leasing companies, which rank third in the overall share, extended 88.4 percent in terms of advances.

Surprisingly, investments by the investment banks during the last few years have changed their composition as investment banks switched from long-term to short-term modes of financing. More specifically, this group's investment ratio dropped from nearly fifty percent of short-term finance to around thirty percent during the last four years. In contrast, DFIs and leasing companies largely financed long-term projects. Specifically, they have a roughly sixty-forty ratio of long-term to short-term finance in 2003 (see **Figure 2.11**). Principally the nature of business of housing finance companies is long-term financing; as is the case with venture capital companies. The mutual funds sector has a mix of short-term and long-term investment, as they invest largely in TFCs and stocks.

Figure 2.11: Short and Long-term Breakup of NBFIs' Investment and Advances in FY03



Source: SBP and SECP

[9] It is important to mention that data on agriculture sector finance may also include the financing to purchase machinery, improve farm structure etc., which is theoretically a part of fixed investment finance. However, further break-up of agri finance data is not available.
[10] To indicate how the scheduled banks facilitated trade, the trade financing data is classified separately, although it is a part of working capital finance.
[11] The analysis of this section is based on data on investment and advances given in Chapter 4.

2.4 SME and Micro Finance

SME Finance

Despite their highly significant contribution in Pakistan's economy, small and medium enterprises have always remained a neglected sector in terms of having access to bank financing (see **Box 2.1**). However, since the last two years, banks' lending to small and medium enterprises has increased substantially.

This was due to: (a) available surplus liquidity with banks which they desired to invest in profitable avenues: (b) prevailing low interest rates that not only squeezed the margins for banks but also led to a significant decline in depositors' returns, and (c) clear directives of SBP which are aimed at diversifying banks' asset portfolio mainly towards agriculture, consumer and SME sectors.

Earning prospects in SME financing are higher than in large corporate financing, because; (a) SME financing is a riskier business as SMEs are not financially sound enough to withstand economic adversities, and (b) their risk assessment requires specific technical expertise.

Box 2.1: The role and financing of SMEs in Pakistan

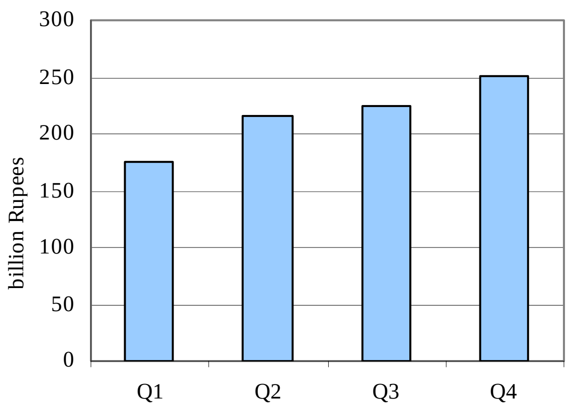
"The significant role of SME is clearly indicated by research and statistics. Enterprises employing up to 99 persons constitute about 90 % of all private enterprises in the industrial sector and SME employ some 78 percent of non-agriculture labor force. They contribute over 30 % to GDP, PKR 140 billion to exports, and 25 % of manufacturing export earnings besides sharing 35 % in manufacturing value added.

Access to equity and formal debt financing has repeatedly been identified as a recurring constraint to the SME growth and development. Commercial banks apply conservative policies in lending to SME. More importantly, the existing structure of financial sector was developed to serve medium to large enterprises which are organized as a formal business. Most banks prefer to hold risk free-income generating assets and lending to SME is unattractive due to a range of objective and subjective factors. These include high transaction costs, inability to do away with tangible collateral requirement, no linkage of financial products with sector needs and the inability to structure/offer and manage risk-prone SME specific medium to long term financing options".

Source: Developing SME Policy in Pakistan
SME Issues Paper for Deliberation by SME Task Force
Policy Planning & Strategy Department, SMEDA

These factors seem to be working in the banking sector. **Figure 2.12** shows a substantial increase in SME financing during the last four quarters. Total outstanding volume reached Rs 250.6 billion at end June 2004 and constitutes around 18 percent of total bank financing. This includes working capital finance, fixed investment and trade financing. However, the largest proportion of financing is for working capital requirements.

Figure 2.12: Outstanding SME Loans-FY04



Source: Banking Supervision Department, SBP

SBP, while closely monitoring the growing volume of SME financing and risks associated with it, issued prudential regulations for the conduct of this business.[12] These regulations mainly focus on the banks' assessment of the repayment capacity of the borrower and on ensuring the appropriate utilization of the funds.

Micro finance

Micro finance is recognized as an effective tool to fight poverty by providing financial services to those individuals/entities who do not have access to or are neglected by the commercial banks and

[12] See BPD Circular No. 35 dated October 28, 2003.

non-bank financial institutions. Financial services provided by micro finance institutions (MFIs) generally include savings and credit. According to an estimate, 67.6 million people around the world have an access to micro financing and this figure is expected to grow steadily in the future.

In Pakistan too, micro finance is gaining importance as an effective tool of social mobilization and poverty alleviation through market-oriented self-employment and income generation schemes. Currently a variety of institutions are delivering micro finance facilities to the poor, ranging from NGOs to private and government sponsored rural support programmes (NRSP & RSPs). Two Commercial banks i.e. First Women Bank and Bank of Khyber are also providing special lines of credit for the micro finance sector. The micro finance sector is the largest financial sector in Pakistan in terms of potential clientele base, comprising of 6.5 million poor households[13]. At present, however, Micro finance services in Pakistan are underdeveloped and only serving 5 percent of the potential clients.

Presently two specialized MFIs i.e. First Micro finance Bank Limited (FMFBL) and Khushali Bank (KB) are operating in the country. With gradually increasing awareness about the MFIs framework, a few more micro finance banks are likely to be established in the foreseeable future. In this regard, an operating license has already been issued to "Network Micro finance Bank Ltd" by SBP and it is expected to start operations in the near future. Moreover two other licensing applications are under process.

The operational growth of the both MFIs is obvious from the fact that they have increased their outreach by increasing the number of branches in different geographical areas, in addition to a considerable increase in their active client base.

MFIs have expanded their branch network from 39 in CY02 to 56 by the end of CY03. As KB started its operation one and a half year prior to FMFBL, it has a larger branch network. Since their inception, both the MFIs have extended 207,120 loans, disbursing an amount of Rs 2,258 million to 145,000 borrowers until end-CY03.

Table 2.3 : Outreach of MFIs

	CY02	CY03
No of Branches		
KB	31	36
FMFBL	8	20
Total	**39**	**56**
Total No. of Borrowers "000"		
KB	56	93
FMFBL	0.7	3.6
Total	**57.0**	**96.4**
Total No. of Depositors "000"		
KB	0.0	0.0
FMFBL	2.8	10.1
Total	**2.8**	**10.1**
Advances (net) million Rupees		
KB	475.5	672.2
FMFBL	17.6	64.1
Total	**493.1**	**736.3**
Average loan size – Rupees		
KB	8796	7696
FMFBL	24697.1	18491.8
MFIs (Average loan size)	**9000.8**	**8093.9**

Source: Banking Supervision Department, SBP

The number of active clients has also increased by 69.2 percent, from 57,000 in 2002 to 96,420 in 2003 (see **Table 2.3**)

Moreover, there has been a 260.7 percent increase in the number of depositors of FMFBL during CY03. It is expected that the depositor base for MFIs would grow further once Khushali bank also starts to provide deposit mobilization services in the near future.

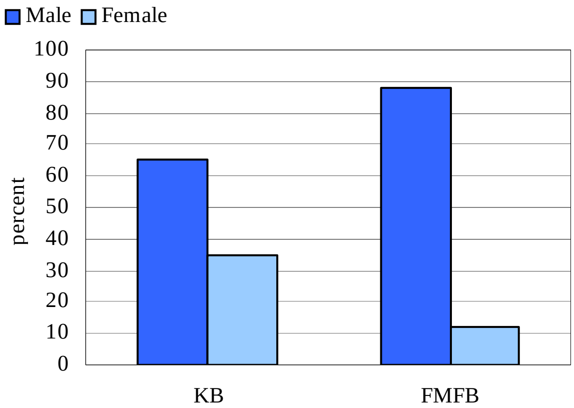
MFIs advances rose by Rs 243.2 million during the year, up 49.3 percent from Rs 493.1 million by end-CY02 .The major share of assets belongs to Khushali bank due to its larger branch network, and

[13] Report of Committee on Rural Finance, State bank of Pakistan, 2002

also because it began operations earlier than FMFBL, as discussed above. The average loan size of MFIs is Rs 8,093 in CY03, which is 10 percent less than CY02.

Gender-wise bifurcation of the MFIs' clients in the country shows that one third of the total clients are female. On a global basis, 79 percent of the targeted poor clients by MFIs are females. This is due to the very special nature of MFIs as they are established for empowerment of the poor segments through income generating activities and poverty reduction.

Figure 2.13: Clients Gender Classification-CY03



Source: Banking Supervision Department, SBP

As can be clearly seen in **Figure 2.13,** Khushali bank is at the forefront in catering to the needs of poor females as 33,009 females are availing loan facilities from it. Khushali banks' female clients are 22 percentage points higher than FMFBL's.

The combined assets of the two MFIs show an increase of 43.8 percent from CY02 and stood at Rs 4334.5 million by end CY03. Khushali bank has a dominant share in the financial assets of the two operating MFIs and accounts for 72 percent of total assets as at end-CY03. The expansion in the asset base of MFIs was mainly funded by borrowing (see **Table 2.4).** The major funding source of MFIs remained share holders' funds although it declined slightly from CY02. The low contribution of deposits in total assets is due to the narrow deposit base as Khushali Bank still has to undertake deposit mobilization as discussed above.

Table 2.4: Micro finance Institutions

percent share

Assets	**CY-02**	**CY-03**
Advances	16.1	17.0
Investments	63.9	53.2
Cash, Bank balance, Placements	10.4	21.9
Other Assets	9.6	7.9
Liabilities		
Deposits	2.1	12.8
Borrowing	13.1	45.7
Capital & other Funds	82.7	78.5
Other Liabilities	2.1	4.3

Source: Banking Supervision Department, SBP

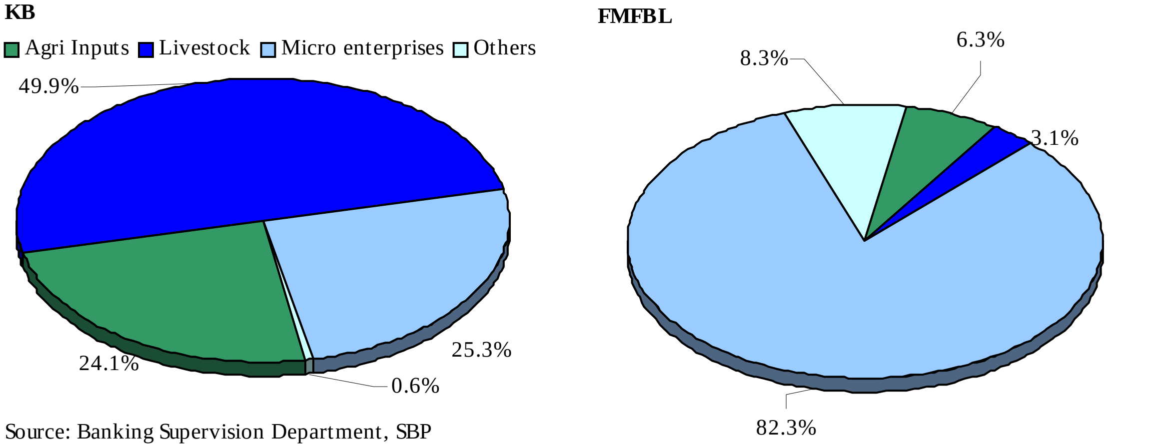
Within assets, although the share of investments has declined over the last year, but it is still dominant and accounts for 53.2 percent of total assets. Cash, bank balances and placements account for around 22 percent of the total assets.

The share of advances in the total asset of MFIs by end CY03 remained low at 17 percent. Khushali bank accounts for 91.3 percent of total MFIs' advances.

This substantially lower share of advances is attributed to the limited retail capacity of the MFIs during the early periods of their operations, as well as the smaller average loan size which renders a sharp rise in advances difficult. However, the low share of advances requires a serious effort on the part of the MFIs to speed up their lending activities to small borrowers but in accordance with prudent risk-management policies due to the very special nature of MFI services.

Moreover, a break up of advances shows that the loan portfolio of MFIs is diversified. The major share of the advances belongs to the livestock sector (42 percent) followed by micro enterprises (30 percent) and agricultural inputs (25 percent), the remaining 3 percent consists of miscellaneous sectors. However, an institutional breakup shows a different picture. Khushali bank has a higher exposure in livestock, which is also reflected in the overall MFIs' loan portfolio due to its dominating size. However FMFBL' loan portfolio is highly skewed towards the micro enterprises (see **Figure 2.14**).

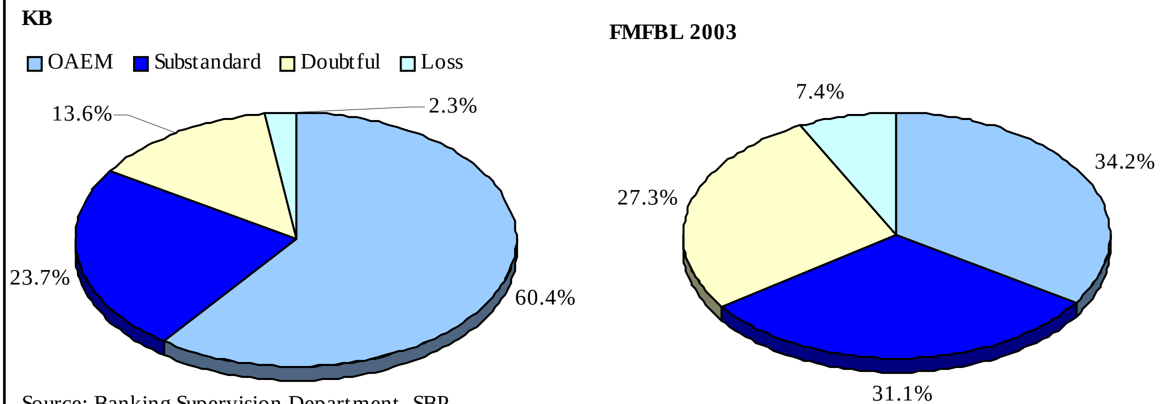
Figure 2.14:Distribution of Advances



Source: Banking Supervision Department, SBP

It is always important to see the asset quality of the institutions while measuring their performance, especially with respect to NPLs in relation to advances. NPLs of MFIs reached Rs 56.3 million, forming 7.2 percent of the outstanding advances by end-CY03. Khushali bank accounts for the major share of NPLs (96 percent), therefore a detailed analysis of its loan portfolio would be more instructive. The break up of Khushali Bank's NPLs in various categories shows that the existing loan portfolio is of a relatively better quality as compared to the previous year given that the loans booked more recently do not pose a problem as compared to the earlier ones. The declining trend in OAEM in CY03 confirms that fresh lending was of a relatively better quality (see **Figure 2.15**).

Figure 2.15: NPL Classification CY03

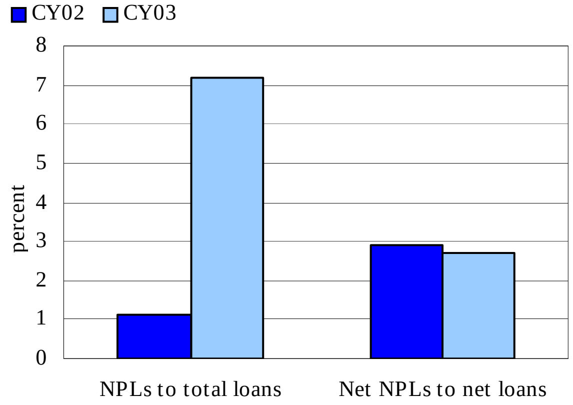


Source: Banking Supervision Department, SBP

Though NPLs have increased notably however this is not expected to pose a problem for MFIs as sufficient provisioning (Rs 23.8 million) has been made. The NPLs to total loans and net NPLs to net loans ratios shown in the **Figure 2.16** also show that the total NPLs to total advances ratio has increased but due to a reasonable amount of provisioning the net NPLs to net advances ratio has declined slightly. The gap between the two ratios also confirms that a substantial portion of NPLs has been provided for.

The coverage ratio of MFIs is at a satisfactory level of 44 percent. But the increasing absolute amount of NPLs is an area of concern and requires careful attention.

Figure 2.16: NPLs of MFIs



Source: Banking Supervision Department, SBP

Micro finance Sector Development Program (MSDP)

Micro finance sector development program, a part of Pakistan's poverty alleviation strategy was established with the help of the ADB to enhance the outreach of micro finance. The MSDP aims at strengthening of micro finance sector through : (i) creating a conducive policy environment; (ii) developing appropriate financial infrastructure; (iii) promoting and strengthening micro finance institutions; (iv) developing linkages with NGOs and community organizations; (v) investing in building social capital; and (vi) mitigating risks of poor households.

In addition, Financial Sector Strengthening Programme[14] (FSSP) of the Swiss agency for development and cooperation (SDC) has also been operational since December 2002.[15] The overall goal of the programme is to assist the Micro finance Sector in providing services to Micro Sector Enterprises (MSEs) and the disadvantaged, on a sustainable basis.

The main objectives of Phase I of this programme (December 2003-November 2005) are to :

(i) Develop human and institutional capacity of all types of MFIs for efficient delivery of micro finance services;

(ii) Build the capacity of the providers of local expertise for increasing the resource base and supporting market-oriented approaches; and

(iii) Support the creation of an enabling environment for the growth of the micro finance sector by promoting and supporting coordination among the stakeholders.

Despite the challenges faced by the micro finance sector, the future prospects for this sector are quite bright due to :

- Higher demand for the micro finance services, as a result of which there is expanding branch network of existing MFIs and entrance of the new banks and NGOs in this sector. The MFIs are emerging as an important player in the country's banking and financial system.

- The full commitment and support on the part of the government and SBP to enhance the development and outreach of MFIs in a sustainable way.

2.5 Penetration of Islamic Modes of Financing

The past few decades have witnessed a significant expansion of the Islamic financial industry on a global basis (see **Box 2.2**). In Pakistan, the efforts for the Islamization of the economy started during the 1970s which bore results in the 1980s with the setting up of the non-interest based banking system (NIBS) that worked parallel with interest-based system. During the 1980s, leasing and modaraba

[14] For detail see www.sdcpakistan.org

15 SDC's funding commitments to Pakistan equal 14.5 CHF million a year.

companies were also established which promoted the use of Islamic modes of financing in the NBFI sector.[16]

In response to the three-pronged strategy defined by SBP,[17] a number of banks have showed interest in setting up stand-alone branches and until end-May 2004, 9 branches have started operations, managed by four banks. However, none of the banks is reported to have opened up a subsidiary for such purpose so far.

Banks that have opened their stand-alone branches to take on Islamic banking business include Bank Al-Falah with 6 branches, MCB, Habib Bank A.G. Zurich, and Bank of Khyber with one branch each. Moreover, as on June 30th 2004, licenses for 13 Islamic banking branches have been issued to 5 commercial banks whose focus was conventional interest based banking.

Activities of financial institutions which primarily focus on Islamic modes of financing, presently form only a miniscule portion of total financing activities of the financial sector (see **Table 2.5**). However, given the clear direction of SBP to promote Islamic banking on a parallel basis, the share of Islamic modes of financing is expected to increase steadily both in the bank and non-bank sector[18].

Box 2.2: Islamic Finance Worldwide
"While it is difficult to identify precisely the date of the first formal Islamic financial institution in recent history, references are often made to the Mitghamr Egypt Savings Association in 1963. Currently about 240 Islamic financial institutions may have total combined assets in excess of US$ 200 billion in more than 48 countries (with some estimates close to US$ 250 billion).

According to the Association of Islamic Banks, as of 1997, 29% of Islamic banks were in South Asia, 20% in Africa, 18% in South East Asia and 15% in the Middle East, 12% in the GCC countries, 5% in Europe and America and 1% in Asia, see Archer & Ahmed (2003). According to some estimates, it is expected that Islamic banking will be able to attract 40% to 50% of the total savings of the Muslim population worldwide within the next few years.

To capitalize on the potential of that market, a number of global financial institutions—including but not limited to, Citibank, Goldman Sachs, BNP-Paribas, and UBS—have established Islamic banking Shariah compatible services in several countries".

Source: Regulating Islamic Financial Institutions: The Nature of the Regulated by Dahlia El-Hawary, Wafik Grais and Zamir Iqbal; World Bank Policy Research Working Paper 3227, March 2004.

For deposit mobilization, these banks offer products like current account, savings and time deposits on Profit and Loss sharing basis. The deposit rates of these Islamic branches are determined on the basis of *actual* profit and loss. Islamic tools, especially Modaraba and Musharika are used in designing these products. For savings and time deposits, weightages are assigned for different maturities on the basis of which returns are decided.

For financing purpose, Islamic banks are using a wide range of products including corporate ijarah, consumer ijarah, trade/project financing, export and import morabaha financing.

Recent Progress of Islamic Banking

With the establishment of Meezan Bank in FY01, the assets of the Islamic banks almost doubled from Rs 33 billion in FY01 to Rs 68.4 billion during FY03. Although the share of Islamic banks in total banks is quite small at present, with the opening up of stand-alone Islamic Banking Branches (IBBs) of conventional banks at end-FY03, it is expected that Islamic banking will soon carve a significant niche in the sector[19].

[16] Mutual Funds were already introduced in the financial sector during 1960s. For more details, please see 'Pakistan: Financial Sector Assessment 2001-2002'.
[17] See IBD Circular Letter No.1
[18] Islamic financial institutions include leasing companies, modarabas, mutual funds and three commercial banks, i.e. Meezan Bank, Bank Al-Baraka and Faysal Bank. This definition does not strictly comply with the Shariah.
[19] Especially, after the amendment in sales tax Act which has resolved the issue of double taxation in Morabaha financing by banks.

As shown in **Figure 2.17**, there is almost a threefold increase in the asset base of IBBs in just six months (from Dec-03 to June-04). This not only exhibits the broader scope of the Islamic banking in Pakistan, but also indicates the sizeable potential demand for Islamic financial products in the country. Deposit mobilization also increased significantly during these five months, registering a growth of 482 percent.

In fact, the extent of prospective depositors for Islamic banks can be seen through the large shares of PLS savings and non-remunerative current account in the overall deposits of the conventional (interest based) banking industry. Fixed deposits and remunerative current accounts together account for only 24 percent for the total customer deposits. It is expected that with the availability of true profit and loss based deposit returns, more savings would be accumulated with Islamic banks in the future.

Supervisory Capability of SBP in Islamic Banking

For regulating and promoting the Islamic banking sector, a full-fledged Islamic Banking Department (IBD) has been established in SBP in September 2003. The department is equipped with the required expertise for regulating the banking industry with an in depth knowledge of Islamic banking, both conceptual and practical (see **Banking Sector Review 2003**).

In its efforts to proactively respond to the needs of the growing business of Islamic banking, SBP issued a draft on Essentials and Model Agreements for Islamic Modes of Financing on its website on April 16, 2004 (see **Box 2.3**) to seek comments and suggestions from Sharia scholars, banks, business community, etc for the formulation and enforcement of all encompassing prudential regulations.

Table 2.5: Islamic Financing in Pakistan

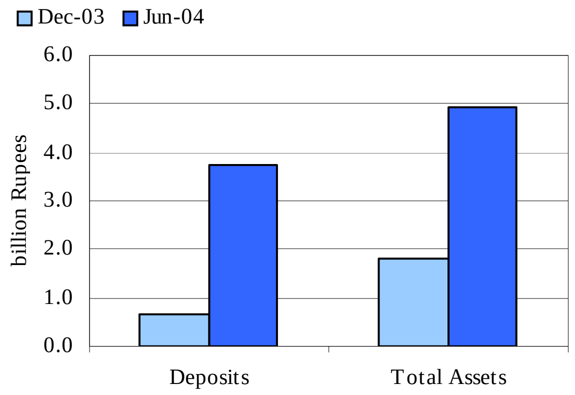
billion Rupees

	FY00	FY01	FY02	FY03
Assets of Scheduled Banks	**1807.6**	**1942.3**	**2223.1**	**2546.0**
Islamic Banks	30.3	33.0	51.9	68.4
Conventional Banks	1,777.3	1,909.3	2,171.2	2,477.6
Share in percent				
Islamic Banks	1.7	1.7	2.3	2.7
Conventional Banks	98.3	98.3	97.7	97.3
Assets of NBFIs	**146.9**	**160.9**	**194.2**	**249.0**
Islamic NBFIs	**66.7**	71.8	83.9	118.1
Conventional NBFIs	80.1	89.1	110.3	130.9
Share in percent				
Islamic NBFIs	45.4	44.6	43.2	47.4
Conventional NBFIs	54.6	55.4	56.8	52.6
Total Banks and NBFIs	**1,954.5**	**2,103.2**	**2,417.3**	**2,794.9**
Islamic Institutions	97.1	104.8	135.8	186.5
Conventional Inst.	1,857.4	1,998.4	2,281.5	2,608.5
Share in percent				
Islamic Institutions	5.0	5.0	5.6	6.7
Conventional Inst.	95.0	95.0	94.4	93.3

Note: The primary purpose of this table is to get a proximate guess of the extent of Islamic modes of financing, in relation to the overall financial activities. Hence, above categorization of banks and NBFIs into Islamic and Conventional does not necessarily conform to strict Sharia definitions. Islamic banks include Meezan, Al-Baraka and Faysal Bank: Islamic NBFIs include Modarabas leasing and Mutual Funds.

Source: Banking Supervision department, SBP

Figure 2.17: Performance of IBBs



Source: Islamic Banking Department, SBP

Box 2.3: Essentials of Islamic Modes of Financing
The Commission for Transformation of Financial System approved essentials of Islamic modes of financing that were reviewed and approved by the Shariah Board of the SBP. These would serve the purpose of guidelines that would form the basis for Prudential Regulations on Islamic Banking. However, it did not preclude the possibility of developing new modes or instruments of financing. The Essentials include:

(**1) Murabaha** (Agreed profit margin sale with cash or deferred payment of price)
Murabaha means a sale of goods by a person to another under an arrangement whereby the seller is obliged to disclose to the buyer the cost of goods sold either on cash basis or deferred payment basis and a margin of profit included in the sale price of goods agreed to be sold. The determined selling price cannot be changed once the sale transaction has been concluded. Besides, buy-back arrangement and the rolling over the contract are also prohibited.

(2) **Musawamah**
Musawamah is a general kind of sale in which price of the commodity to be traded is stipulated between seller and the buyer without any reference to the price paid or cost incurred by the former. Thus it is different from Murabaha in respect of pricing formula. Unlike Murabaha, seller in Musawamah is not obliged to reveal his cost. All other conditions relevant to Murabaha are valid for Musawamah as well. Musawamah can be an ideal mode where the seller is not in a position to ascertain precisely the costs of commodities that he is offering to sell.

(3**) Ijarah** (Leasing)
In Ijara/leasing, the corpus of leased commodity remains in the ownership of the lessor and only its usufruct is transferred to the lessee. Any thing which cannot be used without consuming the same cannot be leased out like money, edibles, fuel, etc. Only such assets which are owned by the lessor can be leased out except that a sub-lease is affected by the lessee with the express permission of the lessor. A lease can be terminated before expiry of the term of the lease but only with the mutual consent of the parties.

(4) **Salam** (Advance payment--Deferred Delivery Sale)
Salam (advance payment against deferred delivery of goods) means a kind of sale whereby the seller undertakes to supply specific goods to a buyer at a future date in consideration of a price fully paid in advance at the time the contract of sale is made.

(5) **Musharaka**
Musharaka means relationship established under a contract by the mutual consent of the parities for sharing of profits and losses arising from a joint enterprise or venture. It is not allowed to fix a lump sum amount for any of the partners, or any rate of profit tied up with his capital. A management fee however, can be paid to the partner managing the Musharaka provided the agreement for the payment of such fee is independent of the Musharaka agreement.

(6) **Modaraba**
Mudaraba means an arrangement in which a person participates with his money and another with his efforts and shall include banks, unit trusts, mutual funds or any other institutions or persons by whatever name called. Mudaraba may be of various types which may be multi purpose or specific purpose, perpetual or for a fixed period, restricted or unrestricted and close or open-ended in accordance with the conditions respective to each of them.

(7) **Istisna**
Istisna‘a is an exceptional mode of sale, at an agreed price, whereby the buyer places an order to manufacture, assemble or construct, or cause so to do anything to be delivered at a future date.