1 Operating Environment and Structure of the Financial Sector

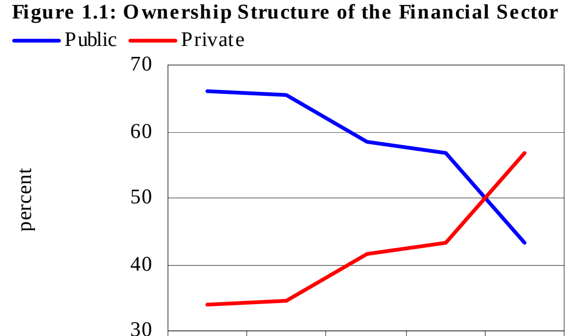
1.1 Structure and Performance of the Financial Sector

The on-going financial sector reforms and a burgeoning economy, have led to significant changes in the size, structure and performance of the financial sector[1] during CY04. The overall size of the financial sector (measured by assets) saw an increase of Rs 569.1 billion to reach Rs 4.5 trillion by end-CY04. This notable change in assets was primarily facilitated by an exceptional growth in credit during the year**.** Although strong credit growth can have negative implications for credit risk, key financial performance indicators clearly reflect the resilience of the financial sector to both internal and external shocks. The risk absorption capacity of the financial sector has improved considerably, as the equity to liability ratio has increased to 8.5 percent by end-CY04 compared to 7.6 percent at end-CY03. Moreover, narrowing average spread and net interest margins along with higher profitability (return on average assets after tax), signify the increasing efficiency of the financial sector. Specifically, the financial sector was able to channel funds from the surplus sectors of the economy to the deficit sectors at a lower cost of intermediation.

1.1.1 Structure of the Financial Sector

The structure of the financial sector has witnessed substantial changes both in terms of its ownership and institutional composition. The privatization of big state-owned commercial banks, aggressive credit activities of private banks, increased activities in private sector mutual funds and net retirement in national savings schemes, have pushed the share of the private sector to 56.6 percent by end-CY04 (see **Figure 1.1**). On the other hand, the share of government owned financial institutions plunged to 43.4 percent, with a reduction of 13.3 percentage points during the year. This is a significant development given that it is for the first time since the nationalization drive of 1974 that private sector institutions have acquired such a dominant share of the financial sector. Furthermore, the bifurcation of the private sector into domestic private financial institutions and foreign institutions indicates that the share of the former has reached almost 86 percent by end-CY04 as compared to 67.2 percent at end-CY00. This changing pattern of market shares clearly indicates that the domestic private sector is playing a leading role in the financial sector.

Figure 1.1: Ownership Structure of the Financial Sector



	CY00	CY01	CY02	CY03	CY04
Public	66.2	65.6	58.5	56.7	43.4
Private	33.8	34.4	41.5	43.3	56.6

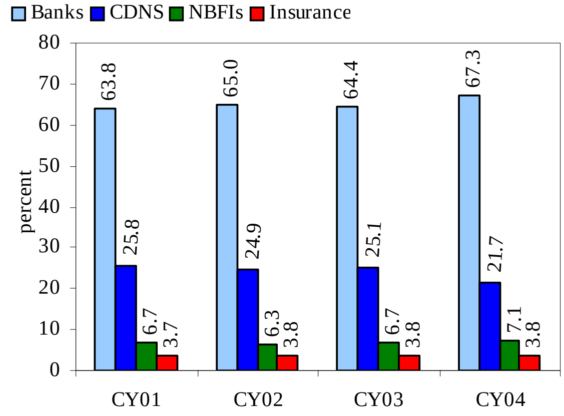
It is important to note that if we exclude CDNS from the overall financial sector, the share of public sector financial institutions in the overall assets of banks, NBFIs and Insurance is only 27.7 percent at end-CY04 as compared to 42.2 percent at end-CY03. This shows that the financial sector (excluding CDNS) is now primarily owned and managed by the private sector. These changes in the ownership structure clearly reflect the government's efforts to promote the role of the private sector in the economy.

---

[1]The overall position of the financial sector has been compiled by aggregating the data of various financial institutions with different accounting years. Data for Commercial Banks, Microfinance Institutions, DFIs, CDNS and Insurance at end-December (CY) is added to the audited data of NBFCs, which is of end June (FY). The total assets to GDP ratio is calculated by using the Gross Domestic Product at current market prices of FY04.

Institutional composition of the financial sector indicates that it not only continues to be heavily skewed towards banks, but the dominance of the banking sector has gained more strength in the overall financial sector. A quick glance at **Figure 1.2** shows that the banking sector was able to increase its share by 3 percentage points during CY04 to reach 67.3 percent. The impressive rise in banking sector assets is largely attributed to massive credit expansion by the banks, mergers/acquisition of NBFIs with commercial banks and disinvestments in national savings schemes. It may be important to note that the dominance of the banking system in the financial sector is not surprising, as "the banks are the most important source of external funds used to finance business"[2].

Figure 1.2: Structure of the Financial Sector



Despite a number of mergers of NBFIs with commercial banks during 2004, NBFIs saw a slight increase in their market share primarily due to a sharp rise in activities in mutual funds, which in turn heavily benefited from all time high stock prices. Specifically, around 80 percent increase in the assets of NBFIs comes from mutual funds only. As a consequence, mutual funds have acquired the leading position in the NBFIs group, with an asset base of Rs 102.9 billion.[3] DFIs, which had maintained a pre-dominant role as the largest group of institutions in the NBFIs sector (on the basis of assets) could not retain their position even with an asset growth of 18.9 percent during CY04. All the other major groups of institutions including investment banks, Leasing companies and Modarabas lost some of their market share to mutual funds.

Within the financial sector, CDNS was the worst hit as its share registered a decline of 3.4 percentage points during CY04 (see **Figure 1.2**). Importantly, CDNS lost its share not because of slow growth in net mobilization through national savings schemes, but due to a record net outflow (negative growth) from national savings schemes for the first time since 1971. This outflow is largely explainable by (1) all time low profit-rates on national savings schemes in the presence of high returns on stocks; (2) individuals' reluctance to lock-in their funds for longer period with expectations of rising interest rates; and (3) maturing institutional investments in NSS which could not be reinvested therein due to the ban of March 2000 on institutional investment in NSS.

Table 1.1: Assets of the Financial Sector

	CY00	CY01	CY02	CY03	CY04
***Assets** (billion Rupees)*					
NBFIs	240.0	204.1	216.2	262.7	319.8
Insurance		113.4	129.8	151.4	173.5
CDNS	729.3	783.8	849.6	987.4	979.0
Banks	1,807.6	1,942.3	2,223.1	2,538.0	3,036.3
Overall	2,776.9	3,043.6	3,418.7	3,939.5	4,508.6
Growth Rates					
NBFIs		-15.0	6.0	21.5	21.7
Insurance			14.4	16.6	14.7
CDNS		7.5	8.4	16.2	-0.9
Banks		7.4	14.5	14.2	19.6
Overall		9.6	12.3	15.2	14.4
As Percent of GDP					
NBFIs	6.3	4.9	4.9	5.4	5.8
Insurance		2.7	2.9	3.1	3.1
CDNS	19.2	18.8	19.3	20.5	17.7
Banks	47.7	46.7	50.5	52.6	54.9
Overall	73.2	73.1	77.7	81.7	81.5

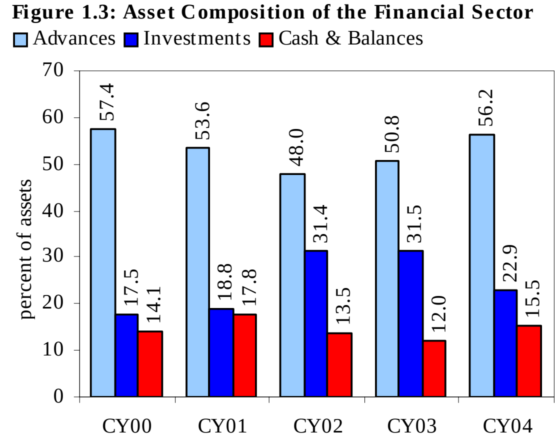
[2] Mishkin, Frederic S. (5th Edition), "The Economics of Money, Banking and Financial markets", p.198.
[3] Please see Chapter 6 : Financial Performance of NBFIs.

Another point to note is the slight decline in the ratio of financial sector assets to GDP, despite a 14.4 percent growth. This implies that the growth in nominal GDP has outpaced the growth of the financial sector. However, this decline was not equally distributed among the various sub-groups of the financial sector. Looking at **Table 1.1**, this decline stemmed entirely from CDNS, which in a way overshadowed the impressive performance of all other institutions, particularly of the banking sector. However, this changing institutional composition of the financial sector is a welcome development, as the role of banks, which are more efficient intermediaries, has increased relative to other financial institutions.

1.1.2 Key Indicators of Financial Sector Performance[4]

As mentioned above, the strong growth in financial sector assets during CY04 was accompanied with visible changes in the asset composition of the financial system. The share of advances, which includes lending to financial institutions, increased to 56.2 percent of total assets by end-CY04 (see **Figure 1.3**). Over 30 percent increase in advances including lending to financial institutions, which pushed its share in the overall assets, can be attributed to a number of factors. First, there was an increased demand for corporate loans during the year, due to both enhanced capacity utilization to meet the increased aggregate demand, as well as installation of new capacity in anticipation of future economic activities. Strong growth in fixed investments indicates that the corporate sector has also continued to borrow funds for ongoing balancing, modernization and replacement (BMR) activities, particularly in the textile sector, to take advantage of the free trade regime. Secondly, the increased focus of the banking sector on small and medium enterprises (SMEs), helped banks to not only provide the much needed credit to this under served sector, but also to channelize their excess liquidity to productive uses. Finally, increased interest of the financial sector in promoting consumer finance also played an important role in the massive credit expansion during the year.[5]

Figure 1.3: Asset Composition of the Financial Sector



In sharp contrast to advances, share of investments in the overall assets of the financial sector witnessed a decline of 8.6 percentage points during CY04 to reach 22.9 percent. More importantly, besides a decline in their share in the overall financial assets, investments of the financial sector decreased by 13.9 percent in absolute terms during CY04. The opportunity to divert funds towards profitable avenues, reluctance of financial institutions to invest in long term government securities in a rising interest rate environment and the divergent views on interest rate movements of the financial institutions and the central bank, are some of the important factors behind this sharp decline in investments' holdings.

The impressive asset growth was funded by a strong growth in deposits, of over 20 percent, during CY04. Besides a continuous inflow of remittances, the increase in overall economic activities in the economy, and the corporate sector in particular, played an important role in deposit growth. As a result, the share of deposits in the overall liabilities of the financial sector reached 81.5 percent by

[4] Key indicators of the financial sector are calculated by consolidating the audited data of banks, microfinance institutions, and NBFIs (excluding mutual funds). CDNS and Insurance sector are excluded from this analysis.
[5] For details of the credit activities of the banking sector, please see Chapter 3: Bank Credit.

end-CY04 as compared to 78.8 percent in the previous year (see **Figure 1.4**). At the same time, the share of borrowings in total liabilities edged down to 12.7 percent. This changing composition of liabilities has strong positive implications for the profitability of the financial sector, as deposits are a cheaper source of funds as compared to borrowing.

Keeping in mind the changing composition of both assets and liabilities, a brief discussion of the performance indicators of the financial sector will be helpful in analyzing its financial health. Looking at **Table 1.2**, the equity to liability ratios, both including and excluding the surplus/deficit on revaluation of assets, have increased during CY04. The ratio at end-CY04 indicates that 8.5 percent of financial sector liabilities (mainly deposits and borrowings) are backed by equity. Within liabilities, it is clear that the share of deposits has increased during the period of analysis, which reinforces the earlier view regarding the availability of relatively cheaper funds for the financial sector.

Figure 1.4: Funding of the Financial Sector

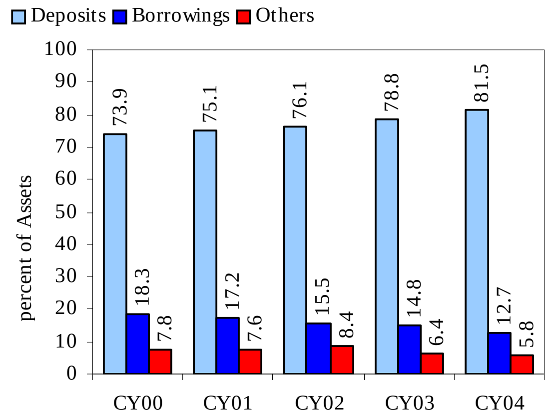


Table 1.2: Key Performance Indicators of the Financial Sector

percent

	CY00	CY01	CY02	CY03	CY04
Equity (excluding surplus/deficit) to liability ratio	4.37	4.71	4.89	6.03	6.84
Equity to liability ratio	5.11	5.41	6.75	7.63	8.52
Equity to assets ratio	4.86	5.13	6.32	7.09	7.85
Borrowing to liability ratio	18.28	17.14	15.36	14.47	12.22
Deposits to liability ratio	73.92	75.12	76.07	78.84	81.50
Average cost of deposits and borrowing	6.53	6.15	4.40	2.09	1.52
Average return on advances and investments	12.42	13.20	9.51	6.49	5.66
Average spread	5.89	7.05	5.11	4.40	4.14
Net interest margin	3.87	5.03	4.35	4.07	3.89
Non-interest income to total income	18.35	15.04	19.09	31.48	28.66
Return on average assets (before tax)	0.19	0.16	1.11	2.07	1.94
Return on average assets (after tax)	-0.21	-0.44	0.39	1.40	1.46
Advances to assets ratio	49.51	46.99	41.61	43.40	51.52
Earning assets to total assets	67.03	65.81	72.99	74.87	74.38
Liquid assets to total assets	31.67	36.63	44.89	43.51	38.34

Note: Indicators are based on consolidated data of Banks, Microfinance institutions and NBFIs (excluding mutual funds)

While both the average cost of funds (deposits and borrowing) and the average return on earning assets (advances and investments) continued to decline for yet another year due to all time low interest rates, the extent of decline in the latter was higher. These changes in average cost and returns narrowed the average spread to 4.14 percent, which reflects the increased efficiency of the financial sector. As a result, the pre-tax return on assets declined by 13 bps during CY04. However, given the reduced burden of taxes on the banking sector due to the harmonization of the tax rate for the banking and the corporate sector, the after tax return on average assets saw a rise of 6 bps despite a narrowing of the net interest margin by 18 bps. Furthermore, a decline in the share of non-interest income in total income suggests that the profitability of the financial sector largely came from core business activities.

Although the focus on core business activities is also evident from a sharp increase in the advances to assets ratio, this is also used as a measure of the credit risk of the financial sector. In other words, the credit risk has also increased during the period under assessment. Notably, this rise in credit risk is not perceived to be a problem for the financial sector as its risk taking capacity (as measured by the equity to assets ratio) has also increased over the same period (see **Table 1.2**).

On an overall basis, it is surmised that the excess liquidity with the financial sector during the last two years has been deployed in core business activities. As a result, the liquid assets to total assets ratio has dropped to 38.3 percent by end-CY04 as compared to 43.5 percent at end-CY03 (see **Table 1.2**).

It is evident from the key performance indicators that the financial sector is well placed to cater to the needs of a growing economy and is well supported by a favorable macroeconomic environment. These indicators also suggest that the financial sector is now positioned on a sound footing for the implementation of second generation reforms focused on increasing the depth of the financial sector while continuing the process of integration with the global financial system.

1.2 Macroeconomic Environment[6]

Given the bi-directional causality between economic growth and soundness of the financial sector, this section assesses the macroeconomic environment in which financial sector developments took place in 2004.

The process of implementation of the various macroeconomic reforms which picked up pace with the advent of the new millennium, has now started to yield benefits as evidenced by the trend witnessed in most of the macroeconomic indicators. Pakistan has been on the road to economic recovery particularly since the year 2002, as indicated by the rapid increase in GDP growth since then (see **Table 1.3**). The growth has been particularly strong in FY05 at 8.4 percent; this is only the fifth time in the history of the country that the growth rate has exceeded 8 percent. Supportive macroeconomic policies, a strong and enabling regulatory framework, fiscal prudence, an accommodative monetary policy, investment in long term capital formation by the private sector, competitive exchange rates and growing domestic demand, are some of the major factors which have altogether contributed to the economic growth process.

Table 1.3: Major Macroeconomic Indicators

	FY01	FY02	FY03	FY04	FY05[1]
Growth rates (percent)					
GDP	1.8	3.1	4.8	6.4	8.4
Agriculture	-2.2	0.1	4.1	2.2	7.5
Industry	3.6	2.6	4.7	12.0	10.2
of which :LSM	11.0	3.5	7.2	18.2	15.4
Services	3.1	4.8	5.2	6.0	7.9
Exports	7.4	-0.7	20.8	10.3	17.0
Imports	4.1	-3.6	18.2	27.6	32.3
CPI (annual average)	4.4	3.5	3.1	4.6	9.3
Exchange rate[2]	-18.6	6.8	3.9	-0.6	-2.6

[1] provisional
[2] Appreciation (+) / Depreciation (-)

Notably, GDP growth has not only been significantly high but also broad-based in terms of its outreach to all the major sectors of the economy. Performance of the Agriculture sector, which accounts for nearly 23 percent in Pakistan's national income, was exceptional, as 7.5 percent growth during FY05 is not only substantially higher as compared to only 2.2 percent growth during FY04, but

[6] All figures have been taken from the Economic Survey 2004-05, unless otherwise mentioned.

also higher than the target of 4 percent for the year. During FY05, the country recorded the highest ever production of cotton and wheat due to a variety of factors such as favorable weather conditions and availability of bank credit. These two crops account for over 24 percent of the value added in agriculture. Major crops, accounting for 37.1 percent of agriculture value added, registered the highest growth of 17.3 percent during the year as against 1.9 percent in the previous year. Minor crops, with a share of 12.2 percent in overall agriculture, grew by 3.1 percent compared to 2.6 percent last year. Performance in the livestock sector, which forms 46.8 percent of the overall agriculture sector, continued to remain tame. However the increased activities of private sector banks in this area has facilitated the availability of credit for all activities in this sector which until the recent past has largely been confined to specialized institutions. This policy shift is deemed to augur well for the long term growth of this sub-sector.

Impressive performance of the agriculture sector also lent crucial support to the industrial sector in keeping its double digit growth intact. Within the industrial sector, Large-scale manufacturing (LSM) in particular has seen a strong growth of 15.4 percent in FY05 over the exceptionally high growth of 18.2 percent in FY04. It is important to note that this strong growth is not concentrated in only a few sub-sectors but is distributed across the board. Besides other factors, the growth was heavily driven by an increased demand for consumer goods, a major part of which comes from easy access to bank credit, which also led the corporate sector to enhance its production capacity to bridge the demand-supply gap.

Given the state of the economic environment, it should hardly come as a surprise that the changing structure of consumer spending in a booming economy would lead to higher prices. In the short run this is due to excessive demand in the face of limited supply as the manufacturing sector needs time to adjust its production capacity. In specific terms, CPI inflation averaged 9.2 percent during FY05. Besides the monetary overhang from an easy monetary policy, exceptionally high oil prices in the international markets and substantial rise in food prices largely contributed to this high rate of inflation.

High oil prices together with the growing need for the import of raw materials and machinery in a growing economy led to the deterioration of the balance of payment position. As a result, the current account balance during FY05 turned into deficit after being in surplus for the last four years. This is largely due to the widening trade deficit despite a strong growth in exports. Imports actually increased to US$ 20.6 billion during FY05 with an exceptional year-on-year growth of 32.3 percent. This pattern of import growth eclipsed the healthy growth of exports during the same period, which increased to US$ 14.4 billion from US$ 12.3 billion in FY04.

The deteriorating trade balance together with rising inflation proved to be a challenging task for the economic managers. Given these developments, the policy framework in place during the year is discussed in the following section.

1.2.1 Policy Framework

The State Bank has consciously strived to maintain a growth-oriented monetary and exchange-rate environment. Prevalence of low interest rates has fueled growth and has accelerated the pace of economic recovery. The main thrust of the monetary policy during the year was on ensuring adequate availability of bank credit to the private sector while containing inflation. SBP remained firm in its stance of measured tightening in order to check inflationary pressures which could entail potential economic costs. In this respect, after maintaining a neutral policy stance since the second half of FY05, SBP decided to undertake an aggressive tightening of the monetary policy. In April FY05, the discount rate was also increased by 150 bps to reach 9 percent which strongly signaled SBP's intentions to raise interest rates in a bid to fight inflation. As a result, the 6-month T-bill cut-off yield touched 7.99 percent by end-FY05, with a sharp rise of 414 bps during H2-FY05.

Exchange rates also began to show the impact of a rapidly declining Balance of Payment surplus as the rupee-dollar parity recorded a marginal depreciation of 0.6 percent during FY04, and a further depreciation of 2.6 percent in FY05, compared with an appreciation of 6.8 percent and 3.9 percent in FY02 and FY03 respectively. SBP had to intervene frequently in the foreign exchange market, starting from March 2004, to ensure the stability of exchange rates. Foreign exchange reserves which have reached US$12.6 billion by end-June 2005 provided the necessary level of comfort in dealing with such adverse situations.

The vital support from the fiscal side to achieve macroeconomic stability, particularly with respect to containing inflation, remained available during the year. The government absorbed a portion of the impact of high international oil prices on domestic prices by reducing its revenue from surcharges on oil and gas. Besides this, the fiscal policy remained prudent as the overall fiscal deficit was contained within targeted levels. Notably, while deficit figures continue to show improvements, development expenditures which are of vital importance in supporting growth, continued to show a visible rise during the past three years.

1.2.2 Investment Climate

The privatization policy of the government also continued to pave the way for the growth of the private sector, which has exerted a profound impact on the structure of the economy and the financial sector. This is evident from the changing composition of public and private sector investments. Private sector investment during FY05 grew by 19.3 percent against a growth of 9.6 percent in FY04 (see **Table 1.4**). In sharp contrast to this, public sector investment registered a decline of 0.4 percent as against a sturdy increase of 36.8 percent increase in the previous year. In other words, the growth in domestic investment, which was largely a public sector phenomenon in FY04, was shaped entirely by the private sector in FY05.

Table 1.4: Growth of Gross Fixed Capital Formation (GFCF)

percent

	FY01	FY02	FY03	FY04	FY05[1]
GFCF	8.5	3.2	8.2	17.4	15.6
Private	7.2	17.3	9.8	9.6	19.3
Public	15.2	-32.9	-8.3	36.8	-0.4
General Govt.	1.9	5.1	24.0	43.0	15.7

[1] provisional

It may be noted that gross fixed capital formation (GFCF) could not keep pace with the nominal GDP growth during FY05 despite a rise of 15.7 percent during the year. As a consequence, the GFCF to GDP ratio saw a decline of 37 bps. This decline came from the public sector (including general government) which saw a reduction of 46 bps during the same period.

This brief review of the policy framework clearly indicates that the development of the financial sector was adequately supported by a favorable macroeconomic environment during the period of analysis. The recent increase in interest rates, which can potentially affect the impressive growth performance by reducing investment activities, may impair the asset quality of the financial sector. While this issue is discussed in Chapter 5, the financial infrastructure which constitutes the regulatory and legal framework and is of vital importance for the efficient functioning of the financial sector, is reviewed in the following chapter.