BSR

Banking System Review

For the year ended December 31, 2005

State Bank of Pakistan

Banking Supervision Department

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List of Abbreviations

ADD	Authorized Derivatives Dealer
AML	Anti Money Laundering
APGML	Asia-Pacific Group on Money Laundering
BCBS	Basel Committee on Banking Supervision
BMR	Balancing, Modernization and Replacement
CAELS	Capital, Assets Quality, Earnings, Liquidity and Sensitivity
CAMELS-S	Capital, Assets Quality, Management, Earning, Liquidity, Sensitivity and Systems & Controls
CAR	Capital Adequacy Ratio
CB	Commercial Bank
CFT	Combating the Financing of Terrorism
CIRC	Corporate and Industrial Restructuring Corporation
COT	Carry Over Transactions
CRSIU	Committee for Revival of Sick Industrial Units
CY	Calendar Year
DFI	Development Finance Institution
DIS	Deposit Insurance System
EBIT	Earning Before Interest and Taxes
FATF	Financial Action Task Force
FB	Foreign Bank
FDBR	Financial Derivatives Business Regulations
FRA	Forward Rate Agreement
FSAP	Financial Sector Assessment Program
FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GST	General Sales Tax
HBL	Habib Bank Limited
IMF	International Monetary Fund
IRAF	Institutional Risk Assessment Framework
IRB	Internal Ratings Based
IRS	Interest Rate Swap
KSE	Karachi Stock Exchange
KYC	Know Your Customer
LPB	Local Private Bank
LSM	Large Scale Manufacturing
MCR	Minimum Capital Requirement
MFB	Micro Finance Bank
MTB	Market Treasury Bill
NMI	Non Market Maker Financial Institution
NPF	Non Performing Finance
NPL	Non Performing Loan
OMO	Open Market Operations
OTC	Over the Counter
PIB	Pakistan Investment Bond
PSCB	Public Sector Commercial Bank
PTC	Participation Term Certificate
ROA	Return on Assets
ROE	Return on Equity
RSA	Rate Sensitive Asset
RSL	Rate Sensitive Liability
RTGS	Real Time Gross Settlement
RWA	Risk Weighted Assets
SB	Specialized Bank
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SME	Small and Medium Enterprise
TFC	Term Finance Certificate
UBL	United Bank Limited
UNO	United Nations Organization
YoY	Year on Year

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Foreword

The banking system of Pakistan has grown from strength to strength in recent years. The growing competition is one of the driving force of change as banks are not only striving to attain cost efficiencies but are also relentless in exploring more profitable and non-traditional avenues of investment. With the increasingly intensified competition and growing exposure of banks to new areas, the financial environment is also getting complex. The creeping intricacies in banks' operations call for gradual evolution and adaptation of risk management and corporate governance practices in line with the changing environment. In this respect, disclosure and transparency come to assume critical importance to ensure smooth flow of information to stakeholders so that they could align their positions according to the changing circumstances and take appropriate decisions.

While prescribing minimum disclosure standards for the financial institutions, State Bank of Pakistan (SBP) has also been releasing important and relevant information particularly on monetary and financial areas through its various publications. In this regard, the Banking System Review (BSR) is an important document, which critically analyses the financial health and soundness of the banking system, captures issues & developments in the banking system and also mentions various initiatives towards financial system stability.

In line with the past practice, the primary focus of BSR for 2005 remains on the banking system because of its dominant size, and hence its systemic significance. For analysis purposes, the banking system has been divided into four broad groups of banks namely, local private banks (LPBs), public sector commercial banks (PSCBs), foreign banks (FBs) and specialized banks (SBs). While the main focus remains on the banking system, the performance, issues and development within Development Finance Institutions (DFIs), Micro-finance Banks (MFBs), Islamic Banks, and Exchange Companies have also been discussed in separate chapters.

In order to ensure consistency and to provide adequate coverage, the basic format of the document has been kept unchanged. The macro-prudential indicators continue to provide the analytical framework for assessing the financial health and soundness of the banking system. The main source of data remains annual audited accounts of banks and DFIs for covering the core topics. For the remaining areas, information has been sought from different sources. In this respect, we would like to express our gratitude to the various departments of SBP that provided the relevant information. In particular, we would also appreciate and acknowledge the contribution of M/S Vital Information Service (VIS) for providing us the data on the corporate sector. As always, we would welcome suggestions for further improvement of the future reviews.

June 27, 2006

JAMEEL AHMAD
DIRECTOR
Banking Supervision Department

1 Overview

During CY05, the banking system succeeded in building upon the gains of the preceding years and finished the year with the results, which overwhelmingly outshined the achievements of the past couple of years. On the back of robust profits, strengthening capital and declining overhang of non-performing loans, the key financial soundness indicators maintained their improvement trend. The healthy posture of the banking system started to manifest itself in the growing resilience to the budding pressures on the macroeconomic front. In this respect, the gradually strengthening risk-management systems and professional approach in policies have provided significant help in containing the downside risks. These positive developments so far have allowed the banking system to continue its march towards the goal of attaining sustainable financial stability. The increasing financial stability and vibrant activities ensured smooth flow of funds to the vital sectors of the economy, thus helping to keep afloat the expectations of higher GDP growth despite some setbacks to the economy during CY05.

Following are some of the major highlights of the year under review:

- After tax profit of all banks shot up to Rs63.3 billion, which comfortably overshadows the profit of Rs34.7 billion in CY04. The high profits rested heavily on the greater volume of business, with the rising share of high yield assets and widening spread; on the back of lagging impact of rising interest rates on deposits. While the proportion of core income in total profits increased sharply, non-core activities, with the larger trade activities, also made valuable contribution. Resultantly, return on assets (after tax) increased appreciably to 1.9 percent from 1.2 percent in CY04; easily surpassing the relevant international benchmark. The rapid growth in profits also resulted in considerably higher return on equity (after tax), which improved to 25.8 percent from 20.3 percent in CY04.
- The strong credit growth has been the hallmark of banking activities in recent years, and has played the most crucial role not only in driving the growth momentum of the economy but also in fuelling the unprecedented rise in profits of banks. In CY05, the growth in loans of the banking system showed deceleration as compared with the growth pattern in CY04. Total loans increased by Rs411 billion as compared with an increase of Rs472 billion in CY04. Despite the relative slow-down, the growth is still very high and is reflective of continued upbeat mood of the economy. Major flow of funds remained towards corporates, SMEs and consumer segments indicating broad-based growth. Corresponding to its large size, the bigger chunk of loans went to corporate sector, though the level of absorption was well below that in CY04. On the other hand, the loans flow to consumer and SMEs segments was more than proportional to their size leading to rise in their respective shares in total loans of the banking system. In particular, the growth in consumer financing was very noticeable, which led to an increase in its share to 12.4 percent from 9.4 percent in CY04; it signifies that consumer financing so far has remained insensitive to the interest rate hike. The flow of Rs77.3 billion to SMEs was a significant development keeping in view the importance of this segment for the economy and policy objectives of regulators.
- While the fast growth in loans invokes high credit risk, the banking system so far has coped with it effectively. This is evidenced by the persistent decline in non-performing loans (NPLs). Total gross NPLs declined by Rs22 billion; a decline of 13 percent. While the gross NPLs have declined in response to focused recovery drives as well as the efforts to cleanse

the balance sheet of chronic NPLs, higher provisions have also proved salutary to the fall in net NPLs, thus causing a marked decline in threat to the banks' capital. The falling NPLs have translated into improvement in the key asset quality indicators. NPLs to loans and net NPLs to net loans ratios improved to 8 percent and 2.1 percent respectively, which indicate far lesser threat to the system's soundness from the overhang of the past portfolio of NPLs.

- With the strong profits, declining overhang of NPLs and fresh capital injections, the solvency position of the banking system strengthened further. Capital Adequacy Ratio (CAR) increased to 11.3 percent from 10.5 percent in CY04. Not only CAR for the entire system improved, the individual position of banks also improved significantly. The number of banks with CAR over 10 percent increased to 30 from 24 in CY04 implying lower systemic threat to financial stability.
- Maintaining the strong growth momentum of the preceding years, deposits increased by Rs441 billion surpassing the growth of Rs430 billion in CY04. Resultantly, the system did not encounter any serious liquidity drain because of the continuing tight monetary policy stance of SBP to check high inflation rate. Thus, the banking system was able to finance high credit demand by the various sectors, which is expected to help the economy to get near the targeted GDP growth rate for the current fiscal year.
- Liquidity risk, nevertheless, is a source of growing concern. Apart from the tight monetary policy, the banks' classification strategies of their liquid assets portfolio also contributed to increasing the liquidity constraints. Loans to deposits ratio (net of ERF), an important liquidity indicator, also increased to 66.4 percent from 61.5 percent in CY04.
- Market risk, dominated mainly by interest rate risk, also depicted increasing concerns. While the upward movement of interest rates started to erode the value of banks' portfolio, especially those held in longer-term, the investment in capital markets garnered precious capital gains due to the rise in stock market index. The absence of any fresh issue of long-term paper gave rise to heightened uncertainty regarding the future movement of interest rates, and market displayed greater interest in short-term paper leading to significant rise in the banks' holding of MTBs.
- On the back of growing branch network and licensing of new Islamic banks, the Islamic banking operations also grew apace. By growing at a rate of 62 percent, the balance sheet footing of Islamic banks increased to Rs71.4 billion from Rs44.1 billion in CY04. Similarly, Microfinance banks also expanded their operations at a brisk pace of 49 percent implying growing outreach of financial services to the poorer sections of the society.
- The competition got further intensified as banks strived to expand their businesses. While the large six banks continued to dominate, their share in overall assets depicted further downward movement as medium-sized banks continued to expand their operations vigorously.
- On the regulatory front, SBP remained untiring in improving the risk management practices at banks. Apart from issuing a number of guidelines to strengthen risk management practices at banks, a clear-cut roadmap for the implementation of Basel-II was issued. Similarly, loans classification and provisioning criteria was amended to bring it in line with the international best practices. Special attention is being given to in-house capacity building to prepare its human and technological resources to meet the challenges of increasingly complex financial environment in the days ahead.
- Despite losing some momentum, the overall performance of corporate sector, which is the major user of banks' funds, remained satisfactory.

- The exposure of banks to the households increased at a fast pace carrying it to more than 12 percent of their total loans. As a percentage of GDP, it hovered around 4 percent; up from 3 percent in CY04. The low default rate remained the prominent feature of lending to households.

While the banking system has grown significantly in strength and has been able to consolidate its gains even further, and has also played a key role in shaping the economic activities, certain risks continue to pervade in the otherwise healthy financial environment. Of these risks, credit risk looms large on the back of fast expansion in loans during the past couple of years. The risk is heightened in view of persistence of inflation in higher bands despite the tight monetary policy stance of SBP. In fact, certain supply side forces continue to exert upward pressure on the already high inflation rate. The rising debt burden on banks' borrowers might potentially erode their repayment capacity if the inflation persists in higher zone and interest rates climb further.

In sharp focus is financing to consumers, SMEs and agriculture to which banks have developed significantly high exposures in recent times. So far the incremental default rate of these sectors has remained low in spite of the sharp rise in interest rates. Encouraged by this phenomenon and also by significantly high returns on such types of financing, banks are rallying to augment their exposures to these sectors even more enthusiastically. While these sectors still present plenty of scope and potential for further bank financing, the growing exposure draws attention to the need for enhancing the existing credit appraisal processes to ensure smooth flow of funds to these segments of the economy, with the simultaneous achievement of risk diversification. However, the over-indulgent banks with lax credit standards might soon find themselves in trouble. Particularly in case of consumer financing, the anecdotal evidence suggests one person availing credit facilities simultaneously from many banks and in the absence of proper database of the credit worthiness of consumers, the risk of losses would increase in case of any adverse shock. This perception appears to be confirmed by banks growing exposure per borrower in CY05. However, the enhanced scope of CIB would assist banks in establishing checks on such exposures.

While the potential losses in view of high credit risk cannot be ruled out, their impact might not be so severe to derail the banking system from its drive to financial strength. In a stark contrast to the past practices, the risk management systems within banks have improved significantly. The greater disclosure requirements and strengthened corporate governance structure have helped promote transparency, which is expected to prevent banks from committing serious mistakes. The strengthened Credit Information Bureau will allow access to the credit reports of all borrowers and hence banks will also be able to determine the credit worthiness of small borrower to ensure proper credit appraisal of retail loans.

Looking Forward

Going by the current trends and the future growth projections of the economy, the banking system is expected to maintain its growth momentum in the days ahead. Deposits are likely to grow further keeping in view the continuing inflow of workers' remittances and ongoing macroeconomic growth trend. Loans growth would also respond to the growth patterns of the major sectors of the economy, particularly to the absorption capacity of the corporate sector. The future movement of interest rates is also expected to wield considerable influence upon the loan growth. These factors would also weigh heavily in banks lending to consumers, SMEs and agriculture segments of the economy. The current trend suggests that banks are likely to further expand their exposures to consumers, SMEs, and agriculture segments keeping in view their developing skills in these sectors and the untapped potential which is still left to be exploited. The behaviour of loans default will depend upon the trend in interest rates as well as growth in incomes of the vital segments of the economy. The capital position of the banking system is bound to strengthen further as more and more banks will be enhancing their capital not only to meet the existing minimum capital requirement (MCR) but also the further enhanced MCR of Rs3 billion by the year end. Profitability will depend upon the volume of business, quality of portfolio and the continuity of the current level of high net interest margins (NIM).

A snapshot of the results for the first quarter of CY06 indicates that the banking system is firmly on course to further consolidate its achievements in CY06. Total profits for the first quarter of CY06 well exceed those in the corresponding period last year. The balance sheets of banks are continuing to expand on the back of growing deposits. Loan portfolio is also growing and threat from NPLs remains low. If the current trend persists and there are no adverse exogenous shocks, the banking system is expected to further strengthen its gains during CY06. The stress test results confirm higher resilience of banks to shocks of varying intensity.

The longer-term prospects rest on the future trend in the macroeconomic variables as well as the continuity of the reform process. Considering the interdependence of the banking system and the economy, the developing pressures in the form of higher current deficit, fiscal deficit and inflation have the potential to exercise adverse impact on the banking activities. However, if the economic managers succeed in restraining these negative tendencies, and the economy continues to perform well in the years to come, the banking system would reap benefits in the form of growing outreach and multiplying profits.

While the financial reforms over the last decade or so have delivered substantial benefits in terms of increasing financial stability, growing vibrancy in operations and rising penetration of financial services to a wider section of the society, it is nevertheless crucial to maintain the current momentum of reforms not only to protect the recent gains but also to build on. Given the gradual increase in capital in the wake of enhanced MCR, the banking system is expected to grow stronger in resilience to sustain adverse shocks. The higher capital requirement will not only increase the solvency position of the banking system, but will also encourage consolidation in the financial sector.

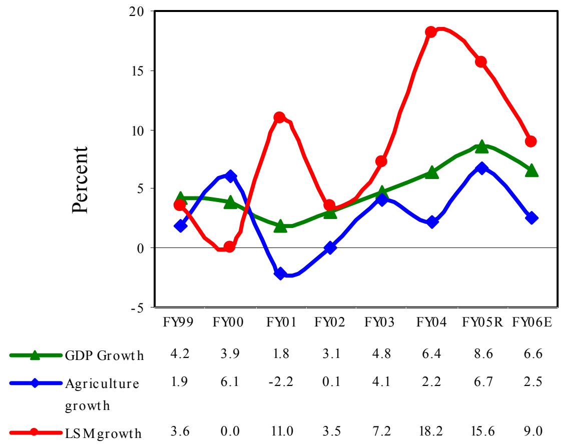
The spirit of competition has already taken a firm hold of the banking system and it is expected to intensify given the fact that about 80 percent of banking assets reside in the private sector. While the medium-sized banks are already engaged in expanding their share and offering attractive products at competitive prices, the recently privatized large banks are yet to unleash their full potential, and their future strategic positioning will play a significant role in shaping the financial activities in the coming days. Apart from the size factor in terms of capital, assets and geographical presence, the use of the state-of-the-art technology and product innovation will also decide the market share of different players in future. The growing competition should lead to greater product innovation, on both the assets and liabilities side, and extensive up-gradation of technology and improvement in work processes. In this context, implementation of Basel-II is a big challenge for the banking industry and smooth transition to the new capital regime will inevitably require banks to further strengthen their risk management systems and internal processes.

With the significantly improved financial soundness indicators, strengthening internal control systems and work processes, the banking system now is standing on a solid footing to further consolidate these gains in the days ahead. The regulatory measures are expected to supplement the prudent and professional policies of banks' managements to promote financial stability, and to enable the banking system to play a more dynamic and effective role in providing efficient financial services to larger segments of the economy. To secure the recent gains and address the emerging risks in the wake of increasingly complex financial environment, not only the regulators will have to continuously evolve the supervisory regime in line with the international best practices but banks will also need to adopt more integrated risk management systems to address the wide array of risks in a comprehensive manner. In the emerging scenario, only those banks are likely to occupy greater share of the market that have competitive advantage in terms of better corporate governance structure, advanced technology, skilled human resources, effective internal control processes, risk diversification, product innovation, and swift adaptability to the new realities.

2 Macroeconomic Environment

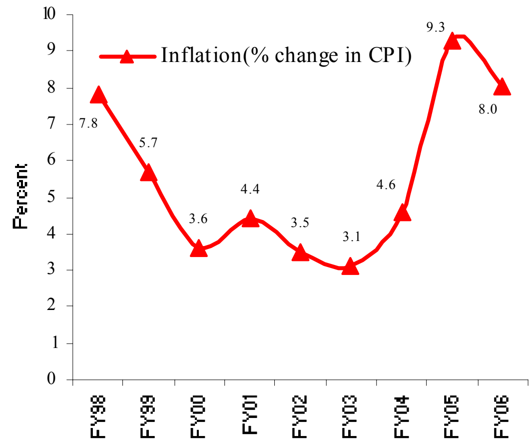
The positive trend in the key macroeconomic variables has been the linchpin of the robust performance of the banking system over the past couple of years. The extraordinary profits of the banking system rested heavily on the strong demand for bank credit, generated through rejuvenated industrial activities. The FY05, in particular, was a landmark in terms of GDP growth, which shot up to 8.6 percent, unprecedented for almost two decades. The strong GDP growth was aided by across-the-board healthy performance by the major sectors of the economy (see **Figure 2.1**).

Figure-2.1: Growth of Pakistan Economy



However, the performance of the key macroeconomic indicators during the current fiscal year remained below targets. The GDP growth declined to 6.6 percent largely because of decline in the growth of agriculture and Large Scale Manufacturing (LSM). Apart from the low agricultural yields, because of inadequate water availability for the *kharif* crops, and widening trade deficit, the developing capacity constraints in the manufacturing sector also contributed to the relatively low pace of growth. The apparent deceleration in economic activities, however, might not undermine the financial stability. Despite the relative slow down, the GDP growth is still quite healthy and does not appear to strain incomes of the vital sectors of the economy to which the banking system holds substantial exposure.

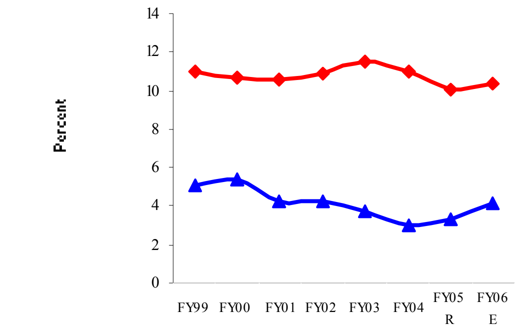
Figure-2.2 : Inflation (CPI)



With its potential fallouts for the financial system and the overall economy, the higher inflation in recent times has been a cause of serious concern for policymakers. Driven by sharp increases in commodity prices caused by lax governance, which allowed big business to manipulate prices, strong aggregate demand spurred by fast credit growth and high oil prices, average inflation peaked to 9.3 percent in FY05. However recently, it has witnessed a downward trend as SBP resorted to a more tight monetary policy stance and the government took a number of remedial measures to boost supply of essential items to bring down their prices. Consequently, average inflation has fallen to 8.0 percent during July-May 2006 (see **Figure 2.2**). On point-to-point basis, however, rate of inflation has shown more rapid decline to 7.1 percent in May 2006 from 11.1 percent in FY05.

While the developments during the first eleven months of the FY06 indicate relatively lower inflationary pressures vis-à-vis the position in the corresponding period of the previous year, their sustainability hinges a great deal upon the future trend in global oil prices and supply of essential commodities. Recently, the global oil prices have again shown a sharp spurt, and given the continued face-off between Iran and the USA, there are apprehensions of further rise in oil prices. This might seriously undermine the efforts to check inflation. While the government and regulators are helpless against these exogenous shocks, they can nevertheless influence the behaviour of variables under their domain. Not only SBP will have to carefully manage the money supply conditions but the government will also have to supplement SBP's efforts by ensuring adequate supply of essential food items through effective and timely administrative measures.

Figure-2.3 : Fiscal Performance



	FY99	FY00	FY01	FY02	FY03	FY04	FY05 R	FY06 E
Budget Deficit to GDP	5.1	5.4	4.3	4.3	3.7	3.0	3.3	4.2
Tax Revenue to GDP	11.0	10.7	10.6	10.9	11.5	11	10.0	10.4

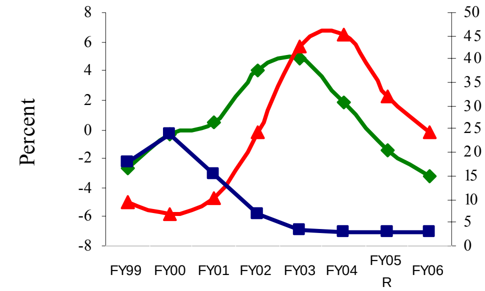
One of the factors, which added to inflationary pressures, was Government borrowings from the central bank**.** The measures to contain inflation will also require improvement in fiscal conditions, which, after witnessing persistent improvement for the past many years, appear to be coming under stress. This is reflected by the rising ratio of budget deficit to GDP (see **Figure 2.3**). Despite the substantial increase in tax revenues, the rising fiscal deficit owes largely to higher expenditures, both current and developmental. While the development expenditure is inevitable to raise necessary infrastructure to achieve sustainable economic growth, the growing fiscal deficit might not be favorable keeping in view the high inflation and negative repercussions of high borrowings from the banking system. This not only requires containment of current expenditures but also substantial increase in the tax base. Tax to GDP ratio at 10.4 percent is very low by international standards, and the Government should strive to improve it substantially to meet its ever-growing developmental needs.

Presently, the industrial sector appears to be carrying the major burden of taxes, which is quite disproportionate to its share in GDP. The Government will have to increase the tax base by capturing the non-taxed or low taxed sectors to enhance its revenue to contain the fiscal deficit, which is estimated to reach 4.5 percent of GDP by the year end. In this respect, services and agriculture sectors offer substantial potential. Government will have to undertake drastic measures to mobilize sufficient funds in the coming days to meet the ever-growing infrastructure needs and impending increase in foreign debt servicing.

Yet another cause of concern is the position on external front. On the back of sharp rise in imports, both in terms of value and volume, trade deficit has deteriorated at a very fast pace. Though exports have also risen quite significantly in the same period, their pace has been substantially lower if compared with imports. The current scenario suggests deterioration in current account deficit to 3.2 percent of GDP, which is high if compared with the target of 2.1 percent for the FY06 (see **Figure 2.4**).

The large current account deficit, at least in the short-term, might not be threatening from the financial stability point of view, as the country is enjoying quite substantial level of foreign exchange reserves to meet its import requirements and foreign debt liabilities[1]. The exchange rate has also remained fairly stable as the strong reserves position enabled SBP to prevent volatility in the exchange rate by frequent intervention in the foreign exchange market. Thus, the currency risk so far has remained contained to a great extent. Moreover, the large volume of imports is also believed to comprise capital goods, which should help the industry to expand its productive capacities to produce substantial exportable surplus in the days ahead. It nevertheless is very crucial for the economic managers to evolve a strategy, which might help in reducing the current account deficit because the current reserves might not be sufficient to sustain this high level of deficit for a longer period.

Figure-2.4 : External Position*



	FY99	FY00	FY01	FY02	FY03	FY04	FY05 R	FY06
CA Bal. to GDP	-2.6	-0.3	0.5	4.0	4.9	1.9	-1.4	-3.2
# of Wks Import Cover (RHS)	9.6	6.8	10.1	24.2	42.8	45.2	31.9	24.2
Foreign Debt to Reserves, Times (RHS)	18.1	23.9	15.5	7.0	3.3	3	3.2	2.8

[1] The most recent information.

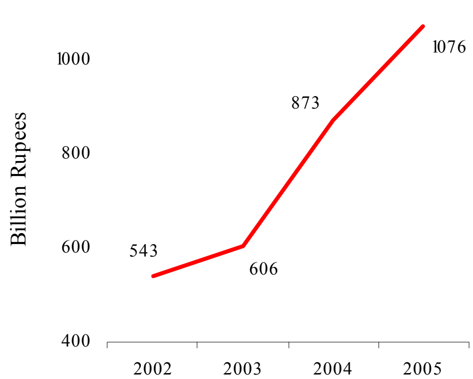
3 Corporate Sector

The corporate sector is the leading user of banking system's lending portfolio. This sector holds more than half of the banks' overall loans and has special significance for the stability of the banking system. The sector has been showing significant upturn in its performance for the past couple of years. The year under review witnessed further improvement in the sector's performance though the year also witnessed some developing pressures.

Enhanced capacity utilization on the back of increased domestic as well as strong foreign demand coupled with improved operational efficiencies in the sector yielded robust profits leading to substantial growth in equity base. Since the growth in debt was slower, the leverage position of the sector improved further to the lowest levels observed over the past few years, while strong profits and cash flow streams reflecting in improved debt servicing indicators allay the risk of loan losses.

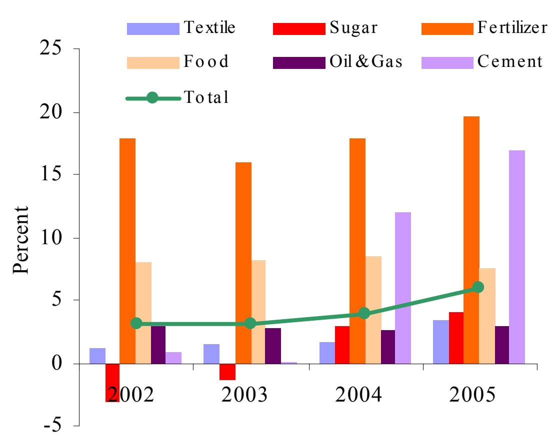
Strong built up in economic activity that has been prevalent in the economy for the last couple of years continued during the year under review as well. However, this year also witnessed a number of impeding factors. There was significant increase in POL prices exerting pressures on cost of production, a gradual tightening of monetary policy pushing up the cost of bank borrowings, and a general slack down in major economies across the globe. Nonetheless, companies in a couple of sub-sectors continued to invest heavily to expand and improve their capacities that significantly expanded the profile of the sector. Particularly, textile and automobile sector received substantial amounts in BMR and capacity expansion. Though the corporations continued to meet their additional fund requirements from their own sources, a substantial part of these additional outlays were financed through bank borrowings, increasing the banking system's total lending to the corporate sector by 23 percent to Rs1,076 billion (see **Figure 3.1**).

Fig-3.1: Growth in Corporate Financing



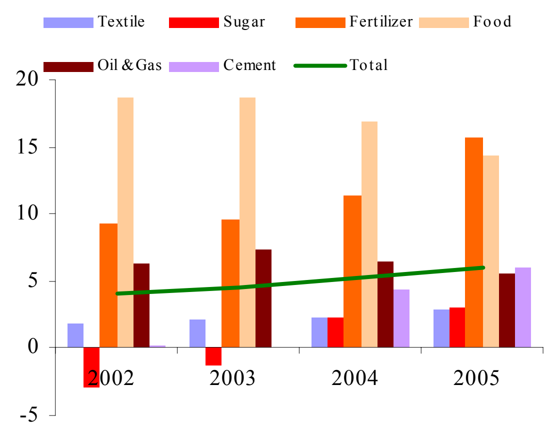
The sector has been investing heavily for expanding production capacities as well as improving operational efficiencies to meet the increasing competition of globalization. This capacity built up has started to translate more markedly in the improved profit margins (see **Figure 3.2**).

Figure-3.2: Net Profits to Sales



These expanded and improved production capacities coupled with strong demand both at home and abroad led to strong profits for the corporate sector. However, the growth was not even for all sectors. Resultantly, the improvement in ROA was not across the board (see **Figure 3.3**).

Figure-3.3: Return on Assets



While these strong profits have added to the financial surpluses of the sector, these have also encouraged more investments to realize the emerging potentials in the coming years. The firms have largely financed these outlays through fresh injection of own funds or plough back of profits. Resultantly, the sector's financial leverage (total assets to net worth) has further come down during the year showing a gradual decline in the encumbrance of the sector (see **Figure 3.4**). The effect of increased support of owners' funds is even more pronounced in financing the long term fund requirements; the debt to equity ratio (long term debt to equity plus long term debt) shows a significant decline, indicating an improved solvency position of the sector (see **Figure 3.5**).

Figure-3.4: Financial Leverage of Corporate Sector

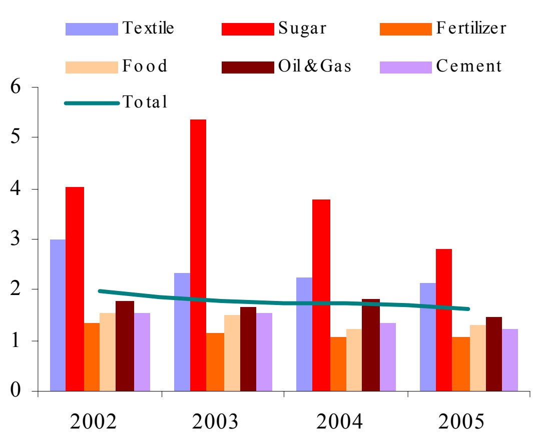
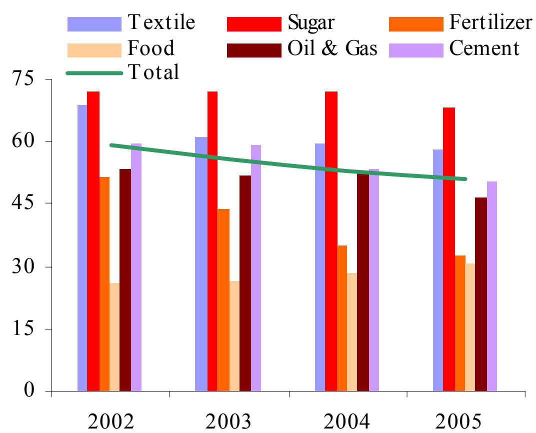


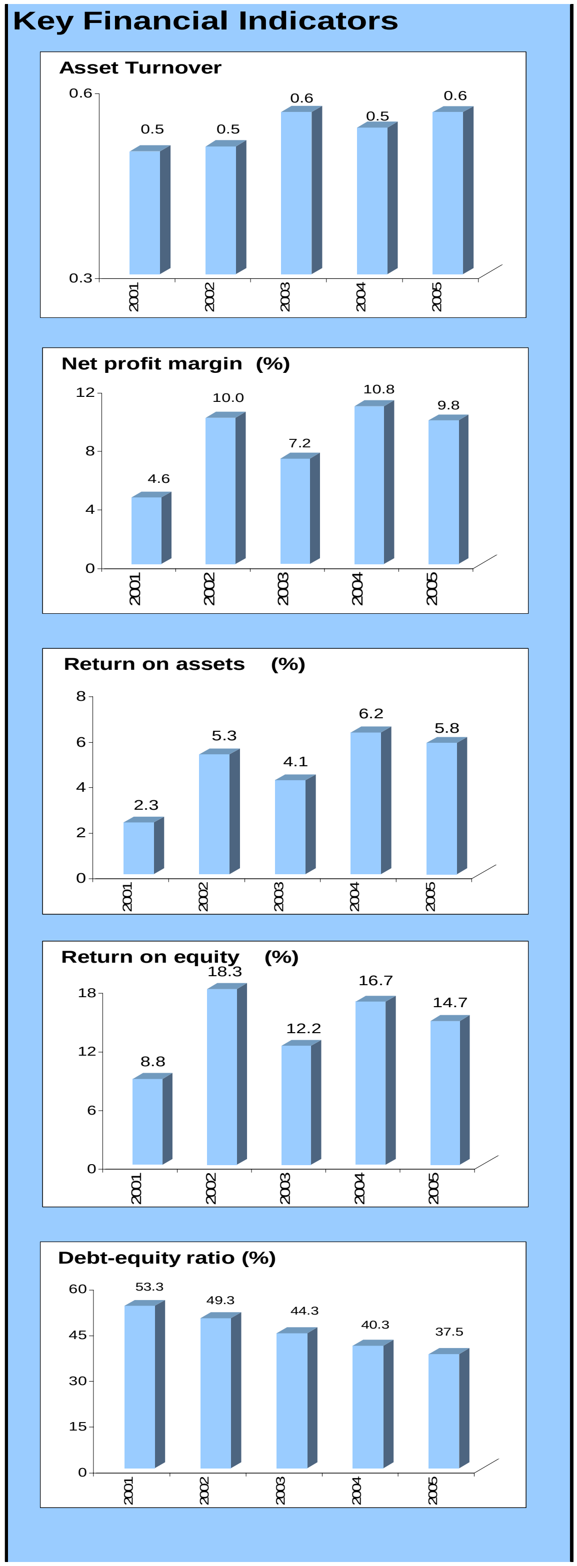
Figure-3.5: Debt to Equity ratio



The corporate sector, especially the large scale manufacturing, has shown high responsiveness to the favourable upturn in the economic conditions and pro-growth policy initiatives. Over the past couple of years the sector has shown strong performance and has substantially supported the patterns of high economic growth in the economy. Further, its role of boosting the economic activity, through its backward linkages with the small and medium enterprises has been even more instrumental in the overall economic development of the country.

3.1 Performance of Top 20 Borrowing Groups

A focused study of top 20 borrowing groups has been carried out to more precisely assess the vulnerabilities of the banking system towards large exposures to the corporate sector. The study covers 85 companies in textile, sugar, cement, power generation, fertilizers, and communication sector. These 20 groups are holding 10.8 percent of the all banks' and DFIs' funded exposure and show satisfactory debt servicing capacity with a delinquency (over due by more than 90 days) rate of 0.8 percent. During the year under review these groups further improved their financial position.

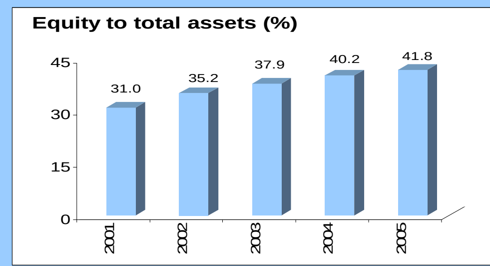


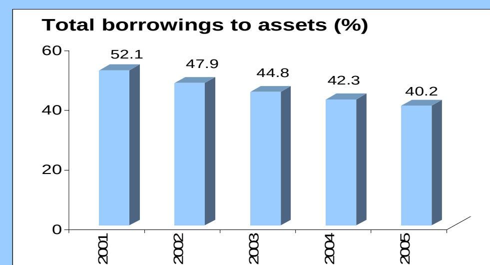
Strong demand both at home and abroad, for textiles supported by bumper cotton crop and favourable policy regime, vibrancy in the construction activities, and high intakes of fertilizers were the major factors that led to the expansion in the profiles of these 20 groups. Their consolidated asset base grew by 9.2 percent over the year and showed significant consolidation in terms of equity support that was largely contributed by large profits.

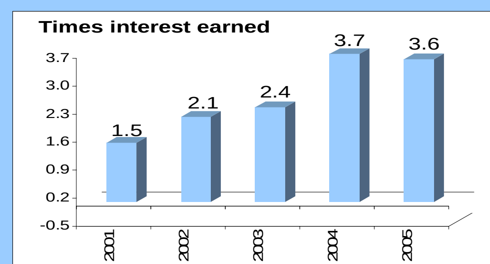
Total sales revenues of these groups increased by 14.3 percent over the last year, due partly to increase in volume and partly to increase in prices, and asset turnover ratio improved to 0.6 times. However, there was increase in pressure from cost of inputs as the cost of goods sold grew at slightly higher pace and contracted the gross margin by 20 basis points to 24.1 percent. Though the dependence on borrowings remained more or less stable, a general increase in rate of interests led to 19.6 percent increase in financial charges that consumed 5.3 percent of sales revenues. The groups, however, contained their operating expenses, while the tax charge increased. Cumulative effect of these factors led to a decline in net margin, while after tax profit increased by 3.9 percent over the last year's unprecedented levels. Since the growth in asset and equity base was much stronger, ROA and ROE registered slight decline over the last year, but stayed in comfortable range of 5.8 and 14.7 percent, respectively.

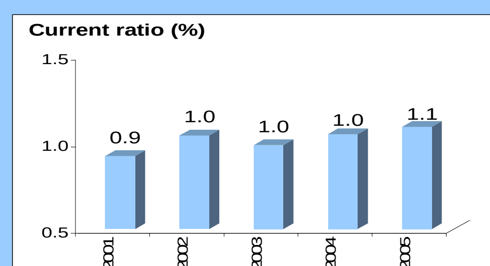
Financial leverage of the top 20 borrowing groups has been showing remarkable and consistent improvement. The groups have been gradually reducing their dependence on borrowed funds. This has been realized on the back of strong profits in recent years that have been largely retained to finance the business growth and capacity enhancement. This trend even persisted in the last couple of years when the interest rates were at historical lows, indicating a prudential change in their preference towards owners' funds for financing long term as well as working capital requirements. During the year under review debt equity ratio further reduced to 37.5:62.5 from 40.3:59.7 and overall support of owners' equity towards total assets increased to 41.8 percent from 40.2 percent in 2004. This reduced dependence on borrowed funds coupled with strong growth in profits has brought about significant improvement in the debt servicing capacity of these groups as the interest coverage ratio (EBIT/Interest Charges) stands at comfortable level of 3.6 times which is though slightly lower than last year's coverage (3.7 times). This decline mainly comes from increase in interest charges due to increase in general interest rate levels.

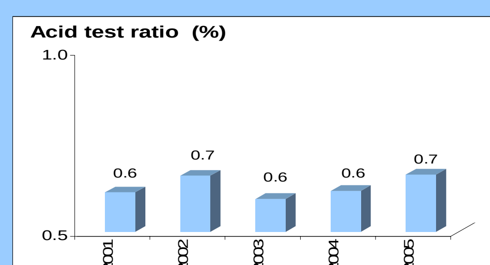
Liquidity position of the top twenty borrowing groups (gauged in terms of current ratio and acid test ratio) also improved over the year. The consolidated current ratio (1.1:1) and acid test ratio (0.7:1) show improvement over the last year. However these ratios and their adequacy standards vary from company to company depending upon the nature of their business.











4 Household Sector

On the back of higher gains and low default rate, the banking system continued to augment its exposure to households[2] during CY05. This was helped by adequate availability of funds, as well as developing familiarity of banks with the risk-profile of this vital segment of the economy. Notwithstanding the hitherto low default rate; the rising cost of loans to households carries higher degree of credit risk in case some unanticipated setback results in erosion of household income.

With a growth of around Rs100 billion during CY05, the overall household debt[3] reached to Rs253 billion from Rs153 billion in CY04, depicting a growth of 65 percent in CY05 as compared to 133 percent in CY04. Consequently, the share of household sector finance in total bank loans also increased significantly **(**see **Figures 4.1 & 4.2)**.

On the demand side, continued utilization of household financing is the manifestation of the positive trend in income levels of households, which continues to push demand for these loans. On the supply side, there have been several factors which have contributed to an incredible upsurge of household financing products which include reduction in the qualification benchmarks for premium products, investing prodigiously on advertising and sales promotion efforts, providing longer tenures and easy repayment options for different household sector products along with many other inducements and above all banks' success in creating awareness about their product menu in an orderly manner.

In more advanced economies, household sector plays a vital role in shaping activities of the real economy, and hence its high indebtedness holds special significance for the soundness of their financial system. However, in our case, household debt to GDP ratio, despite a very healthy growth

Figure-4.1: Share in total outstanding advances CY2005

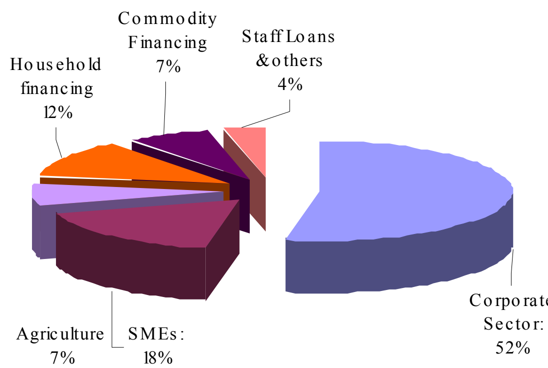


Figure-4.2: Share in total outstanding advances CY2004

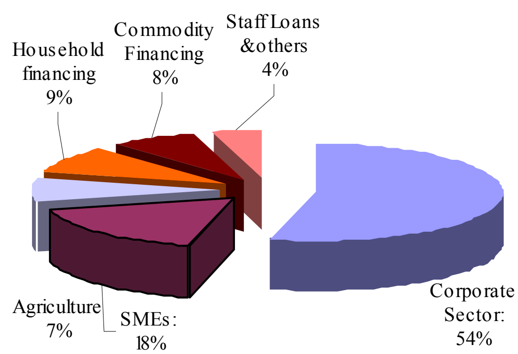
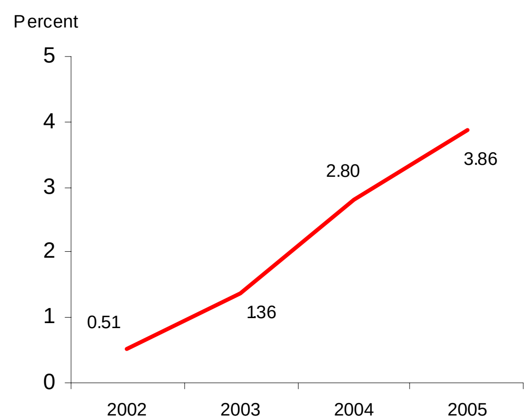


Figure-4.3: Household Debt to GDP ratio

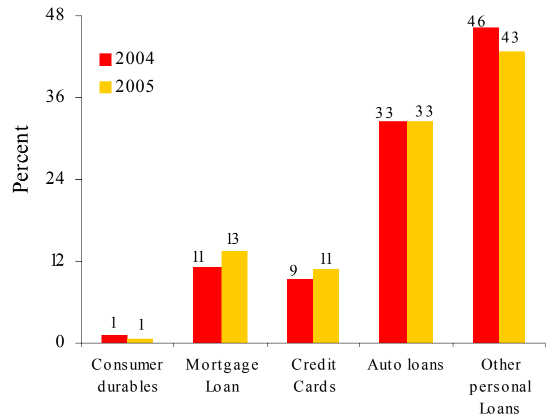


[2] Individuals
[3] Consumer debt from banks only

during CY05, remains in a very low zone and presents a plenty of scope for further rise (see **Figure 4.3**).

A comparative analysis of household financing portfolio for CY04 and CY05 reveals unprecedented growth in mortgage loans (103 percent) and credit cards loans (92 percent). While the share of personal loans receded due to faster growth in mortgage loans and credits cards, they still hold the largest share followed by auto loans (see **Figure 4.4**).

Figure-4.4: Share in Household Financing



Though the mortgage loans stand a distant third with only 13 percent share in overall household sector financing, still a surge in the demand for mortgage loans is expected in the near future. There are several factors which can contribute towards it, which include 1) the demand for housing finance in the country is enormous and there is a huge backlog of housing units. 2) the outreach of financial services to the underserved segments of population is yet to increase. 3) restrictions on commercial banks to lend for housing and other consumer durables have been minimized. The upper limits on mortgage loans have been raised and foreclosure laws have been revised so that banks can repossess properties without recourse to courts; this has renewed the confidence of banks.

Table-4.1: NPLs and Outstanding Loans & advances in Household sector

(Rs In Billions)

	Amount Outstanding	NPLs	NPLs to loans (%)
Credit Cards	27.2	0.2	0.8
Auto Loans	82.1	0.7	0.9
Consumer Durable	1.7	0.1	7.8
Mortgage Loan	34.2	0.2	0.6
Other	108.0	1.8	1.7
Overall Consumer Finance	252.8	3.1	1.2

While the fast growth in household financing is a welcome sign as it enables the individual segments of the economy to take advantage of the bank financing to improve their life styles, the higher indebtedness nevertheless carries important implications for the future outlook of the banking industry of the country due to the risks inherent in this type of financing. So far, the incidence of NPLs has remained low in consumer financing, even when debt repayment capacity of borrowers was feared to erode on account of soaring inflation and rising interest rates. Total NPLs against consumer financing increased to Rs3.1 billion from Rs1.4 billion in CY04. However, as a percentage of their respective shares in consumer financing, the overall position, excluding the category of 'consumer durables', portrays satisfactory state of affairs (see **Table 4.1**).

Disaggregated analysis of NPLs reveals that these small sized NPLs contained in consumer durable category are emanating from only a small number of banks primarily due to relatively lax credit appraisal and monitoring standards.

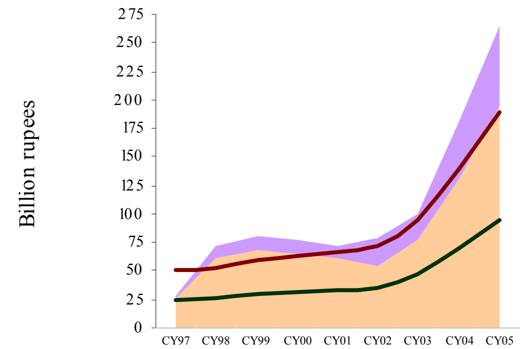
By most standards, the performance of household sector financing has been very encouraging over the past couple of years. The growing penetration of banks into this segment has not only yielded rich dividends for banks but has also delivered considerable benefits to the economy in general and the households in particular. The households have been able to get access to the goods and luxuries, which they could not otherwise afford to purchase on cash. The greater demand for different products has simultaneously helped in promoting industrial growth, thus playing a vital role in higher GDP growth. However, mindful of current developments, such as surge in domestic as well as imported component of inflation with a potential to affect adversely the domestic consumer markets, the default rate, which so far has remained very low, might go up. Such a scenario might dampen the banks' interest in household lending. In the mean time, banks need to assume a well guarded stance on household sector financing as its future outlook will largely depend on robust credit appraisal techniques, proper monitoring of loan utility, efficient guarantee verification and over all up gradation of service capability. The establishment of CIB would also help banks further strengthen their credit appraisal standards for consumer financing by discouraging multiple loans to a single borrower.

5 Financial Soundness of the Banking System

5.1 Solvency

On the back of healthy profits and heavy capital injections, the solvency position of the banking system improved markedly during CY05. While the banking system piled up huge profits because of expanding operations, heavy capital injections responded to the enhanced minimum capital requirement by SBP[4]. This had a very salutary impact on the key solvency indicators implying increasing soundness and resilience of the banking system.

Figure-5.1.1: Risk-based Capital Position



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
Supplementary Capital	2.9	11.8	12.1	11.3	12.0	23.5	23.3	50.8	69.7
Core Capital	25.4	60.7	67.8	65.1	60.5	55.2	77.0	131.7	195.3
Required Core	25.0	26.7	29.5	31.5	33.1	35.9	47.3	69.6	94.2
Required Total	50.0	53.4	58.9	63.1	66.2	71.8	94.7	139.3	188.3

Recent years have seen gradual strengthening of the qualifying risk-based capital. During CY05, it increased to Rs265.0 billion, showing an impressive growth of 45.2 percent (see **Figure 5.1.1**). The encouraging aspect of the persistent growth in risk-based capital is that the share of core capital has expanded very fast. During the last three years, core capital has been growing at a rate of more than 40 percent. Consequently, the core capital alone is large enough to meet the overall required risk-based capital. The contribution by supplementary capital has also been worthwhile; however, its pace of growth was considerably lower if compared with growth in core capital. Resultantly, the share of supplementary capital in overall qualifying capital has reduced to 26.3 percent from 27.8 percent in CY04.

Table-5.1.1: Capital Adequacy Indicators

Percent	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
CAR									
PSCBs	(1.3)	11.6	10.6	10.4	9.6	12.3	11.0	13.4	14.5
LPBs	11.9	11.4	10.7	9.2	9.5	9.7	9.0	10.1	10.6
FBs	14.6	15.6	18.6	18.0	18.6	23.2	23.0	17.4	16.4
CBs	6.0	12.5	12.2	11.4	11.3	12.6	11.1	11.4	11.9
SBs	(6.2)	(1.4)	0.3	(3.3)	(13.9)	(31.7)	(28.2)	(9.0)	(7.7)
All banks	4.5	10.9	10.9	9.7	8.8	8.8	8.5	10.5	11.3
Tier 1 Capital to RWA									
PSCBs	(2.0)	8.3	7.7	7.7	7.1	8.6	8.2	8.6	8.8
LPBs	11.4	10.2	9.3	8.1	8.4	6.6	7.0	7.5	8.3
FBs	14.4	15.4	18.4	17.9	18.6	23.0	23.0	17.1	16.1
CBs	5.5	10.5	10.3	9.8	9.7	9.7	9.1	8.6	9.1
SBs	(6.3)	(1.6)	0.3	(3.4)	(13.9)	(31.7)	(28.7)	(15.0)	(13.6)
All banks	4.1	9.1	9.2	8.3	7.3	6.2	6.5	7.6	8.3
Capital to Total Assets									
PSCBs	0.3	4.9	3.7	4.6	3.7	5.6	6.1	8.7	12.6
LPBs	4.9	4.9	4.9	3.5	3.8	5.2	5.3	6.5	7.0
FBs	7.9	8.8	9.7	8.8	8.5	10.6	9.9	8.9	9.5
CBs	3.1	5.6	5.0	4.9	4.6	6.1	6.1	7.2	8.4
SBs	8.8	0.2	1.7	(1.1)	(10.3)	(23.0)	(10.0)	(9.4)	(8.1)
All banks	3.5	5.3	4.8	4.5	3.8	4.8	5.5	6.7	7.9
Capital (free of net NPLs) to Total Assets									
PSCBs	(6.8)	(1.1)	(4.1)	(1.1)	(2.2)	0.9	3.1	7.3	11.9
LPBs	2.8	2.4	(0.2)	(1.9)	(1.0)	2.4	3.2	4.9	6.1
FBs	7.1	8.2	8.7	8.0	8.0	10.1	9.6	9.0	9.8
CBs	(1.4)	1.6	(0.9)	0.2	(0.0)	2.8	3.9	5.9	7.6
SBs	(24.6)	(17.1)	(23.9)	(25.5)	(34.4)	(44.5)	(30.9)	(27.2)	(21.1)
All banks	(2.9)	0.4	(2.4)	(1.4)	(1.9)	0.7	2.5	4.7	6.7

The gradual fortification of the capital base is also apparent by persistent improvement in the capital adequacy ratio of the banking system (see **Table 5.1.1**). It increased to 11.3 percent from 10.5 percent in CY04. The core capital to RWAs ratio also improved to 8.3 percent from 7.6 percent in CY04. Both these ratios comfortably satisfy the generally acceptable benchmarks for well-capitalized banks[5]. The growth in these ratios might have been higher but for the fast growth in RWAs. The rapid expansion in the loan portfolio of the banking system in recent years has resulted into simultaneous growth in the RWAs of the banking system. This is visible by increase in RWAs to total assets ratio to 64.3 percent from 57.2 percent in CY04 (see **Figure 5.1.2**).

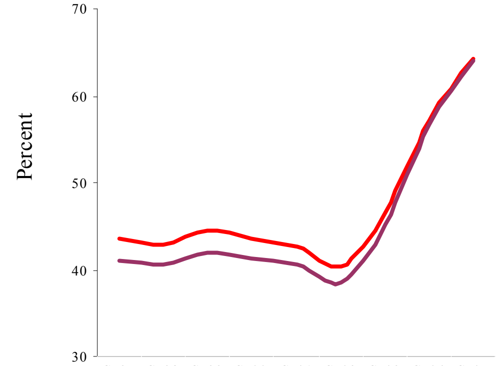
[4] The banks were required to raise their Paid-up capital free of losses to Rs2.0 billion by the end of December 2005. Till 2009, they are required to raise it to Rs6 billion in a phased manner.

[5] For a well-capitalized bank the capital adequacy ratio should be above 10%, tier 1 to capital to RWA ratio and capital to total assets ratios should be above 5%.

Consequently, the effect of rapid expansion in capital appears less visible on the CAR on account of fast increase in RWAs.

Yet another solvency indicator is the ratio of capital to total assets. It also improved to 7.9 percent from 6.7 percent in CY04. The ratio is not only well above the generally accepted benchmark of 5 percent, but also indicates declining leverage. Moreover, the capital coverage ratio, which measures the capacity of the capital to absorb the maximum possible loss from uncovered portion of NPLs, shows the consistently improving trend. In addition to the strengthening capital, the declining burden of NPLs is also responsible for this improvement.

Figure-5.1.2: RWA to Total Assets

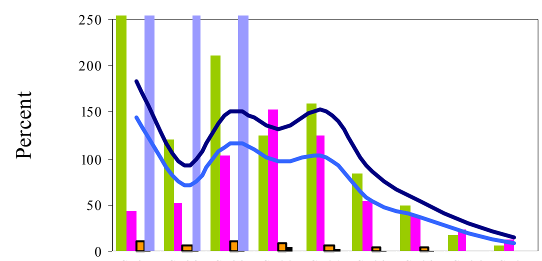


	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
All Banks	43.5	42.9	44.5	43.6	42.6	40.3	46.5	57.2	64.3
Comm. Banks	41.1	40.6	41.9	41.2	40.5	38.6	45.2	56.6	64.1

The declining threat from asset quality is also evident by the gradual fall in net NPLs to capital ratio (see **Figure 5.1.3**). Consistently improving loan appraisal standards and consequent low fresh infection has resulted in reducing the quantum of NPLs. This reduction coupled with sharp build-up in capital during CY05 brought about marked decline in capital impairment ratio to 14.3 percent from 29.2 percent in CY 04, which signify the reducing threat to capital from uncovered portion of NPLs

The group-wise position shows that the PSCBs performed well on all key solvency indicators, followed by LPBs. In contrast to the improving ratios for PSCBs and LPBs, the ratios for FBs depict somewhat mixed trend. For FBs, the key capital ratios have declined consistently over the past few years, and they followed the same trend in CY05. However, this corresponds to expansion in their loan portfolio. Moreover, the ratios for FBs are still the highest among all groups, thereby, do not show any significant solvency concern as they still hold sufficient cushion to absorb any adverse shock or sustain expansion in their loans. These ratios for SBs also deteriorated due to losses sustained by one of them.

Figure-5.1.3: Net NPLs to Capital



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	2,081.	119.9	212.0	124.5	160.2	83.4	50.0	16.2	5.5
LPBs	43.3	51.4	103.5	153.5	125.2	54.8	39.1	24.3	13.0
FBs	10.0	7.1	9.9	9.0	5.8	4.7	3.3	(0.2)	-3.0
SBs	380.0	11,139.	1,502.	-	-	-	-	-	-
CBs	143.6	72.1	117.4	96.7	100.7	54.2	36.9	19.0	9.0
All Banks	183.8	92.6	149.8	131.3	150.5	85.5	54.4	29.2	14.3

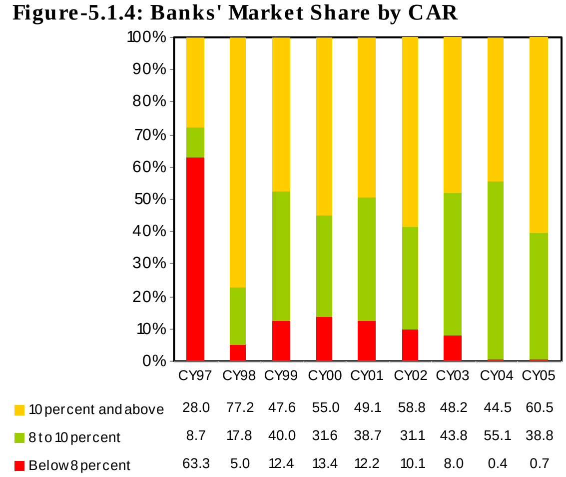
The top five banks, holding more than 50 percent of the overall banking assets, hold systemic importance as far as the behavior of solvency indicators is concerned. Their solvency indicators have also improved during the period under review. The overall risk based capital to RWA, core capital to RWA ratios and balance sheet capital to total assets ratios improved to 11.37 percent, 7.80 percent and 8.4 percent from 10.9 percent, 7.3 percent and 7.3 percent respectively.

The disaggregated analysis of banks reveals that most of the banks have improved their CAR (see **Table 5.1.2).** The number of undercapitalized banks increased from 1 to 2, but still their market share remained less than 1 percent (see **Figure 5.1.4)**. At the same time, number of well-capitalized banks increased to 30 from 24, and consequently their market share also increased to 60.5 percent from 44.5 percent in CY04. As regards the compliance of minimum capital requirement of 2 billion, 12 banks were non-compliant out of 39 banks. However, by the end of May-06 the number has reduced to 8 and majority of remaining non-compliant banks are expected to meet the MCR by the end June 2006 through issuance of bonus or right shares or through the process of mergers with other institutions.

Table-5.1.2: Distribution of Banks by CAR

Nos.	Total	Below 8%	8 to 10 %	10 to 15 %	Over 15 %
CY97	46	7	5	12	22
CY98	46	2	4	17	23
CY99	44	3	6	16	19
CY00	44	5	6	16	17
CY01	43	5	5	11	22
CY02	40	4	4	9	23
CY03	40	4	10	5	21
CY04	38	1	13	9	15
CY05	39	2	7	13	17

Figure-5.1.4: Banks' Market Share by CAR



The above analysis amply indicates that the solvency of the banking system has improved significantly over the past couple of years. The trend is expected to continue in future, as banks will raise their capital in a phased manner to meet the enhanced MCR. This bodes well for the solvency and ultimately the financial stability of the system, as its resilience to sustain shocks will be further fortified. The stress results vindicate this perception, as shocks of varying degrees do not appear to cause any substantial decline in CAR of banks (see **Chapter 18**). However, to ensure smooth functioning and maintain the positive trend, banks will have to be vigilant about the quality of their loans and hence the need for proper credit appraisal and monitoring standards cannot be over-emphasized. The recent years have shown growing maturity of banks in the various areas of risk-management. This is reflected by the consistent improvement in credit ratings of banks for both the short term and long term (see **Box 5.1**).

CREDIT RATINGS OF BANKS / DFIs UPDATED AS OF 15-05-2006

Sr. No.	Name of Bank / DFI	Rating Agency	Previous Credit Rating			Latest Credit Rating		
			Short Term	Long Term	Date of Rating	Short Term	Long Term	Date of Rating
NATIONALIZED BANKS								
1	First Women Bank Limited.	PACRA	A2	BBB	Aug, 2002	A2	BBB+	Aug, 2003
2	National Bank of Pakistan	JCR-VIS	A-1+	AAA	May, 2004	A-1+	AAA	June, 2005
PRIVATIZED BANKS								
3	Allied Bank Limited	JCR-VIS	A-1	A	Dec, 2004	A-1+	A+	Nov, 2005
4	Habib Bank Limited	JCR-VIS	A-1+	A+	April, 2004	A-1+	AA	June, 2005
5	MCB Bank Limited	PACRA	A1+	AA	June, 2005	A1+	AA+	May, 2006
6	United Bank Limited	JCR-VIS	A-1+	A+	June, 2004	A-1+	AA	June, 2005
PROVINCIAL BANKS								
7	The Bank of Khyber	JCR-VIS	A-2	BBB	June, 2004	A-2	BBB	July, 2005
8	The Bank of Punjab	PACRA	A1	A+	June, 2004	A1+	AA-	June, 2005
PRIVATE BANKS								
9	Askari Commercial Bank Limited	PACRA	A1+	AA+	June, 2004	A1+	AA+	June, 2005
10	Bank Alfalah Limited	PACRA	A1+	AA-	June,2004	A1+	AA	June, 2005
11	Bank Al-Habib Limited	PACRA	A1+	AA	June, 2004	A1+	AA	June, 2005
12	Mybank Limited	JCR-VIS	A-3	BB+	June, 2004	A-2	BBB	Feb, 2005
13	CresBank	JCR-VIS	A-2	BBB+	June, 2004	A-2	BBB+	June, 2005
14	Faysal Bank Limited	JCR-VIS	A -1	AA	July, 2005	A -1+	AA	Feb, 2006
15	KASB Bank Ltd.	JCR-VIS*, PACRA	A2	BBB+	April, 2004	A2	BBB+	June, 2005
16	Metropolitan Bank Limited	PACRA	A1+	AA+	June, 2004	A1+	AA+	June, 2005
17	Meezan Bank Limited	JCR-VIS	A-1+	A+	June, 2004	A-1	A+	June, 2005
18	NIB (NDLC-IFIC Bank) Ltd.	PACRA	A2	A-	July, 2004	A1	A+	July, 2005
19	PICIC Commercial Bank Limited	JCR-VIS	A-1	A	June, 2004	A-1	A+	June, 2005
20	Prime Commercial Bank Limited	PACRA	A1	A	June, 2004	A1	A+	June, 2005
21	Saudi Pak Commercial Bank Ltd.	PACRA, JCR-VIS	A3	BBB	June, 2005	A-2	A	Feb, 2006
22	SME Bank Ltd.	JCR-VIS	A-3	BB+	June, 2004	A-2	BBB	March,2005
23	Soneri Bank Limited	PACRA	A1+	AA-	June,2004	A1+	AA-	March,2005
24	Union Bank Limited	PACRA,	A1	A+	June, 2004	A1+	AA-	June, 2005
FOREIGN BANKS								
25	ABN-AMRO Bank	Standard & Poor's	A-1+	AA-	April, 2005	A-1+	AA-	April, 2006
		Moody's	P-1	Aa3		P-1	Aa3	
		Fitch-IBCA	F1+	AA-		F1+	AA-	
26	Al-Baraka Islamic Bank	PACRA, JCR-VIS**	A1	A-	June, 2004	A-1	A	March, 2005
27	American Express Bank	Standard & Poor's	N/A	N/A	June, 2003	A-1	A+	June, 2004
		Moody's	P1	A2		P-1	A2	
		Fitch-IBCA	F1	A-		F-1	A+	
28	Bank of Tokyo-Mitsubishi Limited	Standard & Poor's	A-2	A-	June, 2004	A-1	A	June, 2005
		Moody's	P-1	A2		P1	A1	
		Fitch IBCA	F1	A-		F1	A-	
29	Citibank N.A.	Standard & Poor's	A-1+	AA	April, 2004	A-1+	AA	Sep, 2005
		Moody's	P-1	Aa1		P-1	Aa1	
		Fitch IBCA	F1+	AA+		F1+	AA+	
30	Deutsche Bank AG	Standard & Poor's	A-1+	AA-	March, 2005	A-1+	AA-	Dec, 2005
		Moody's	nil	nil		nil	nil	
31	Habib Bank AG Zurich	JCR-VIS	A-1+	AA+	June, 2004	A-1+	AA+	June, 2005
32	Hong-Kong Shanghai Banking Corp. (Non HK$)	Standard & Poor's	nil	A+	March, 2004	nil	nil	August, 2005
		Moody's	A1	Aa3		P-1	A1	
		Fitch-IBCA	nil	AA-		nil	nil	
33	Oman International Bank	JCR-VIS	A-2	BBB	June, 2004	A-2	BBB	June, 2005
34	Standard Chartered	Standard & Poor's	A-1	A	July, 2003	A-1	A	July, 2004
		Moody's	P-1	A2		P-1	A2	
		Fitch-IBCA	F1	A+		F1	A+	
SPECIALISED BANKS								
35	Punjab Provincial Cooperative Bank	JCR-VIS	A-3	BB+	Feb, 2004	A-3	BB+	January, 2005
36	Zarai Taraqiati Bank Ltd.	PACRA	A-1+	AAA	April, 2004	A2	BBB+	April, 2005
		JCR-VIS	A-3	BB+	April, 2004	A-3	BB+	April,2005
DEVELOPMENT FINANCIAL INSTITUTIONS								
37	Pak Kuwait Investment Co. (Pvt.) Ltd.	PACRA	A1+	AAA	June, 2004	A1+	AAA	June, 2005
		JCR-VIS	A-1+	AAA	June, 2004	A-1+	AAA	May, 2005
38	Pak Libya Holding Company	PACRA	A1+	AA-	June, 2004	A1+	AA-	May, 2005
39	Pak-Oman Investment Company	JCR-VIS	A-1+	AA+	June, 2004	A-1+	AA+	May, 2005
40	Pakistan Industrial Credit & Investment Corp.	PACRA	A1+	AA	June, 2004	A1+	AA	June, 2005
41	Saudi Pak Industrial & Agricultural Inv. Co.	JCR-VIS	A-1+	AA+	April, 2004	A-1+	AA+	April, 2005
42	Investment Corporation of Pakistan	PACRA	A1+	AA	March, 2005	A1+	AA	October, 2005
43	House Building Finance Corporation	PACRA	A1	A	Oct. 2004	A1	A	August, 2005
MICROFINANCE BANKS								
44	The First Microfinance Bank Ltd.	JCR-VIS	A-1+	A+	June, 2004	A-1+	A+	June, 2005

* For April 2004 credit ratings, ** For March 2005

5.2 Profitability

The Banking sector, during CY05, further geared up the pace of growth in profitability and achieved tremendous expansion. Favorable economic environment, growing credit volumes especially in the high yield areas, rising spread (due to widening gap between deposit and lending rates), expansion in fee based activities, low incremental infection in the assets quality and operational efficiency have been the major factors behind the increase in profitability. The net profit of the banking system increased by Rs28.6 billion showing growth of 82.6% (see **Table- 5.2.1**).

Table-5.2.1: Profitability of Banking System

(Billion Rs)	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
Profit before tax									
PSCBs	(22.9)	(3.0)	(3.3)	3.9	0.2	10.9	16.1	14.2	22.8
LPBs	4.9	3.3	3.9	(0.6)	5.0	11.9	23.8	31.0	60.5
FBs	7.4	4.6	4.6	3.7	5.0	6.6	7.1	7.2	11.6
CBs	(10.6)	4.9	5.2	7.0	10.3	29.4	47.0	52.4	94.9
SBs	(0.2)	(9.2)	1.8	(2.5)	(9.2)	(10.4)	(3.3)	(0.4)	(1.1)
All Banks	(10.8)	(4.2)	7.0	4.5	1.1	19.0	43.7	52.0	93.8
Profit after tax									
PSCBs	(21.4)	4.9	(8.3)	1.8	(4.6)	4.8	9.4	8.0	15.5
LPBs	1.8	1.4	1.7	(3.5)	2.0	6.4	14.8	21.8	41.1
FBs	3.4	1.1	1.7	1.4	2.4	4.2	4.2	5.8	8.0
CBs	(16.2)	7.4	(4.9)	(0.2)	(0.2)	15.3	28.4	35.6	64.6
SBs	(0.2)	(9.2)	1.8	(2.6)	(9.5)	(12.4)	(3.7)	(0.9)	(1.3)
All Banks	(16.4)	(1.8)	(3.1)	(2.8)	(9.8)	2.9	24.7	34.7	63.3

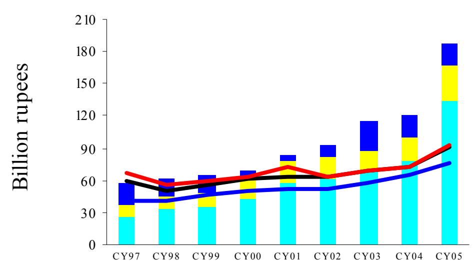
Resultantly, profitability indicators recorded further strengthening. The return on assets (ROA) of commercial banks went up to 2.0 percent, which is very strong keeping in view the internationally accepted benchmark. Similarly, their return on equity also increased to 25.8 percent from 20.3 percent in CY04 (see **Table- 5.2.2**).

Table-5.2.2: Profitability Indicators

(Percent)	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
Before Tax ROA									
PSCBs	(3.40)	-0.4	-0.4	0.5	0.02	1.3	1.8	2.4	3.3
LPBs	1.40	0.9	0.9	-0.1	0.9	1.4	2.2	1.7	2.7
FBs	3.00	1.7	1.8	1.4	1.7	2.3	2.6	2.5	3.6
Comm. Banks	(0.80)	0.4	0.3	0.4	0.6	1.5	2.1	2.0	2.9
SBs	(0.20)	(9.4)	1.8	(2.3)	(8.4)	(10.2)	(2.5)	(0.4)	(1.0)
All Banks	(0.8)	(0.3)	0.4	0.3	0.1	0.9	1.9	1.9	2.8
Before Tax ROE *(based on Equity plus Surplus on Revaluation)*									
PSCBs	(272.7)	(14.6)	(9.6)	10.9	0.5	26.3	29.9	30.8	30.7
LPBs	29.0	17.5	18.5	(3.2)	25.4	32.3	42.2	28.8	40.1
FBs	37.7	20.5	19.3	15.6	19.3	24.2	25.2	26.7	38.9
Comm. Banks	(23.8)	8.0	6.5	8.8	12.2	27.5	34.0	29.0	37.2
SBs	(1.8)	(211.0)	182.8	-	-	-	-	-	-
All Banks	(20.2)	(6.4)	8.7	5.7	1.4	21.1	35.4	30.5	38.2
After Tax ROA									
PSCBs	(3.1)	0.7	(1.0)	0.2	(0.5)	0.6	1.0	1.3	2.2
LPBs	0.5	0.4	0.4	(0.7)	0.4	0.8	1.4	1.2	1.8
FBs	1.4	0.4	0.7	0.6	0.8	1.5	1.5	2.0	2.5
CBs	(1.3)	0.5	(0.3)	(0.0)	(0.0)	0.8	1.2	1.3	2.0
SBs	(0.2)	(9.4)	1.7	(2.3)	(8.8)	(12.1)	(3.7)	(0.8)	(1.2)
All Banks	(1.2)	(0.1)	(0.2)	(0.2)	(0.5)	0.1	1.0	1.2	1.9
After Tax ROE *(based on Equity plus Surplus on Revaluation)*									
PSCBs	(255.0)	24.0	(24.0)	4.9	(12.2)	11.5	17.3	17.2	20.9
LPBs	10.9	7.3	8.1	(17.4)	10.3	17.3	25.8	20.2	27.2
FBs	17.2	5.1	7.1	6.1	9.1	15.2	14.8	21.5	27.1
CBs	(36.2)	12.0	(6.2)	(0.3)	(0.3)	14.3	20.3	19.6	25.4
SBs	(2.0)	(211.6)	179.1	-	-	-	-	-	-
All Banks	(30.7)	(2.7)	(3.9)	(3.5)	(12.6)	3.2	20.0	20.3	25.8

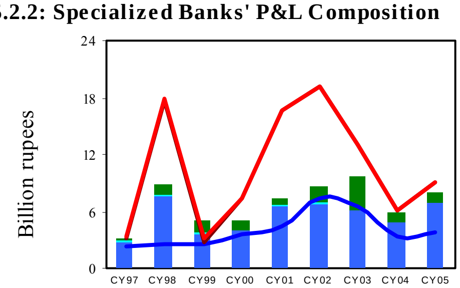
The composition of income for commercial banks reflected positive shift, as net interest income, which is considered hard-core earnings contributed 71.3 percent of gross income as compared to the previous year's share of 61.9 percent. Current year's net interest income of Rs133.3 billion was sufficient to absorb total operating expenses and provision charges. For specialized banks 87.7 percent of gross income came from net interest income **(**see **Figures 5.2.1 & 2**).

Figure-5.2.1: CBs P&L Composition



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
Other Non-Int. Inc.	19.4	16.2	16.8	7.3	5.2	11.8	27.7	19.9	19.2
Fee-based &currency dealing Inc.	11.0	11.1	12.6	19.7	20.6	19.7	19.8	22.7	34.4
Net Int. Inc.	26.3	34.2	35.0	42.6	57.2	61.4	68.2	77.3	133.3
All exp.+Extraordinary charges	67.3	56.5	59.2	62.6	72.8	63.4	68.6	72.4	92.0
Op. Exp.+Prov.	59.6	49.6	56.4	60.5	62.5	62.8	68.3	72.9	91.0
Op. Exp.	40.9	41.3	46.7	49.8	52.0	52.7	56.7	64.6	77.0

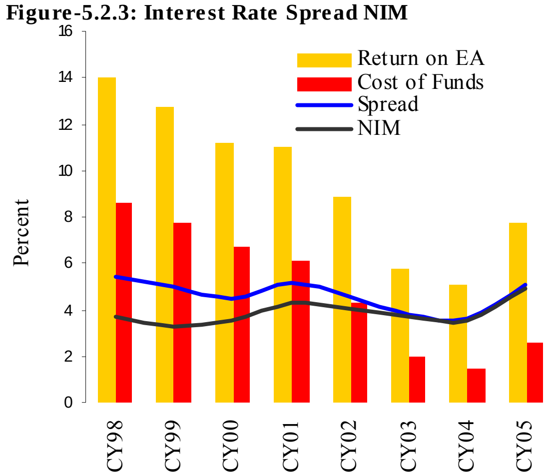
Figure-5.2.2: Specialized Banks' P&L Composition



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
Other Non-Int. Inc.	0.3	1.1	1.2	0.9	0.7	1.7	3.6	1.0	1.0
Fee-based &currency Dealing Inc.	0.1	0.2	0.2	0.2	0.2	0.2	0.0	0.0	0.0
Net Int. Inc.	2.8	7.5	3.6	3.9	6.4	6.8	6.0	4.8	7.0
All exp. + Extraordinary charges	3.3	18.0	3.1	7.5	16.6	19.1	13.0	6.2	9.1
Operating Exp.+	3.2	17.6	2.7	7.5	16.6	19.1	13.0	6.2	9.1

The year was marked with gradual rise in interest rates that came in the wake of SBP's policy to tighten the monetary policy. However, increase in return on earning assets exceeded increase in cost of funds, which eventually led to increased spread. These changes are well reflected in spread and net income margin as both indicators increased by 1.5 percentage points and 1.4 percentage points respectively (**see Figure-5.2.3**).

Figure-5.2.3: Interest Rate Spread NIM



Interest income on loans registered a remarkable growth of 93.5 percent in year 2005. A detailed analysis of interest income reveals that though a growth of 26.6 percent in advances led to volume driven change in interest income on loans, however, major growth in the interest income came from increased lending rates in sharp contrast to the trend observed in previous couple of years (see **Table- 5.2.3**).The recent rise in return on government securities had also made a reasonable contribution in high interest income of the banks. Total interest expenses increased from Rs37.2 billion to Rs75.3 billion thereby showing growth of 102.2 percent whereas total interest income grew by the 80.7 percent from Rs119.3 billion to Rs.215.6 billion. Growth in the interest expense was due to increase in the rates on deposits and inter bank borrowings. Cumulative effect of those variations resulted in 70.9 percent rise in the net interest income. **Table- 5.2.4** explains sources of this increase.

Table-5.2.3: Sources of Change in Interest Income on Loans

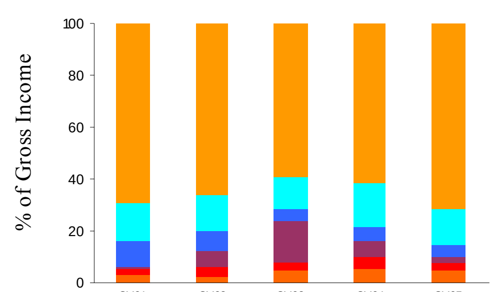
(Billion Rs)	Interest Income in Last Year	Change Due to Rate Variation	Change Due to Volume	Interest Income for the Year
CY01	81.5	8.0	6.5	96.0
CY02	96.0	(10.7)	1.8	87.1
CY03	87.1	(29.5)	9.4	67.0
CY04	67.0	(11.6)	21.6	77.0
CY05	77.0	46.7	25.3	149.0

Table-5.2.4: Sources of Change in Net Interest Income (NII)

(Billion Rs)	NII in Last Year	Interest Income Rate Variance	Interest Income Volume Variance	Interest Expense Rate Variance	Interest Expense Volume Variance	NII for the Year
CY99	41.7	12.3	(19.6)	12.2	(8.0)	38.5
CY00	38.5	11.8	(11.4)	16.4	(8.9)	46.5
CY01	46.5	(10.2)	27.0	9.1	(8.7)	63.7
CY02	63.7	(40.8)	23.2	34.3	(12.2)	68.1
CY03	68.1	(61.3)	29.6	48.7	(11.0)	74.2
CY04	74.2	(18.7)	22.0	11.5	(6.9)	82.1
CY05	82.1	68.3	28	(31.6)	(6.5)	140.3

Though non-interest income increased by 12.5 percent; its contribution in the gross income further went down from 38.1 percent to 28.7 percent during the period under review. Capital gains further declined to 2.6 percent of gross income and 5.4 percent of the profit before tax of the whole banking sector. Overall composition of the gross income reflects that soundness of the profitability of income further strengthened as 97.4 percent of income comes from core activities. **Figure-5.2.4** substantiates the strong base of the gross income of commercial banks.

Figure-5.2.4: Sources of CBs Gross Income

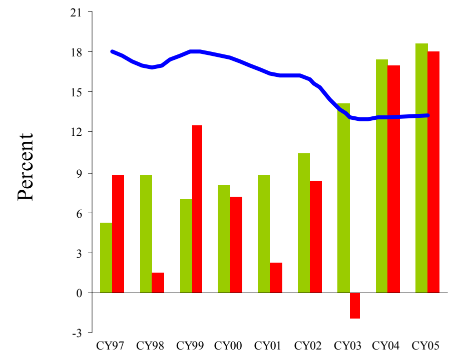


	CY01	CY02	CY03	CY04	CY05
Net Interest Income	68.9	66.1	59.0	61.9	71.3
Fee Based Income	14.6	14.2	12.7	16.8	14.0
Currency Dealing Income	10.2	7.0	4.3	5.4	4.4
Gain on Sale of Securities	0.7	6.2	16.4	6.2	2.7
Dividend Income	2.3	4.4	3.4	4.2	2.9
Other Income	3.3	2.1	4.2	5.5	4.6

Increased economic activity and improvement in the foreign trade gave boost to fee based and foreign currency related income as both incomes grew by 24.3 percent and 23.4 percent respectively. Corporate sector sustained its profitability that enabled banks to further strengthen their earnings on account of dividend income which shows an increase of 4.2 percent constituting 2.9 percent of the gross income.

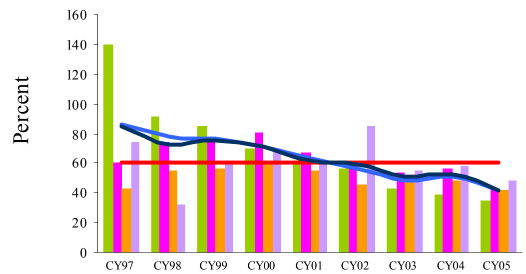
Strong profitability rested significantly on the greater operating efficiency. Operating expenses grew by 18.8 percent during the year. Remarkably, local private banks managed to increase their after tax profit by 88.6 percent whereas their operating expenses grew by only 15.7 percent whereas operating expenses of foreign banks and public sector commercial banks grew by 30.6 percent and 26.2 percent respectively but this growth was well supported by strong earnings. More than 95 percent growth in the non-interest expenses of one foreign bank was due to heavy expenditures incurred on voluntary retirement scheme. Some of the local private banks reflected higher growth in the operating expenses due to their aggressive branch expansion policy. However, this expansion in operating expenses was well behind the mushroomed profitability and growth in average funds. Resultantly, cost income ratio (operating expenses to gross income) as an efficiency indicator further ameliorated to 41.5 percent against acceptable benchmark of 60 percent and intermediation cost remained stable at 2.7 percent. The cost income ratio for all sub sectors of the banking system further improved, which also reflects enhanced operating efficiency (see **Figures-5.2.5 & 5.2.6**). The banking sector has been striving to improve the assets quality for last few years. These efforts have brought positive impact on the profitability, reducing the level of non-performing loans and capital impairment levels. Though provisioning charges for infected assets increased by 71.2 percent, they consumed only 7.9 percent of gross income, and had little impact on the profit margins given the remarkably strengthened gross income.

Figure-5.2.5: Intermediation Cost



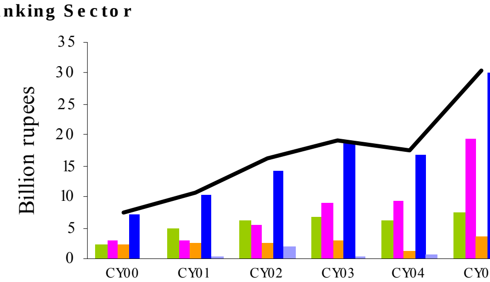
	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
Growth in Avg. Funds	5.2	8.8	7.1	8.1	8.8	10.4	14.1	17.4	18.6
Growth in Admin. Exp.	8.8	1.5	12.5	7.1	2.3	8.4	-2.0	17.0	18.1
Intermediation Cost (RHS)	3.5	3.3	3.5	3.4	3.2	3.2	2.7	2.7	2.7

Figure-5.2.6: Operating Exp. to Gross Income



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	140.0	92.1	84.7	70.1	62.3	56.9	42.8	39.4	34.3
LPBs	60.9	73.8	76.6	80.9	67.3	60.0	53.2	56.2	43.1
FBs	43.6	55.5	57.0	59.4	54.5	45.4	48.2	49.0	42.2
SBs	74.6	32.2	62.2	70.5	59.0	84.7	55.6	57.8	47.8
Bench Mark	60.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0
CBs	85.8	78.5	76.9	71.6	62.7	56.7	48.6	51.7	41.2
All	85.2	72.7	75.8	71.6	62.4	59.1	50.5	52.0	41.5

Figure-5.2.7: Annual Tax Contribution by Banking Sector



	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	2.2	4.8	6.1	6.8	6.3	7.3
LPBs	2.8	3.0	5.5	9.0	9.3	19.4
FBs	2.3	2.7	2.5	2.9	1.4	3.5
CBs	7.3	10.5	14.1	18.7	17.0	30.3
SBs	0.1	0.3	1.9	0.4	0.5	0.2
All	7.3	10.8	16.1	19.0	17.5	30.5

Higher tax rate applicable to the banking sector has been gradually decreasing with the government plan to equate it with rates for non-banking corporate sector by 2007. Despite reduction in the tax rate, banks have been able to contribute Rs30.5 billion to the national exchequer on account of strong profitability (see **Figure-5.2.7**) and strengthen their capital base on account of significant retained earnings. Tax charges as proportion of profit before tax further came down from 33.5 percent to 32.5 percent (ratio for in-the-profit banks stood at 32.0 percent in 2005, 31.9 percent in 2004).

The profitability achieved by the banking industry is contributed by wide range of individual banks. Total number of banks with ROA of 1.5 percent and above increased from 15 to 21, which are holding 82.7 percent of total assets of the system. This reflects that banks with solid assets base are making optimal use of their resource base to earn significant profitability. Increase in number of banks in ROA of 0.5 percent and below was caused by in addition to three local private banks; one foreign bank that is under the process of merger. **Table-5.2.5** depicts that individual banks are improving their performance.

Table-5.2.5%age Breakdown of Banking System's Total Assets by ROA

	CY03		CY04		CY05	
ROA	No. of Banks	% of TA	No. of Banks	% of TA	No. of Banks	% of TA
O and below	7	1.7	6	3.9	7	3.5
0 to 0.5	4	5.5	2	5.2	4	2.8
0.5 to 1	5	48.7	11	21.3	2	7.0
1.0 to 1.5	9	23	12	45.3	5	4.0
1.5 and Over	15	21.1	7	24.3	21	82.7

Outlook

Ongoing favorable economic environment will likely to continue in coming years and it will largely determine the course of banking industry in the future. The level of growth in the earning assets coupled with movement in the interest rates will have decisive impact on the sustainability of the earnings achieved during 2005. In view of the tight monetary stance taken by SBP to deal with the rising inflationary pressures the banks may not find it very comfortable to enhance their profitability on the basis of volume expansion. Banks will also likely to continue their profitability on account of increased returns on investments. Banking system is heavily dependant on depositors for its funding base. There is growing concern that banks have not been able to pass the benefit of thriving profitability to the depositors. This issue is needed to be looked into sooner rather than later. Banks' efforts to enhance their capacity building in terms of adoption of hi-tech and improving the skills of their human resource base will help them to offer customized services more efficiently. It will have positive bearing on the non interest portion of the income. Quality of assets will be another significant factor in determining the future profitability of the industry. The level of robustness in formulation and placement of risk mitigation techniques will play an important role in this regard.

5.3 Prudential Stability of the Recent Increase in Banks' Profits

The strong earnings and growing return on equity have been the hallmark of the banking systems' operations during the past few years. To get a deeper insight of this significant turnaround, a detailed analysis has been made by dissecting ROE into its various components. The analysis reveals that banks have been able to achieve exceptional ROE on account of multifaceted factors.

The forthcoming paragraphs discuss the two possible sources of change in ROE, i.e.:

1. Operating Efficiency, and
2. Policy on the funding structure

A brief of this framework is given in **Box – 5.3**.

Box - 5.3

Sources of Change in Return on Equity

The two broad sources of change in ROE viz. operating efficiency and policy as to the funding structure are further broken into the three components each. The following three indicators analyze the banks' operating performance. A rise in these indicators generally contributes towards the improvement in ROE and their rise is considered a healthy sign.

Net Margin (Profit After tax to Operating Profit before Provision): This measures the performance of banks on maintaining their margins. An improvement in ROE through the increase in the margin is a healthy sign. However, the contributions of the credit risk, extraordinary charges, and tax provisions require further analysis.

Operating Efficiency (Operating Profit before Provision to Gross Income): This measures the operating efficiency of the banks in containing the costs and directly complements the cost income ratio.

Productivity of the Risk-Adjusted Assets (Gross Income to Risk Weighted Assets): This measures the value added by the banks. A rise in the ratio is a healthy sign.

Banks can improve their ROE by adopting a less prudent policy as to their funding structure deteriorating the financial stability i.e. by adopting funding policy that compromises quality and quantity of equity and resorts to excessive risk taking. In this regard, the following three indicators have been identified to measure any shift in their funding structure. A rise in these indicators generally contributes directly towards the improvements in return, but damages the financial stability.

Risk Profile of Assets (RWA to Total Assets): Banks can improve their returns by simply taking on more risky stance in their assets profiling. The ratio measures the risk appetite of banks, and an increase shows a rise in the appetite.

Leverage (Assets to Total Regulatory Capital): This ratio measures the degree of banks' dependence on third party funds for carrying on business. A higher ratio acts counter to the financial stability and generally further spurs the risk appetite.

Quality of the Regulatory Capital (Total Regulatory Capital to Equity): The ratio indicates the banks policy towards meeting the regulatory capital requirements through equity or core capital vis-à-vis non-core capital i.e. hybrid instruments, subordinated loans, and revaluation surpluses. An increase in the ratio indicates deterioration in financial structure.

This entire framework can be summed up in the following equation:

$$ROE = \frac{PAT}{OP} X \frac{OP}{GI} X \frac{GI}{RWA} X \frac{RWA}{Assets} X \frac{Assets}{TRC} X \frac{TRC}{Equity}$$

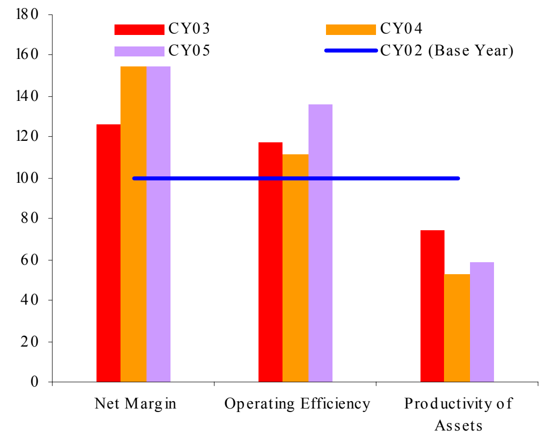
PAT = Profit after Tax
OP= Operating Profit before Provision
GI = Gross Income
RWA = Risk Weighted Assets
TRC = Total Regulatory Capital

The ROE of commercial banks has jumped up from negative 0.3 percent in 2001 to 25.4 percent in CY05. For in-depth analysis of this improvement, the different components of ROE have been evaluated by basing them on year 2002 levels.

Operating Efficiency

Net Margin: The increasing trend in net margin observed during past couple of years could not be maintained during 2005 as the index remained almost at level achieved in 2004. A further analysis reveals that substantial increase in provision and tax charges inhibited the growth in net margin.

Figure-5.3.1: Operating Performane, CY02 to CY05



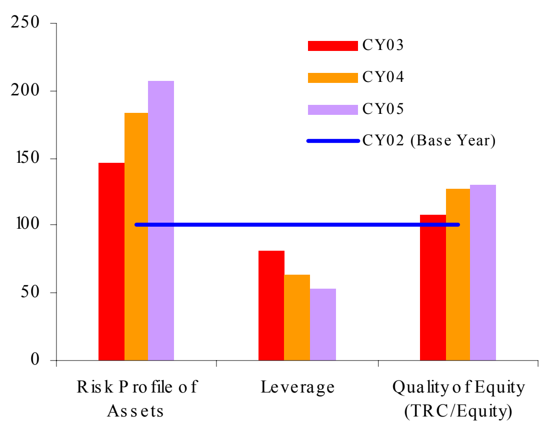
Operating Efficiency: The commercial banks succeeded to improve their operating efficiency index from 112 in CY04 to 136 in CY05 based on CY02 level. Massive growth in interest based income and containment of operating expenses along with rise in fee based and divided income contributed towards improved operating efficiency.

Productivity of Assets: The productivity of the assets improved thereby reversing the decline observed after CY02. Based on the index of CY02, the indicator went up from 53 in CY04 to 58 in CY05. This reflects that commercial banks are enhancing and consolidating their profits and returns through optimum utility of their enlarged assets base under rising return scenario.

Funding Structure Policy

Risk Profile of Assets: Banking sector has been increasing its risk profile since 2003 in sharp contrast to their previous excessively conservative policy of assets mix. Rise in the risk weighted assets of the banks on account of significant increase in credit had a positive bearing on the ROE. The index further inched up from 183 in CY04 to 217 in CY05 (see **Figure 5.3.2**).

Figure-5.3.2: Funding Structure, CY02 to CY05

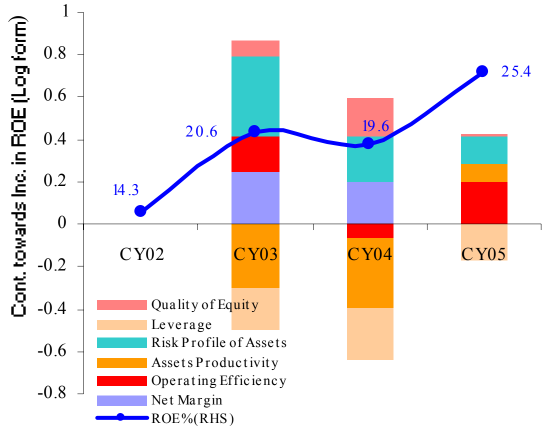


Leverage: The leverage of the banking sector further went down in CY05. Based on the index of 100 in CY02 the indicator came down from 64 in CY04 to 54 in CY05. This shows that banks are increasing their equity base to support expansion in their business activity. The rise in the equity base is in conjunction with banks' efforts to meet enhanced regulatory capital requirement and increased level of retained earnings on account of increased profitability. The reduction in leverage generally constrains ROE; however, it signifies the improved solvency of the banking system (see **Figure 5.3.2**).

Quality of Capital: The quality of capital improved over the year due to increase in core capital (see **Figure 5.3.2**). This increase in the core capital came on the back of fresh injections as well as improved profits. Besides, the burden of unprovided losses and capitalized costs on equity reduced which is well reflected in the increase in the share of equity capital eligible for regulatory requirements i.e. regulatory core capital as percent of balance sheet equity increased to 92% from 88% in last year.

Figure 5.3.3 summarizes the above discussion and gives a brief of the contribution by each identified factor towards year-on-year improvement in ROE. The main contributory element towards improved performance was operating efficiency as banks expanded both interest and non-interest components of their income along with reduction in cost income ratio. Increase in risk profile coupled with enhanced productivity of assets also moved up the ROE. Continuous increase in the risk profile may have its adverse implications on the soundness of the banking industry; however, it also shows that banks are no more pursuing conservative policy of assets utilization. It also depicts that banks are moving ahead to meet the credit requirements of different sectors thereby playing an important role in the growing economy. On the other hand, it demands that banks need to behave prudently while striving for higher profits. Positive reversal of trend in the productivity of assets is a worthy change especially when banks are continuously expanding their assets base. The reduction in the level of leverage leads to prudent use of funding base. It not only enhances the confidence of depositors but also envisages that banking sector would expand their business activities on solid footings.

Figure 5.3.3 Contribution to Changes in ROE, CY02 to CY05

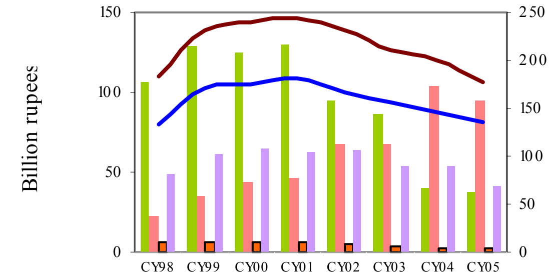


6 Risk Assessment of Banking System

6.1 Credit Risk

On the back of fast expanding loans, the concerns relating to high credit risk continued to prevail during CY05. These concerns multiplied on account of the gradual rise in lending rates. However, the banking system so far has succeeded in managing it very effectively. This is evident by a persistent fall in non-performing loans, which saw a decline of Rs22.6 billion in CY05; a fall by 13 percent (see **Figure 6.1.1**). This signifies improved market discipline coupled with the successful privatization of banks, which seems to have infused a more matured and professional approach in the key lending decisions.

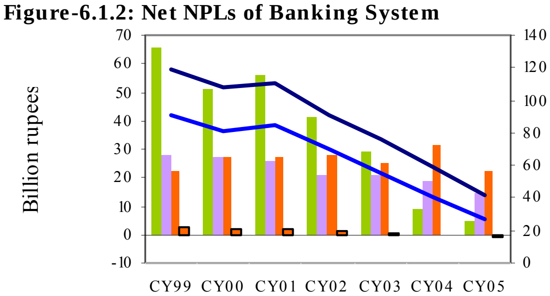
Figure-6.1.1: NPLs of Banking system



	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	106	129	125	130	96	86	40	38
LPBs	22	35	43	46	67	67	103	96
FBs	7	7	7	6	5	4	3	2
SBs	49	61	65	63	64	54	54	42
CBs(RHS)	134	170	175	181	168	157	146	136
All(RHS)	183	231	240	244	232	211	200	177

With the persistent fall in gross NPLs and higher provision, net NPLs also declined by Rs18 billion **(**see **Figure 6.1.2)**. The fast declining net NPLs have very positive overtones for the overall solvency of the banking system as it would lead to lower burden on its capital in the days ahead. Further analysis of the decline in NPLs during CY05 shows substantial contribution by specialized banks. This happened as one of the large specialized banks resorted to clean its balance sheet of the chronic and lingering portfolio of NPLs. Resultantly, the fall of Rs12 billion in the NPLs of SBs made a substantial contribution to the overall decline in system's NPLs.

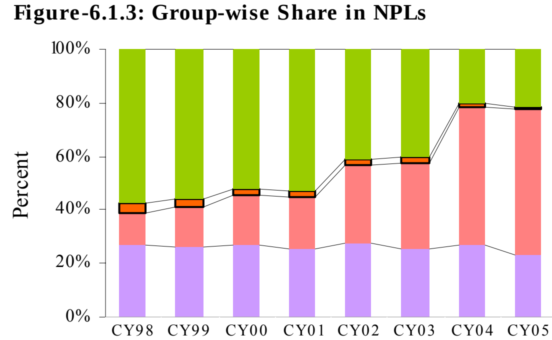
Figure-6.1.2: Net NPLs of Banking System



	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	66	51	56	41	29	9	5
SBs	28	27	26	21	21	19	15
LPBs	23	27	27	28	25	31	23
FBs	2	2	2	1	1	0	-1
CBs(RHS)	91	81	85	70	55	40	27
All (RHS)	119	108	111	91	76	59	41

However, decline in NPLs was not restricted to SBs only. Other groups also shared in bringing about the overall decline in total NPLs of the banking system. In absolute terms, LPBs with a decline of around Rs8 billion came second. The gradual fall in NPLs of LPBs holds special significance for financial stability because of the systemic significance of this group. Though not very substantial, the decrease in NPLs of PSCBs and FBs during CY05 is still very encouraging given the fact that it is coming in an environment characterizing high credit risk. More or less, the same trend is visible for group-wise contribution to the decline in net NPLs of the system. The underlying reasons remained the same.

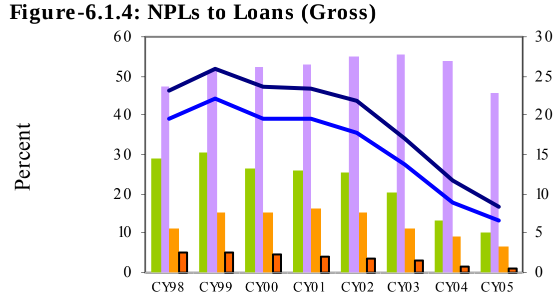
Figure-6.1.3: Group-wise Share in NPLs



	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	57.8	55.7	52.1	53.1	41.3	40.6	20.1	21.4
FBs	3.6	2.9	2.7	2.5	2.2	1.9	1.3	1.2
LPBs	12.0	15.1	18.1	18.7	28.9	31.9	51.8	53.9
SBs	26.6	26.3	27.1	25.7	27.6	25.6	26.87	23.50

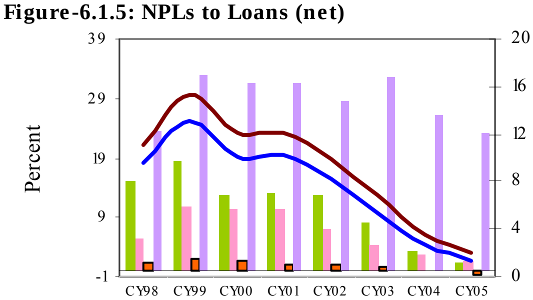
As is apparent by the foregoing paragraph, all groups shared in the overall decline of NPLs, however, relatively greater decline in the NPLs of SBs impacted the movement in respective share of the each group in the total NPLs of the system. While the share of SBs declined, the shares of LPBs and PSCBs increased despite witnessing a decline in their NPLs during the year (see **Figure 6.1.3**). In fact, the decline in the NPLs of these two groups was not proportionate to their respective size in total NPLs of all banks whereas SBs made more than proportionate decrease in their NPLs, which eventually reduced their share. Likewise, FBs also managed a more than proportionate decline in their NPLs which also helped them effect a fractional fall in their share of total NPLs.

Figure-6.1.4: NPLs to Loans (Gross)



	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	29	31	26	26	26	20	13	10
SBs	47	52	52	53	55	56	54	46
LPBs	11	16	15	16	15	11	9	6
FBs	5	5	5	4	4	3	2	1
All(RHS)	23	26	24	23	22	17	12	8
CBs(RHS)	20	22	20	20	18	14	9	7

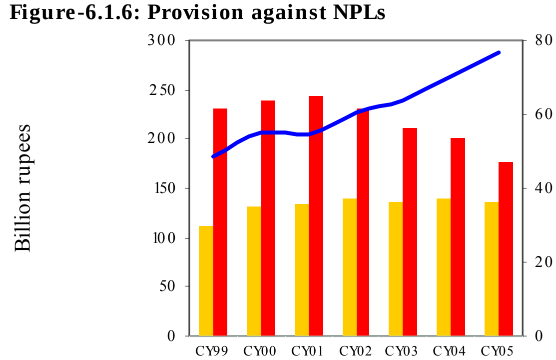
Figure-6.1.5: NPLs to Loans (net)



	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	15	18	13	13	13	8	3	1
LPBs	6	11	10	10	7	5	3	2
FBs	1	2	2	1	1	1	0	-1
SBs	24	33	32	32	29	33	26	23
CBs(RHS)	10	13	10	10	8	5	3	1
All(RHS)	11	15	12	12	10	7	4	2

The positive trend in NPLs is also obvious by the persistent improvement in the key indicators of asset quality during CY05. NPLs to loans ratio for all banks declined appreciably to 8 percent from 12 percent in CY04 (see **Figure 6.1.4**). Similarly, net NPLs to net loans ratio, which is a more precise indicator of asset quality, also shows an all round improvement **(see Figure 6.1.5)**. If examined closely, the key indicators depict greater improvement as compared with the absolute fall in NPLs. This is because of the rapid growth in loans of the banking system, which in addition to the falling NPLs also played a key role in bringing down this ratio.

Figure-6.1.6: Provision against NPLs



	CY99	CY00	CY01	CY02	CY03	CY04	CY05
Provision	112	132	134	140	135	141	136
NPLs	231	240	244	232	211	200	177
Provision to NPLs (RHS)	49	55	55	61	64	70	77

Depicting the trend in absolute fall in net NPLs, net NPLs to net loans ratio also improved at a faster pace. The reason once again is the fast increasing provisions against NPLs. This is evident by the coverage ratio, which increased sharply to 77 percent from 70 percent in CY04 (see **Figure 6.1.6).** Apart from a number of measures taken in past, the change in loans classification and provisioning criteria by SBP in the latter part of CY05 also appears to have spurred greater provision against NPLs. Another pertinent reason is the strong earning performance of the banking system, which has enabled it to make more provisions against the chronic NPLs.

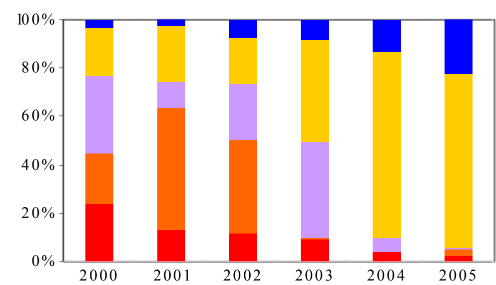
Another, less used but useful, indicator of asset quality is to determine the level of incremental NPLs as against incremental loans. This gives a raw idea of default against fresh loans. The results are once again encouraging. Incremental gross NPLs to gross advances and incremental net NPLs to net advances ratios precisely reflect the improved trends depicted by NPLs during the current years (see **Table 6.1.1**).

Table 6.1.1 Incremental NPLs Indicators

Amount (Rs. In Billion)	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
Incremental Gross NPLs								
PSCB	0	23	-3	4	-34	-10	-46	-2
LPBs	3	13	9	2	21	0	36	-8
FBs	0	0	0	0	-1	-1	-1	0
Comm. Banks	3	36	5	6	-14	-10	-11	-10
SBs	7	12	4	-2	1	-10	0	-12
All banks	10	48	9	4	-13	-20	-11	-23
Incremental Net NPLs								
PSCB	-3	19	-15	5	-15	-12	-20	-4
LPBs	2	12	5	0	1	-3	6	-8
FBs	0	1	0	-1	0	-1	-1	-1
Comm. Banks	-1	32	-10	4	-15	-15	-15	-13
SBs	-16	11	-1	-2	-4	0	-4	-4
All banks	-17	43	-11	3	-19	-15	-19	-18
Incremental Gross NPLs to Gross Loans (percent)								
PSCB	-2.1	42.4	-6.1	17.6	26.8	-20.3	38.4	-2.8
LPBs	22.6	49.2	14.9	-230.3	13.8	0.3	6.5	-2.4
FBs	21.8	-2.3	-0.7	-7.7	11.9	12.0	-3.8	-4.8
Comm. Banks	9.2	42.9	4.1	21.1	-72.6	-5.3	-2.3	-2.5
SBs	33.0	121.3	70.1	38.0	-123.0	50.0	-20.8	139.7
All banks	17.6	48.7	7.2	16.8	-69.8	-11.3	-2.4	-5.5
Incremental Net NPLs to Net Loans (percent)								
PSCB	-17.0	37.6	-32.5	19.5	14.1	-25.5	21.5	-5.4
LPBs	16.8	49.9	8.7	6.4	0.4	-1.6	1.1	-2.4
FBs	-59.9	16.7	-2.1	-13.0	2.9	5.4	-2.4	-11.0
Comm. Banks	-3.2	40.3	-9.3	15.5	-82.6	-7.6	-3.3	-3.1
SBs	713.4	81.6	-46.4	33.2	62.6	3.4	240.0	534.4
All banks	-54.4	46.3	-9.7	11.5	-177.0	-8.2	-4.1	-4.3

The disaggregated analysis also depicts improvement in the asset quality of individual banks. The number of banks with their respective ratios of NPLs to loans (net) below 5 percent increased to 33 from 31 in CY04. The share of these banks in total assets of all banks comes to 94 percent as against 90 percent for those in CY04, denoting marked decline in systemic risk. On the contrary, there are only two banks representing around 2 percent share in total assets of banking system, which have their respective NPLs to loans (net) ratios above 15 percent. Therefore, it can be safely mentioned that individual participants as well as the banking system as a whole, have improved their capabilities of credit risk management **(see Figure 6.1.7)**.

Figure-6.1.7: %age Breakdown of Total Assets by NPLs to Loans (net) ratio



	2000	2001	2002	2003	2004	2005
0 and below	2.9	2.8	7.4	7.9	12.9	22.5
0 to 5	20.1	22.9	18.9	42.7	76.9	71.9
5 to 10	32.5	11.0	23.2	39.2	6.1	0.5
10 to 15	20.2	49.7	38.8	1.0	-	2.6
15 and above	24.3	13.5	11.7	9.1	4.2	2.5

Credit concentration in any single sector can pose serious risk to the financial health of an institution in case of adverse developments within that sector. Sector wise concentration of loans to private sector portrays the continuity of old trends with larger share being occupied by the textile sector (see **Figure 6.1.8**). This high level of concentration appears to be inevitable keeping in view the size and contribution of this sector to the country's exports and GDP growth. Regardless of the indispensability of this sector for the economic activities, such a high exposure of the banking system portrays high concentration risk. There is therefore a need to establish adequate credit policies and procedures with clear credit concentration limits for textile units based on their vitality. In this respect, banks can also use industry specific sophisticated stress testing and modeling techniques to predict the developing trends within the sector to manage their exposure.

Figure-6.1.8: Concentration of Loans to Private sector Businesses

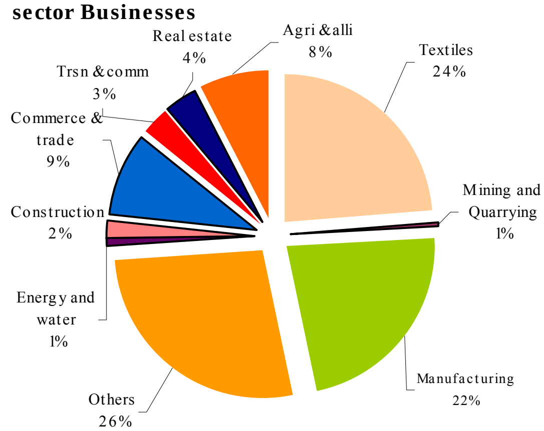


Table: 6.1.2 Segmentwise Infection of Loans Portfolio as of 31-12-2005					
(Domestic Operations)					(Rs In Billions)
Sector	Amount Outstanding	Share %	NPLs	Share in overall NPLs	NPLs as % of Outstanding
Corporate	1076.2	52.7%	75.5	43.6%	7.0%
SMEs	361.4	17.7%	42.1	24.3%	11.6%
Agriculture	138.0	6.8%	42.9	24.8%	31.1%
Consumers	252.8	12.4%	3.1	1.8%	1.2%
Credit Cards	27.2	1.3%	0.2	0.1%	*0.8%*
Auto Loans	82.1	4.0%	0.7	0.4%	*0.9%*
Consumer Durables	1.7	0.1%	0.1	0.1%	*7.8%*
Mortgage Loans	34.2	1.7%	0.2	0.1%	*0.6%*
Others	108.0	5.3%	1.8	1.1%	*1.7%*
Commodity Finance	140.6	6.9%	1.7	1.0%	1.2%
Staff Loans	42.4	2.1%	0.4	0.3%	1.0%
Others	31.6	1.5%	7.4	4.3%	23.3%
Total	2,043.0	100%	173.108	100.0%	8.5%

In recent years banks have started to venture rather more aggressively in new areas such as consumer financing and SMEs. Resultantly, the loan portfolio of banks is relatively more diversified compared to the one a few years back. An added gratifying feature of the growing exposure in these areas is the incidence of low default despite the developing pressures in the form of high interest rates.

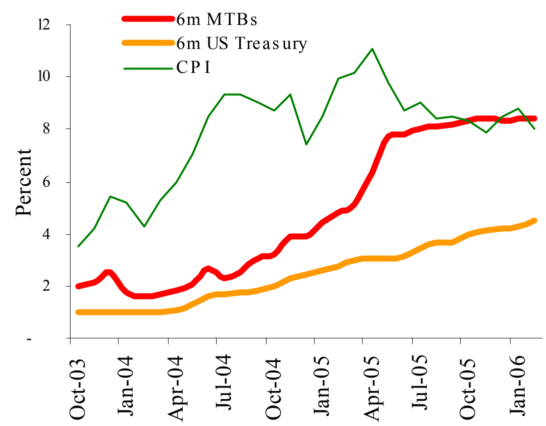
The segment wise performance reveals only a minor contribution of consumer sector to the overall NPLs, shifting slightly up to 1.8 percent against 0.8 percent in CY04. This happened as NPLs to loans ratio of the consumer sector increased to 1.2 percent from 0.9 percent in CY04 (see **Table 6.1.2**). Keeping in view the sharp increase in consumer financing during CY05, the rise in NPLs is not very alarming. The SMEs also attracted substantial amount of funds during CY05; a growth of 27 percent in outstanding loans, albeit, the fact that the share of SME sector in total outstanding amount has insignificantly increased, posting 17.7 percent against 17.5 percent in CY04. However, the contribution of sector’s NPLs in total NPLs has jumped up to 24.3 percent. This sharp rise in SMEs’ share to total NPLs of banks was because of the inclusion of a specialized bank carrying large portfolio of chronic NPLs to the SME sector. However, the inclusion of the gross NPLs of this bank tends to overstate the level of NPLs of the SME sector. In fact, the bank has already made heavy provisions against these NPLs and hence the threat to the banking system seems a bit exaggerated. Another stellar occurrence during the preceding year has been the sharp decline in the NPLs to loan ratio for corporate sector and a mild downward shift in case of agriculture sector as well, which signifies improved debt servicing capabilities in these two sectors.

It is evident by the above analysis that despite the fast expansion of the loan portfolio and rising interest rates, the banking system so far has succeeded in containing the high credit risk. There is little evidence of the deterioration in the asset quality, suggesting improved credit appraisal techniques, up gradation of service capacity of banks and, therefore, overall improvement in credit risks assessment techniques of banking system. However, this fact leaves little room for complacency, as banks will have to remain steadfast to carefully monitor the ongoing economic situation as well as the income and cash flow trends of its borrowers to properly assess its exposure to credit risk. Particularly, the fast expanding retail lending activities require extra-vigilance given the fact that banks are still undergoing an evolutionary phase in these types of activities.

6.2 Market Risk

Market risk profile of the financial sector continued to be dominated by *interest rate risk*. Monetary policy tightening in response to the inflationary tendencies in the market amidst rising oil prices and widening current account deficits and gradually increasing interest rates on international front resulted into further rise in the interest rates (see **Figure 6.2.1**). This has adversely affected the value of portfolio of the financial institutions with assets having longer-term maturities than those of liabilities.

Figure 6.2.1 CPI & 6m MTBs Vs US Treasuries



As was in CY04, yield curve experienced an unequal move across different maturities thus giving further rise to the yield curve risk. Squeezing market liquidity in response to the inflationary pressures has led to higher volatility in short term interest rates thus making interest rate management a challenging task for banks **(**see **Figure 6.2.2)**. Whereas, in the absence of ample stock of long term papers in the secondary market, the yields on the scrips of over 10-years remained almost flat **(**see **Figure 6.2.3)**, which in turn has made them unattractive for the long term investors. Resultantly, this has accelerated the demand for short term papers in the market thus pushing the short-term rates further up.

Figure: 6.2.2 Volatility in Short Term Rates

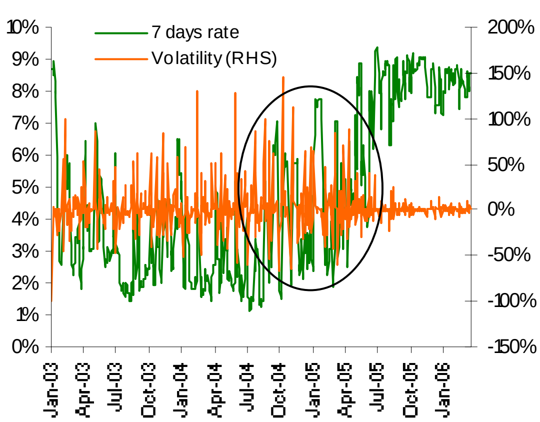
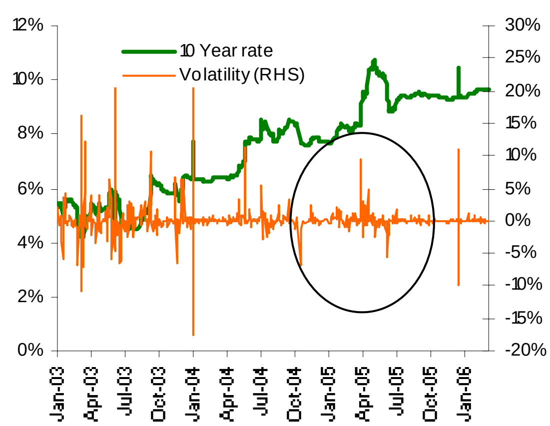


Figure: 6.2.3 Volatility in Long Term Interest



This is evident by a substantial rise of more than 4.3 percentage points in short term rates as against a rise of around 1.5 percentage points in the 10-year yield (see **Figure 6.2.4**). As a corollary, the yield spread between the short term and the long term squeezed further **(**see **Figure 6.2.5)**. On account of this, the yield curve has become more flattened as compared to the one in CY04. This development has given rise to a greater risk to banks' portfolio in case the yield curve gets steeper on account of any significant rise in interest rates on long-term papers.

Figure 6.2.4 Shift in Yield Curve

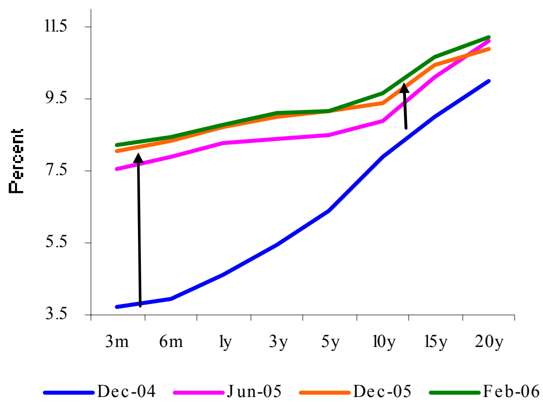
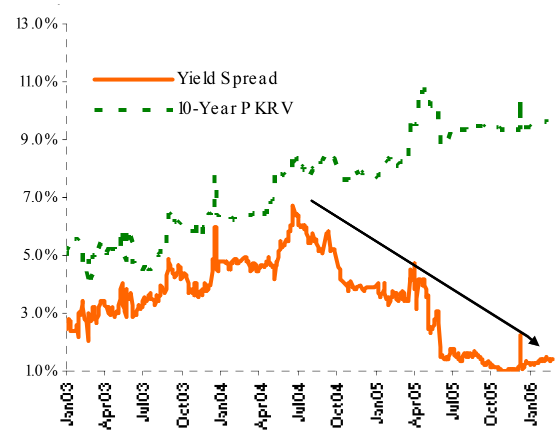
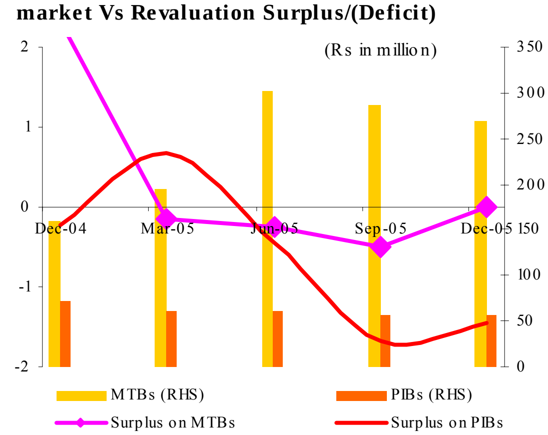


Figure 6.2.5 Yield Spread b/w 10y & 3m PKRV



This shift in the yield curve along with its flattening has increased the revaluation risk, which is a source of threat especially for the banks with significant exposures in fixed income securities. Of all the fixed income securities, the Pakistan Investment Bonds (PIBs) having long term maturities are more susceptible to this change in interest rates due to their higer effective maturities. Though banks have already availed comfort of classifying their investment portfolio into three categories; namely Held-for-Trading (HFT), Available-for-Sale (AFS) and Held-to-Maturity (HTM), and hence are not required to mark to market their investments in HTM category, the revaluation deficits on Market Treasury Bills (MTBs) and PIBs portfolio under AFS category has been increasing on account of this rise in interest rates. The deficit on PIBs has increased to Rs1.4 billion in CY05 from Rs0.2 billion in CY04 (see **Figure 6.2.6)**. Had there been higher increase in yields on long term papers, the deficit would have been quite substantial. Moreover, the banks have categorized around 63 percent of their PIBs under the HTM, which though saves them from booking much likely deficits on such securities but is still a source of hidden losses. Further, by following this strategy, banks seem to be compromizing on lower returns on the portfolio. In case there is any reshuffling of the investments away from HTM, the balance sheet footing of the the banks with significant chunk of risky securities in HTM would be adversly affected.

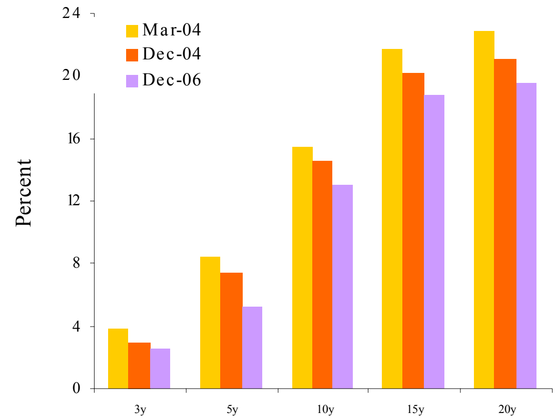
Figure 6.2.6 PIBs and MTBs subject to mark to market Vs Revaluation Surplus/(Deficit)



Duration, a measure of effective maturity, hence price sensitivity, of these fixed income securities has declined with the passage of time and the rise in the interest rates and in the absence of new issues. However, the level seems on the higher side. Weighted average Macaulay's duration of all the PIBs and MTBs remained at 4.17y and 0.45y respectively in CY05. Scrip wise, the Macaulay's duration of 3y, 5y, 10y, 15y and 20y bonds have stayed at 0.9y, 1.91y, 4.97y, 7.49y and 8y respectively, which as percentage of their contractual maturity remained at 30 percent, 38 percent, 50 percent, 50 percent and 40 percent respectively. Since the weighted duration as percent of their maturity is higher in case of 10y and 15y PIBs, these securities assumes greater risk of revaluation.

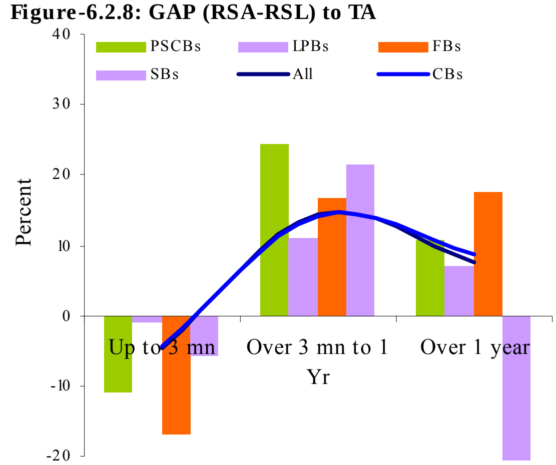
The ongoing rise in the interest rates has also lowered the level of modified duration, a measure of price sensitivity, of this fixed income portfolio. Calculated by using the maturity in years, rate, yield, redemption value and frequency of payments of all these securities, the measure suggests that if the interest rates rise by 3 percentage points, the value of 3y, 5y, 10y, 15y and 20y PIBs would fall by 2.55 percent, 5.28 percent, 13 percent, 18.8 percent and 19.54 percent respectively **(**see **Figure 6.2.7)**.

Figure-6.2.7: Fall in Value of PIBs with 3 %age point rise in Interest Rates



Looking at the total portfolio of the banks, this increase in the interest rate also has significant bearing on the net worth of the banks whose rate sensitive assets (RSAs) significantly exceed the rate sensitive liabilities (RSLs) or where the GAP between these two along different time buckets remained significant. It was due to the squeezed liquidity and the increasing credit to deposit ratio that banks are experiencing negative GAP position in the three months bucket **(**see **Figure 6.2.8)**. This negative GAP in the short-term buckets is quite undesirable in the current rising interest rate scenario, especially when the short-term interest rates are volatile. However, for the one-year and over one-year time buckets the GAPs are significantly positive. Group wise, the repricing GAP in terms of total assets in the three months bucket is the highest in foreign banks followed by PSCBs. Overall GAP in terms of total assets is the highest among the PSCBs. These large positive GAPs in the long term signify that the duration of assets significantly exceeds the duration of liabilities. This in turn affects the value of the overall portfolio or economic value of equity (EVE) of the banks.

Figure-6.2.8: GAP (RSA-RSL) to TA



Concisely, given the present interest rate scenario, both the yield curve risk and the revaluation risk remain concerns for CY05. The concern may rise given the expectations of further rise in interest rates. Banks need to manage such risks by employing efficient funds management practices. Hedging the present exposures and keeping their GAP positions within the acceptable limits would provide a rescue to the banks in the adverse scenarios if any. Derivatives market though is at a developing phase, the forward, swap and option contracts may provide a better solution to the banks to square their positions and deal with large exposures.

As for *exchange rate*, rupee experienced slight volatility on account of rising interest rates and deterioration in the current account balances. The average monthly exchange rate inched up to

Figure 6.2.9 10y Yields Vs Rs/$ ER

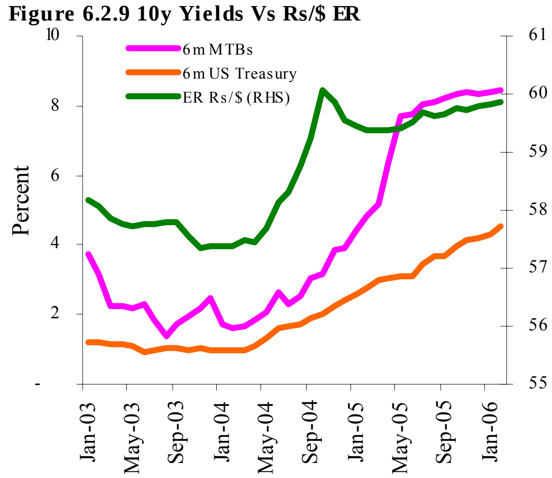
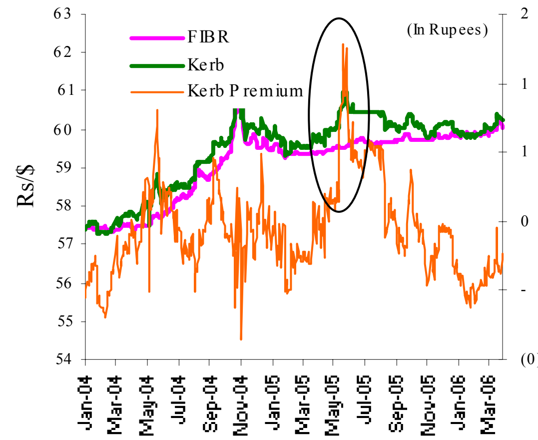


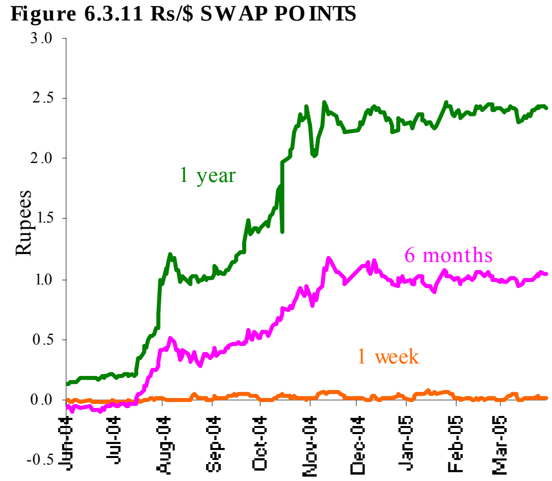
Figure-6.2.10: FIBR Vs Kerb Rate



Rs59.8 in Dec-05 from Rs59.4 in Jan-05 **(**see **Figure 6.2.9)**. Since Jan-05, the exchange rate reached to all time high in March 2006, when it went up to Rs60.2. This volatility in the rupee dollar exchange rate has also pushed the kerb market premiums up **(**see **Figure 6.2.10)**.

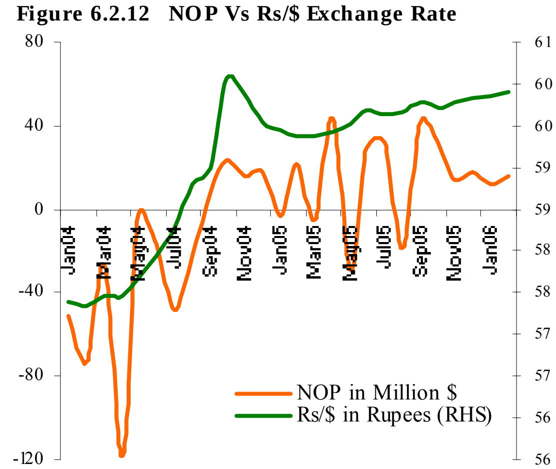
However, the direct foreign exchange risk, which talks about the change in the net value of the foreign currency portfolio with any change in the exchange rate, remained subdued. In fact, since the foreign currency assets of the banks generally exceed the liabilities in foreign currency, any depreciation in rupee would add value to the bank's portfolio. It is the only appreciation in the rupee that would actually hit the value of the banks' foreign currency portfolio.

Figure 6.3.11 Rs/$ SWAP POINTS



SWAP points remained positive for all the maturities and hence the expectations of further weakening of rupee hold in the forex market **(**see **Figure 6.3.11)**.

Figure 6.2.12 NOP Vs Rs/$ Exchange Rate



Net open position (NOP), a measure of foreign exchange exposure, remained positive and is quite desirable given the pressures on rupee under the current scenario. Though the banks also had some negative NOPs during the year, such positions of the banks were well within the acceptable limits **(**see **Figure 6.2.12)**.

Indirect foreign exchange risk, which considers the impact of changes in exchange rate on the repayment of foreign currency loans, is of concern under the current scenario. However, since on average the proportion of foreign currency loans in the total loans portfolio is not significant, the exposure is well contained.

While the stock market performed exceptionally well primarily in the later half of CY05, and first quarter of CY06 (see **Figure 6.2.13**), *the equity price risk* of the banks remained well in check. Given the erratic movements in the index especially in the first quarter of CY05 and the resulting uncertainty in the market, the banks were compelled to keep their exposures in stock market within prudent limits. Most of the banks streamlined their direct exposures in equities to comply with the cap imposed by SBP. The indirect exposures through badla financing also came off from Rs12 billion in CY04 to around Rs8 billion in CY05. Although, the stock market trends are favorable, however its past volatile behavior requires that the banks act prudently and rationalize their high indirect exposures as well.

The absolute direct exposure of the overall banking system increased in CY05 to Rs34.7[6] billion from Rs25 billion in CY04 recording a growth of 39 percent over the year. However, with the capital growth at an even faster pace, the equity exposure to capital ratio reduced from 13 percent to 12 percent in CY05 (see **Figure 6.2.14**). The increase in the equities investments is also reflected in their increased share of 4.3 percent in total investments of the banking system from 3.7 percent in CY04 (see **Figure 6.2.15**). Group-wise position of the banking sector shows that PSCBs recorded the highest increase in the equity investments, followed by LPBs. However, their exposures declined in terms of capital as the capital base grew at a relatively greater pace. Consequently, the equities exposure of all banking groups remained less than 15 percent. Bank-wise, although most of the banks had their exposures in

Figure 6.2.13 KSE-100 Index Monthly Average

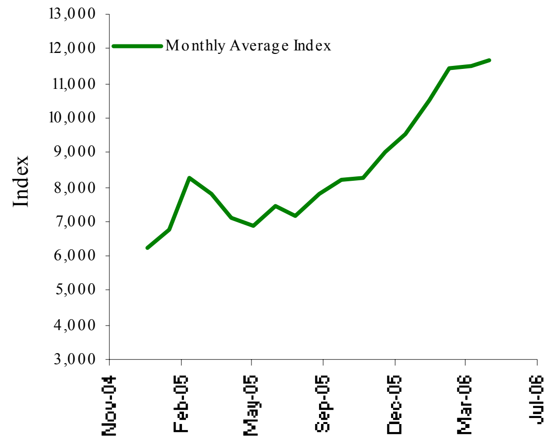


Figure-6.2.14: Exposure of Banks in Equities-CY05

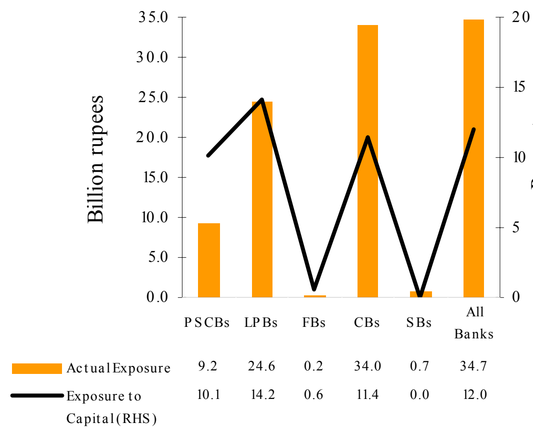
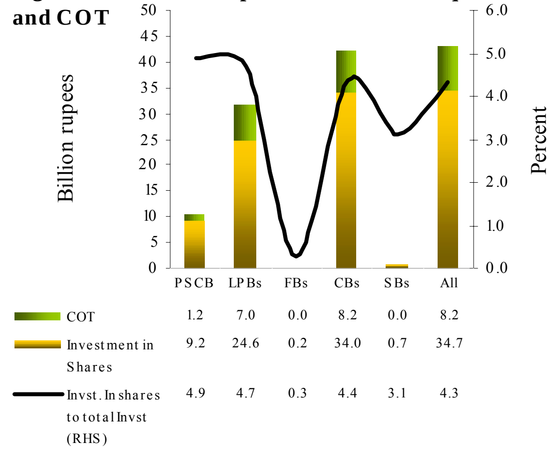


Figure-6.2.15: Breakup of Investment in Equities and COT



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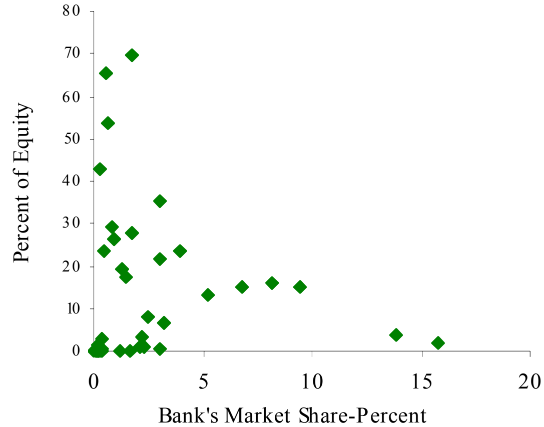
[6] Market value of investment in shares (other than investment in subsidiaries and associated undertakings)

reasonable limits, few banks still carried significant indirect exposures in relation to the capital (see **Figure 6.2.16)**[7]. This is manifested from the fact that only 6 banks accounted for 75 percent of the carry over transactions (COT) of the banking system in CY05. The market share of banks, being very low in the banking system, keeps the chances of any systemic risk minimal, though these banks are exposed to risk at their individual end. The above analysis reveals that banks exposure in the equity market, though increasing, is still too negligible as a percentage of their total assets to pose any significant risk to their solvency. Nevertheless, it does not obviate the need for banks to manage their equity investments prudently.

Figure-6.2.16: Total Exposure of Banks-CY05

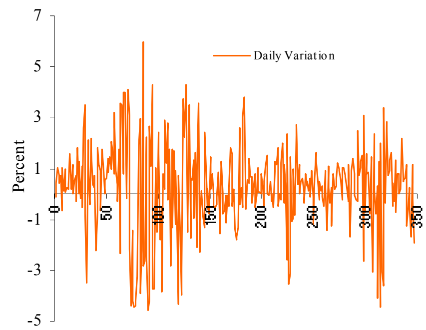


[7] The exposure includes investment in shares at cost and investment in COT.

BOX – 6.1

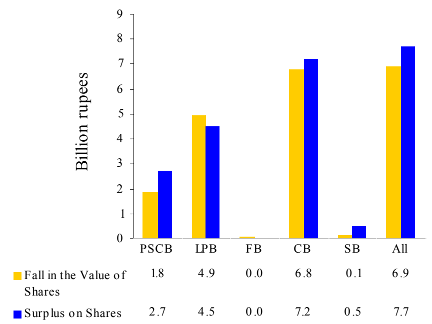
Resilience of Banks towards Stock Market Volatility

Figure 6.2.17 KSE Index Variation Dec04-Apr06



The stock market volatility holds special risk implications for its participants. From time to time, regulators, investors and all the other stakeholders have expressed their concern over the level of stock market volatility. But the perception that prices move a lot--and have been moving a lot more in recent times--is in part a reflection of the historic index movements. Whilst an overly optimistic market sentiment may move the index up; such upward movement in the market is always prone to sudden decline and is a cause for regulatory concerns. The same holds for the recent KSE index situation. The index crossed major barriers and reached 11,000 level in first quarter of CY06. This market rise is considered to have links mainly to increased interest of foreign investors, privatization proceeds, general upbeat mood of the economy and encouraging performance on the corporate side. Continuing with the upward movement, index reached 12000 in the early second quarter of CY06 leading to higher stakes. As expected the overheated market witnessed some correction in April 06. After rising steadily in the first half of April 06, the KSE index began to slide again reflecting the volatility of the stock market (see **Figure 6.2.17**).

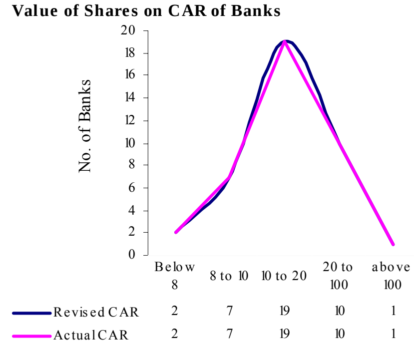
Figure-6.2.18: Impact of Adverse Movement in KSE-100 Index by 20 Percent



Based on the banks growing exposure in the stock market and keeping in view its past erratic behavior, it is of much interest to the regulators to measure the resilience of the banking system towards the stock market. Although, the current situation on a standalone basis does not seem very critical, the index movements suggest that the chances for sudden decline can not be ruled out. To gauge the resilience of the banking system to stock market movements, an exercise has been carried out. In this regard, empirical study of the KSE index movements over the last one year shows that the maximum decline in the index, based on monthly averages, was 9 percent. Considering these past movements and adopting a conservative approach, it is assumed that the decline in the index would be more than the empirical fall. Hence, a 20 percent fall in the market index has been assumed to gauge the likely impact on banks. Further, it is assumed that this fall in the index would translate into an equivalent fall in the value of investment in shares held by the banks as of Dec05. As any market dip shall first erode the surplus available against investment in shares, therefore, the fall in investments has been directly compared with the surplus available thereagainst. A look at CY05 position shows that the overall surplus of the banking system against the investment in shares increased by 20 percent over the year. However, the position of individual banks shows that seven banks were already carrying deficit against such investments. On a group-wise basis, the surplus of LPBs falls short of the assumed decline in the value of shares **(see Figure 6.2.18).** FBs were not carrying any surplus; however, their exposure in shares was also quite limited. Bank-wise, 22 banks carrying 59 percent share in the banking system shall carry deficits against such investments in case of decline in the value of their shares at the assumed rate. As for the five big banks, while their investment in equities declined in terms of the investment of overall banking sector to 44 percent in CY05 from 63 percent in CY04, three of these banks carried very thin surplus available against fall in the value of such investments.

As the revaluation deficit against investment in shares is likely to impact the capital adequacy ratio (CAR) of the banks, it is pertinent to translate such impact in terms of CAR as a true test for resilience of banking system against stock market movements. Except for two banks, the before-shock CAR of remaining 37 banks was well above the benchmark CAR of 8 percent, hence reducing the vulnerability of the capital. This is further affirmed from the CAR of banks after the calibration of shock, as none of the banks moves to the lower capital adequacy brackets, even with fall in CAR by few basis points (see **Figure-6.2.19**).

Figure-6.2.19: Impact of 20 Percent Fall in Market Value of Shares on CAR of Banks



The stock market position suggests that much of the index movement shall be based on the news from the corporate side. Considering the volatility in the market over the last one year, the banks need to take account of their exposures therein. Regulatory pressures though continue to keep the risks in check in line with the prevailing market stance. Accordingly, the regulations requiring banks and DFIs/Islamic Banks to contain their aggregate exposure in shares at 20 percent and 35 percent respectively of their equity have been amended in order to broaden the scope of exposure in shares*. Resultantly, the limits of 20 percent and 35 percent have been enhanced to 30 percent and 45 percent of the banks' and DFIs/Islamic Banks' equity respectively, with the condition that their aggregate exposures do not exceed the level of 20 percent and 35 percent of their equity in direct equity investment in ready/cash market and 10 percent of their equity in future contracts. In this connection, the 10 percent exposure limit for future contracts includes both positions taken in futures buying and selling. As regards the indirect exposure of banks and DFIs, the introduction of margin financing has provided the banks with a prudent and secured mode of trading in the stock market. In this regard, banks and DFIs are required to maintain minimum margins as prescribed by SBP from time to time together with the adherence to the conditions for extending such financing to brokers. Compliance to these regulations will help strengthen the resilience of banks towards the stock market volatility and diversify their risk base simultaneously.

* Vide BPD Circular Letter No.40 of 2005

6.3 Liquidity Risk

After enjoying a flush of liquidity during the past couple of years, liquidity risk started to emerge as a concern for the banking system in CY05. In pursuit of tighter monetary policy amidst inflationary pressures, SBP carried out frequent liquidity mop-ups, which drained much of the excess liquidity available with the banks. Another pressure emerged in the form of high credit growth, which changed the composition of balance sheet away from liquid assets to advances thus further squeezing the available liquidity.

While pursuing tighter monetary policy, SBP continued to drain excess liquidity through Open Market Operation (OMOs) from the inter-bank market during CY05. This was supplemented with the gradual hike in the benchmark interest rates in auctions of MTBs. During CY05, the increased frequency of OMOs is apparent by a mop up of around Rs601 billion as against Rs567 billion in CY04. However, to prevent any significant deterioration in liquidity conditions, SBP, at times, resorted to liquidity injections as well, especially during the last quarter of CY05 **(**see **Figure 6.3.1)**. Another phenomenon highlighting liquidity constraints was the frequent visits to SBP discount window by banks to gain short-term liquidity supports. These visits were repeatedly observed in the last quarter of CY05 and in fact there was net inflow into the banking system out of these activities.

Figure-6.3.1: OMOs by SBP Vs Discounting availed by the banks

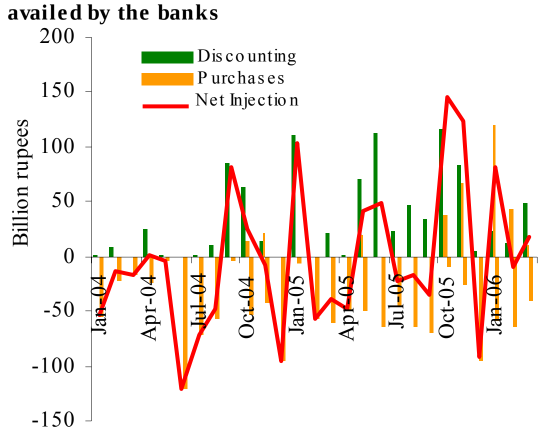
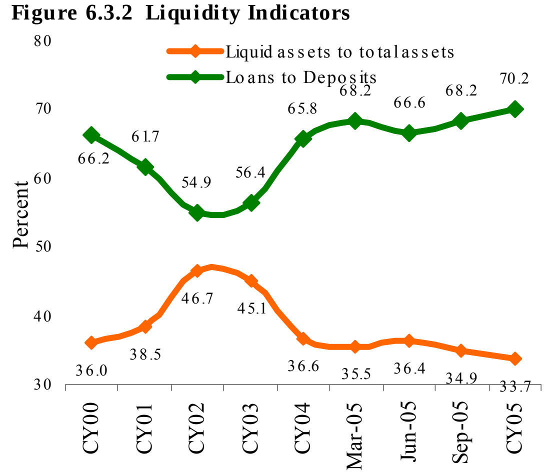


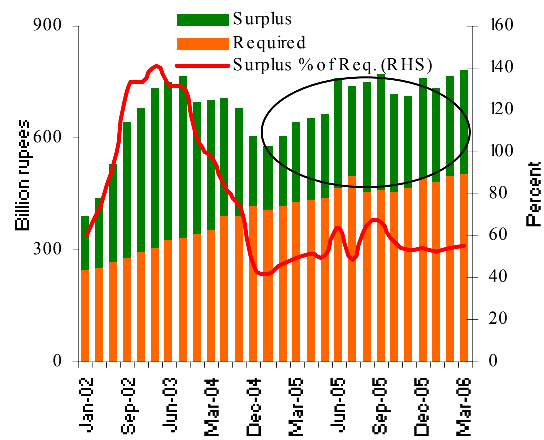
Figure 6.3.2 Liquidity Indicators



On the face of it, such retrenchment in the available liquidity has largely been perceived as the phenomenon of the aggressive lending by banks away from the consideration of what is the optimum level of loans in terms of their liquid liabilities or deposits. The loans of the banking system witnessed a substantial growth of 26 percent as against 18 percent increase in total deposits during CY05. Resultantly, the loans to deposit ratio surged to 70.2 percent from 65.8 percent in CY04 **(**see **Figure 6.3.2)**. After adjusting for export refinance, the credit to deposit ratio stayed at 66.4 percent. This increasing level of credit to deposit ratio though is a concern for liquidity if seen in the light of conventional benchmark, there are certain indicators, which mitigate the concern to a fair degree. Loans to total assets ratio at 54 percent is below the range beyond which the serious concerns regarding liquidity starts to crop up. Similarly, the liquid assets in terms of total assets, though squeezed to 33.7 percent from 36.5 percent in CY04, seem acceptable. The liquidity coverage ratio i.e. liquid assets to liquid liabilities, at 36 percent, is also reasonable.

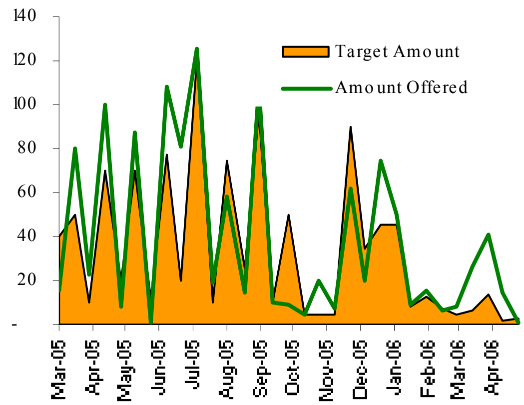
The average level of liquidity held by banks as against the statutory requirement is well above the required. The banks are still maintaining around 56 percent in excess of what is required under CRR and SLR, against their total time and demand liabilities **(**see **Figure 6.3.3)**. This excess holding of the banks liquid assets with SBP questions the apparent liquidity strain.

Figure-6.3.3: Liquidity Held by Banks



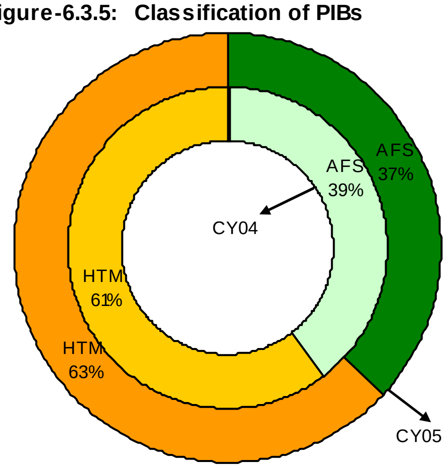
Moreover, the banks continued to actively participate in the MTBs auctions and the offered amount against the targeted amount for the MTBs auction remained on higher side **(**see **Figure 6.3.4)**.

Figure-6.3.4: MTBs Auction -Target Vs Offered Amount (In billio Rupees)



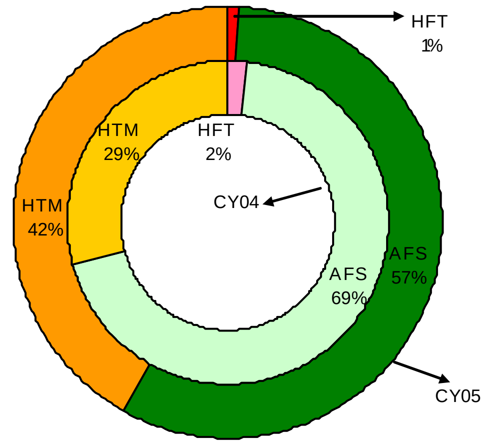
While the preceding liquidity indicators do not reflect any serious strain, there are certain classification strategies regarding the liquid assets, which tend to land banks in the stress situation. The concern arises when the liquid assets are not capable of providing enough liquidity. Around half of the liquid assets of the banking system are in the form of government securities. Such securities need active secondary market to be able to provide liquidity to its holder. However, the market-based liquidity is actually squeezing due to the lack of on-the-run securities i.e. the securities, which are actively tradable in the secondary market. Of the total investment portfolio of the banks, which constitutes around 22 percent of their total asset portfolio, around 67 percent constitute the tradable securities that mainly consist of market treasury bills (MTBs) and Pakistan investment bonds (PIBs). However, due to the shrinking of the trading portfolio of banks, following the introduction of three categories for classification of investments i.e. Held-for-Trading (HFT), Available-for-Sale (AFS) and Held-to-Maturity (HTM), the market-based liquidity has considerably declined. Of the total PIBs portfolio, more than 60 percent has been categorized under HTM, while under HFT category, the amount is insignificant **(**see **Figure 6.3.5)**. Since the amount of PIBs available for trading in the secondary market is negligible, the trading activity of these securities has been affected significantly. Moreover, in the absence of reflective benchmark yields for such securities, it is difficult for the holder of the security to find buyers in the

Figure-6.3.5: Classification of PIBs



secondary market to generate liquidity since the prospective buyers look for other options for their investments. However, MTBs provide some comfort in the form of market- based liquidity. Of the total MTBs portfolio, about 58 percent has been categorized under HFT and AFS, which fuels the secondary market activity **(see Figure 6.3.6)**. Hence, finding limited sources of liquidity from the secondary market, banks find it easy to go for inter-bank repos against such securities or to get such securities discounted from SBP to meet liquidity needs.

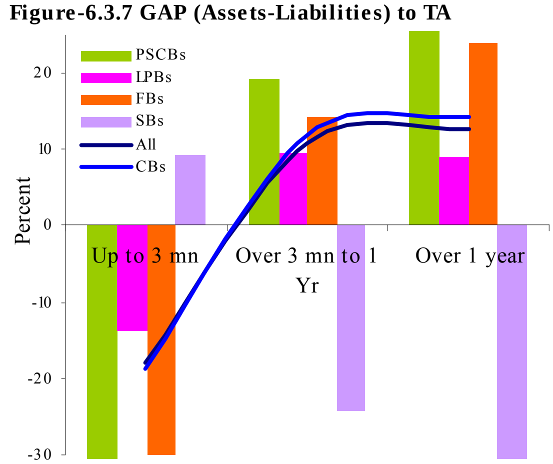
Figure-6.3.6: Classification of MTBs



Looking from another perspective, the policy announcement made in July 2004 regarding the classification of securities states that to classify securities under "Held-to-Maturity", the banks or DFIs should have the intention and ability to hold them till their maturities. However, the banks have moved their risky portfolio to the Held-to-Maturity category to avoid booking revaluation losses in the scenario of rising interest rates. While at the same time, to meet their short-term liquidity needs, they are also borrowing against their securities placed under HTM category. This questions their ability to hold such securities under this category. Once banks classify such securities as per their liquidity requirements, the market would have sufficient liquidity to fund their short-term obligations.

Funding liquidity risk is another concern given the fact that the maturity mismatches in the short term have been quite adverse **(see Figure 6.3.7)**. Significantly negative maturity GAP between assets and liabilities of banks is of due concern especially when the short-term interest rates are already under stress. The concern aggravates since the mismatches in terms of total assets are quite high. For three months bucket, the maturity GAP is around 18 percent of the total assets, which exceeds the acceptable limits. Group wise, the mismatch is more pronounced in PSCBs followed by FBs and LPBs. However, the large negative maturity GAP in three months is largely due to the chunk of current and saving deposits, which in the absence of contractual maturity are categorized here, and since a major portion of such deposits are never withdrawn, the negative GAP may actually appear a little exaggerated.

Figure-6.3.7 GAP (Assets-Liabilities) to TA



6.4 Operational Risk

The banking sector has gone through paradigm shift in recent years. Developments in processing and information technology, introduction of new and complex products, outsourcing, merger and acquisition have added to both the risks and rewards for the banking industry. In this scenario the importance of operational risk both in terms of volume and gravity has assumed significant importance. This requires better understanding of operational risk and adoption of relevant risk mitigation techniques.

Lack of adequate historical data necessary for analyzing the nature and severity of operational risk is a challenge faced by bankers and regulators. In order to minimize the threats emanating from operational failures, SBP has been gathering, on quarterly basis, the data on frauds and forgeries committed in the banking system. Though volume and frequency of frauds and forgeries do not represent the whole operational risk, but they give an important indicator for assessing the operational risk in the banks. During the year, the number of fraud and forgeries cases increased from 2482 to 2758 whereas amount recoverable against those cases grew from Rs3.8 billion to Rs4.5 billion **(**see **Figure 6.4.1)**. Resultantly, the amounts outstanding at the year-end as a percentage of last three years moving average reflected rising change in contrast to previous two years declining trend **(**see **Figure 6.4.2)**

Figure 6.4.1 Frauds & Forgeries in Banks

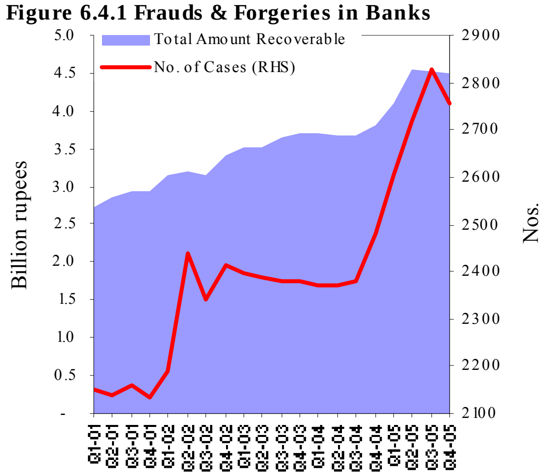
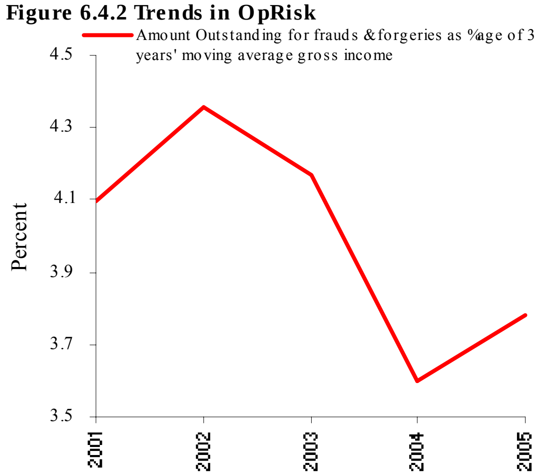


Figure 6.4.2 Trends in OpRisk



The data on frauds and forgeries is being collected under three categories namely serious fraud cases (Rs10 million and above), Medium Severity cases (Rs1-10 million) and Low severity cases (below Rs. 1 million). This comprehensive data would help SBP to remain informed about fraud and forgeries incidents, monitor follow up action, measure operational risk and determine capital requirement there against. The data submitted by banks revealed that proportion of serious fraud cases was 4.2% whereas amount involved there against was more than 67% of the total amount outstanding **(**see **Table 6.4.1).**

Table-6.4.1 Break up of fraud and forgeies for 2005

(Billion Rs)	No.of cases	Amount outstanding
Serious Fraud	116	3.0
Medium Severity	403	1.0
Low Severity	2239	0.4

SBP arranged a workshop in collaboration with a foreign based advisory firm for the banking industry and number of seminars for in-house stakeholders in continuation of its efforts to enhance awareness on operational risk, its identification, assessment, monitoring and mitigation/ control.

Keeping in view the importance of operational risk on the back of increasingly complex financial environment, and potential threat to banks capital, the Basel Committee has recognized it as an independent risk category under the new Basel II capital framework. Under the new accord, the committee has recommended specific capital charge for the operational risk. Accordingly, SBP, vide its recent Basel II draft circular, has encouraged banks to move along the spectrum of alternative methods to calculate operational risk capital approach depending on level of data availability and risk measurement systems and practices. However, at initial stages, banks are likely to opt for Basic Indicator Approach as there are no qualifying criteria for this approach and banks are expected to follow guidelines on operational risk issued in 2003.

7 Assets and Funding Structure

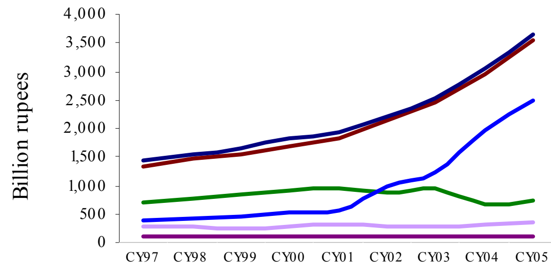
The banking system continued to grow strongly in CY05. The growth in total assets by 20.2 percent over-shadowed the extraordinary growth of 19.7 percent witnessed in CY04 (see **Figure7.1)**. The persistent increase in deposits remained the main stimulant; deposits accounted for 72 percent of the growth in total assets. Total equity, supported by healthy profits and capital injections on the back of enhanced MCR, and higher borrowings were the other major factors responsible for the unprecedented growth in total assets.

The main flow of funds remained towards loans, which, despite losing some pace as compared with the previous year, again grew very strongly. Consequently, the share of loans in total assets increased to 54.4 percent from 51.7 percent in CY04 (see **Figure7.2**). Notwithstanding the increase in volume, investment portfolio continued to lose its share because of the relatively faster increase in total loans of the banking system.

By growing at 25.4 percent, LPBs further strengthened their overall share in total assets. During the year, LPBs accounted for 81.5 percent of the increase in total assets. Resultantly, their share in total assets of the banking system also surged to 67.8 percent from 65.1 percent in CY04. The remaining groups are finding it hard to keep pace with the rapidly growing LPBs, and hence are witnessing gradual decline in their shares vis-à-vis LPBs.

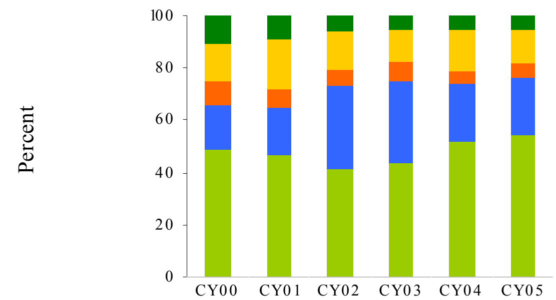
PSCBs, which used to dominate the banking scene till CY01, saw further shrinkage in their share to 19.8 percent from 21.5 percent in CY04. This happened as they observed a moderate growth of 10.9 percent, which is significantly below the industry's growth. The reason for relatively slower growth can be traced to the slackness exhibited by the largest bank in the group. The share could have declined even further if one of the banks in this group had not grown at a remarkable pace. In fact, this bank alone accounted for 63.1 percent of the increase in total assets of PSCBs.

Figure-7.1: Total Assets of Banking System



	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	697	789	844	902	947	878	959	653	724
LPBs	373	405	449	513	566	967	1212	1,980	2,483
FBs	269	263	253	281	324	280	272	304	339
CBs	1,339	1,458	1,545	1,696	1,836	2,125	2,443	2,937	3,546
SBs	97	98	109	112	106	98	100	106	113
All	1,436	1,556	1,654	1,808	1,942	2,223	2,542	3,043	3,659

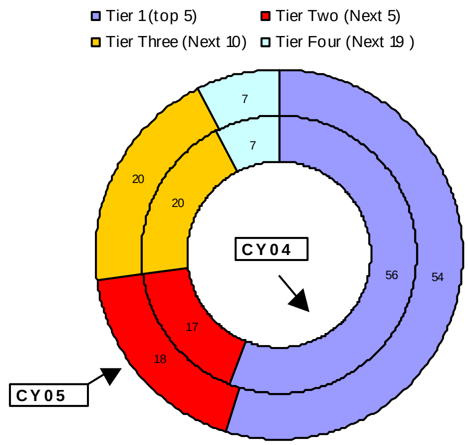
Figure-7.2: Composition of Banks' Total Assets



	CY00	CY01	CY02	CY03	CY04	CY05
Other Assets	10.4	9.4	6.4	5.2	5.1	5.2
Cash & Bank Balances	14.7	18.7	14.0	12.6	16.1	12.8
Lending to FIs	8.9	7.0	6.6	7.7	4.7	5.8
Investments	16.8	18.1	31.5	30.9	22.3	21.9
Advances	49.1	46.9	41.4	43.6	51.7	54.4

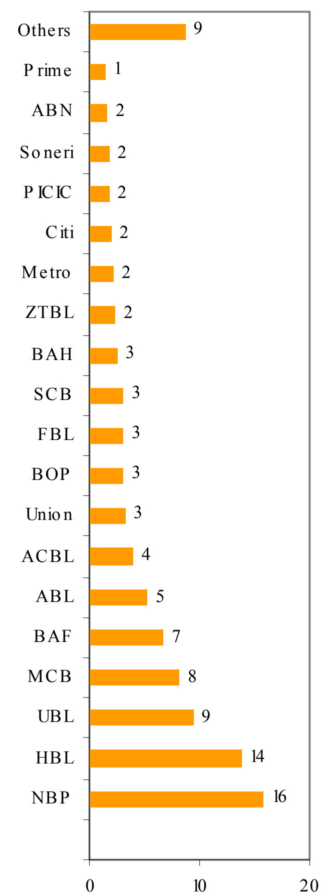
FBs grew at a rate of 11.6 percent, but also lost their share in the asset base of the banking system. It declined to 9.3 percent from 10 percent in CY04. The dwindling share of FBs finds its explanation in the relatively dormant performance by majority of the banks in this group. A deeper examination of the assets growth of this group reveals that 72.1 percent of the growth owes mainly to two banks. In fact, majority of the banks in this group are faced with the smallness of size, both in terms of assets and branch network, which serves a natural barrier to their growth. Of the 11 banks in this group, four banks account for 85.6 percent of its total assets reflecting highly skewed asset base.

Figure-7.3 Banks Tier-Wise



The disaggregated analysis shows concentration of assets into five large banks. These banks hold 54.1 percent of the total assets of the banking system (see **Figure 7.3**). However, this concentration is on a gradual decline. This is evident by the fact that top five banks held 56 percent of total assets in CY04, 58.9 percent in CY03 and 60.8 percent in CY02. While this insinuates growing competition in the banking system with expectations of further improvement in efficiency and delivery of services in the days ahead, the concentration is still very large. Out of the 39 banks, there are 20 banks which have an asset base below Rs50 billion, and hence reveal a considerably high degree of segmentation in the banking industry. These banks hold a mere 9 percent of the total assets of the banking system (see **Figure 7.4**). In view of the changing realities and growing burden in the form of enhanced capital requirements, the mutual survival of these banks depends on consolidation to compete with the giants of the industry.

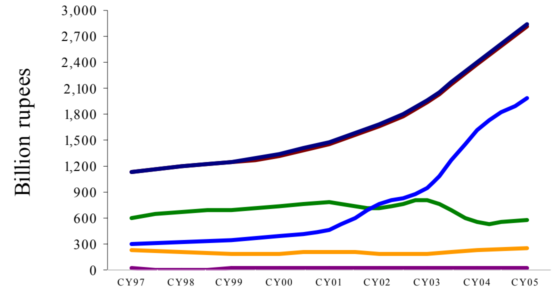
Figure-7.4: Share of Banks with Assets above Rs 50 Billions



Over the past couple of years, **deposits** have been the driving force behind the robust banking activities and their ultimate translation into higher profitability. The year under review was no exception as deposits, maintaining the strong momentum, grew at a rate of 18.4 percent as compared with 21.9 percent in CY04 (see **Figure 7.5**). While the growth looks lower in percentage terms because of the higher base effect, in absolute terms, deposits, by growing at Rs441 billion outstripped the healthy growth of Rs430 billion during the previous year. The major factors remained the unhindered inflow of workers' remittances, expanding branch network and persisting vibrancy in the economic activities.

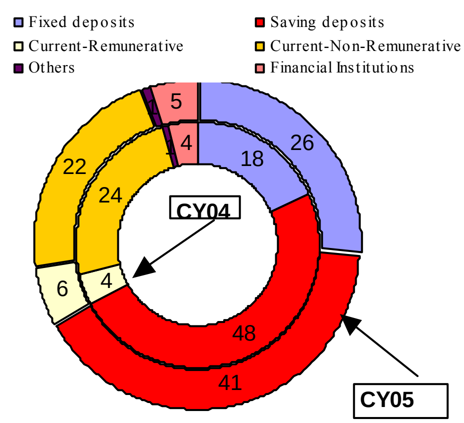
Except for SBs, all groups contributed to the deposits growth of the banking system. However, the share of LPBs, owing to their dominant size, was the most conspicuous. LPBs, by recording a growth of 24.4 percent, contributed an impressive 88.7 percent to the overall deposits increase. This led to an increase in their share in the deposits base of the banking system to 70.4 percent from 67 percent in CY04. PSCBs and FBs by growing at 6.1 percent and 7.9 percent were far behind the industry's average for deposits growth. The below par performance of these two groups is because of their heavy dependence on two banks each in these groups, and whenever they slacken in their growth, it impacts the overall standing of the two groups. Remaining banks in these groups are constrained by their extremely small size, which does not allow them to generate sufficient deposits to match the overall industry's pattern. In addition to the size factor, such banks also lack the matching managerial skills, marketing acumen, and growth orientation to come up with the attractive financial products.

Figure- 7.5: Deposits of Banking System



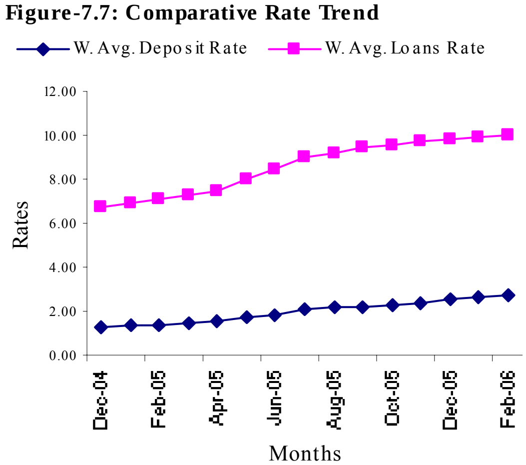
	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	597	659	701	744	795	722	799	545	578
LPBs	304	327	355	394	454	757	954	1,604	1,995
FBs	221	213	183	187	208	183	194	227	245
CBs	1122	1199	1239	1325	1457	1662	1947	2376	2818
SBs	13	11	14	16	18	16	17	17	16
All	1135	1210	1254	1341	1475	1678	1964	2393	2834

Figure-7.6: Deposits Structure



Recently, the use of information technology has also become a deciding factor in establishing the market share of different banks. In this respect, LPBs are not only out-maneuvering their competitors in other groups but are also engaged in intense competition among them by gradually enhancing their technology base. LPBs also include in their ranks two recently privatized large banks. Their private ownership seems to have awakened them from the long slumber and now they are resorting to aggressive marketing to take the benefits of their size and network.

Figure-7.7: Comparative Rate Trend



Deposits mix reflects significant increase in the share of fixed deposits (see **Figure 7.6**). It increased sharply to 26 percent from 18 percent in CY04, leading it to acquire the second position after saving deposits in terms of size in total deposits. Saving deposits, which continue to occupy the largest pie, declined significantly during the year. Similarly, the share of non-remunerative current deposits also declined, causing it to slip to the third position. The peculiar shuffle in the deposits structure appears to have corresponded to the slow but consistent uptrend in the rate of return offered on deposits during the year (see **Figure 7.7**). The weighted average deposits rates increased by 125 basis points (bps), which though looks lower if compared with an increase of 312 bps in weighted average lending rates, nevertheless entails higher opportunity cost of keeping deposits in low yield current and saving deposits, thus stimulating significant growth in fixed deposits and the eventual increase in their share of the deposits pie.

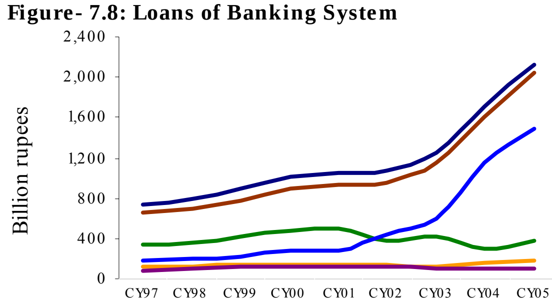
The share of top six banks in each deposit category brings to fore an interesting aspect pertaining to low rate of return being offered on deposits. While the share of these banks in fixed deposits is 56 percent, their share in saving and non-remunerative current deposits is quite high at 73 percent and 65 percent, respectively. As the return on saving deposits is quite negligible and current deposits do not carry any return, the huge share of these banks in these deposits categories renders the overall return on total deposits of the banking system quite low. This fact leads to the conclusion that the overwhelming presence of these top six banks in every nook and corner of the country helps them to mobilize more funds at significantly low return. This causes the overall return on deposits quite low.

While deposits have always been the main source of funds, the rapidly rising **capital** of the banking system in recent years has also been an important source. This is reflected by an increase of Rs86 billion in the total capital of banks in CY05 as compared with an increase of Rs62 billion in CY04. The rising contribution of capital is because of the banks' practice to plough back major share of their heavy profits into the system as they are vying to augment their capital base to meet the enhanced capital requirements.

In the wake of relatively tighter monetary policy and the consequent liquidity pressures as well as growing business operations, the banking system's appetite for more funds also increased. This resulted in increase in **borrowings** of the banking system by Rs51.3 billion in CY05. The significant portion of the increase i.e. 81.8 percent came from borrowings under repurchase agreement. The borrowings under export refinance also increased but witnessed deceleration as compared with the strong growth in the preceding year.

The **loan** portfolio of the banking system grew at a relatively lower rate of 23.7 percent in CY05 as compared with that in CY04. The slow down, however, was inevitable because of the huge intake of loans by the industry in CY04, which significantly inflated the base. Moreover, the gradual increase in interest rates on the back of tighter monetary policy also rendered loans more expensive leading to relatively lower demand from the corporate sector.

Figure- 7.8: Loans of Banking System



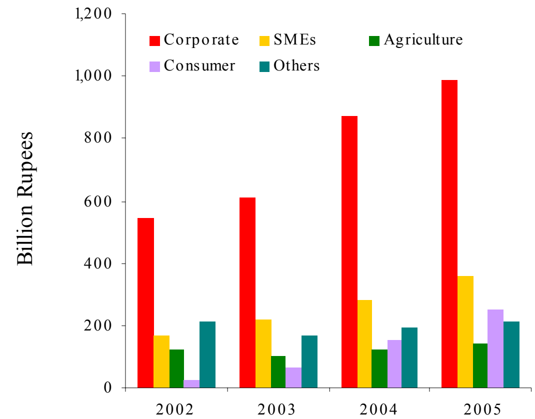
	CY97	CY98	CY99	CY00	CY01	CY02	CY03	CY04	CY05
PSCBs	345	365	419	476	501	374	422	302	379
LPBs	183	198	224	282	281	435	597	1,153	1,486
FBs	124	126	129	138	143	135	127	162	171
CBs	652	689	772	896	926	945	1146	1616	2036
SBs	83	103	118	124	118	117	97	99	91
All	735	792	890	1020	1044	1062	1243	1715	2126

Notwithstanding the relative slow-down, the growth of Rs411 billion in loans is still very high (see **Figure 7.8**), which is reflective of the enduring upbeat mood of the economy and persistent demand for credit despite higher lending rates. As mentioned in the deposits section, the funds inflow into the system remained very strong, enabling the banking system to extend credit to various segments of the economy despite the growing liquidity pressures. While lending rates exhibited persistent upward trend during the year, high rate of inflation rendered the real interest rate quite low and hence demand for credit remained rather strong.

LPBs remained in the forefront in terms of loans growth. By growing at a rate of 28.9 percent, they contributed 81 percent to the overall loans growth. This led to increase in their share of total loans to 70 percent from 67 percent in CY04. The share of PSCBs increased fractionally as their loans grew at the rate of 25.4 percent. In a sharp contrast to LPBs and PSCBs, loans of FBs increased at a very low pace of 5.9 percent leading to a fall in their share in total loans to 8 percent from 9 percent in CY04.

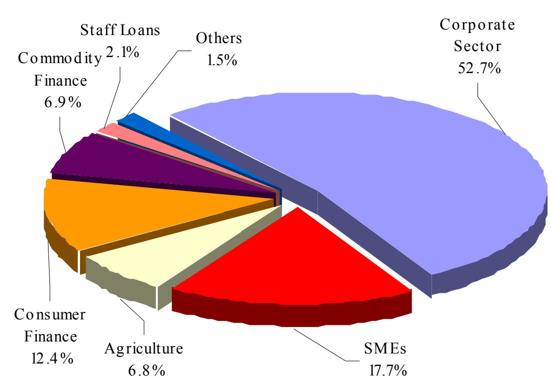
Over the past couple of years, the banking system has increasingly resorted to broad-basing its loans portfolio, which is not only favourable in context of risk diversification but has also helped in generating alternative and more productive avenues of earnings. In CY05, the growth in loans once again remained diversified and, for the first time, more than 50 percent of the loans growth went to finance activities other than those of the corporate sector (see **Figure 7.9**).

Figure-7.9: Sector-wise Loans Trends
(Domestic Operations)



The demand for loans has a direct correlation with the industrial activities, and compared with the preceding year, these are believed to have moderated during CY05. Consequently, corporate sector's demand for bank loans also reflected marked decline. As compared with the increase of Rs266 billion in CY04, loans to corporate sector increased by Rs203 billion, showing a decline to 48 percent in the loans growth from 58 percent in CY04. Consequently, the share of corporate sector in the outstanding loans of all banks also declined to 52.7 percent from 53.9 percent in CY04 **(see Figure 7.10)**.

Figure-7.10 : Loans by Type of Borrowers-CY05
(Domestic Operations)

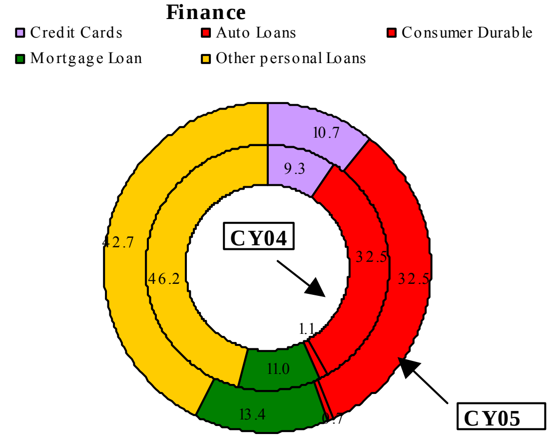


While the corporate sector's demand for bank loans decelerated, other sectors kept up the strong momentum of the preceding years. In this respect, the role of consumer financing remained very noticeable. With the growth of 66 percent, the share of consumer financing in total loans of all banks climbed to 12.4 percent from 9.4 percent in CY04. In the total loans growth, the share of consumer financing was 23.7 percent, second only to corporate sector.

The fast growing consumer loans portfolio owes to the combination of both the demand as well as supply side factors. On demand side, it depicts growing appetite of the consumers motivated by healthy incomes and intensive marketing campaigns of banks. Consequently, the significant rise in interest rates on such loans so far has not diluted their demand. On the supply side, banks have found an important avenue to generate higher incomes because of relatively high return on consumer loans. So far, lower default rate on consumer finance may have been encouraging banks to continue to grow in this area. Moreover, lower risk weight to consumer finance under Basel II (which would be implemented by January 2008) may also be described another motivating factor for banks to expand their exposure in this important sector.

Further analysis of consumer finance shows that personal loans with 42.7 percent continue to have the dominant share. This share, despite the highest increase in absolute terms in CY05, declined from 46.2 percent in CY04 (see **Figure 7.11**). This is because of the cumulative faster increase in other types of consumer finance.

Figure-7.11: Category-wise Consumer Finance



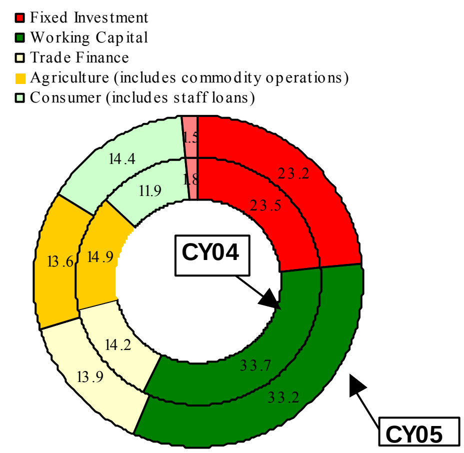
In percentage terms, mortgage finance exhibited the highest growth of 103 percent leading to significant increase in its share in consumer finance to 13.4 percent from 10.9 percent in CY04. The rapid rise appears to be the outcome of a number of policy measures including the removal of the maximum per party limit of Rs10 million during CY05.

Credit cards also exhibited strong growth of 92 percent leading to increase in its share in consumer finance to 10.7 percent from 9.3 percent in CY04. The increase corresponds to the growing competition as banks resort to aggressive marketing to increase the number of cardholders. The wider use and acceptability of credit cards in retail transactions has also helped in the fast growth in financing against credit cards. This is because of the entry of new banks as well as rising number of cardholders. The share of consumer durables, despite witnessing a slight increase squeezed further in CY05 because of much faster growth of the other segments of consumer loans.

The growth in auto loans has been at the heart of fast expansion in consumer loans in recent years. In terms of their size in total consumer loans, auto loans occupy the second place with 32.5 percent share. In absolute terms, the increase in auto financing was higher as compared with that in CY04, however, the momentum of growth showed weakness. This is apparent by a rise of 66 percent in CY05, which is well below the growth rate of 123 percent witnessed in CY04. The slackened momentum perhaps is the outcome of SBP’s restriction on financing of premiums as well as rise in lending rates to which auto financing appears to be more sensitive.

The relatively slower-growth in corporate financing also caused a minor change in the end-use distribution of loans of the banking system (see **Figure 7.12**). Despite showing healthy growth, the respective shares of loans for fixed investment, working capital and trade activities declined slightly. The main reason again is the faster growth in consumer financing (including staff loans). However, the persistent growth in loans for fixed investment is a positive indication for the expanding productive capacities, which would help the economy to remain on a persistent growth path.

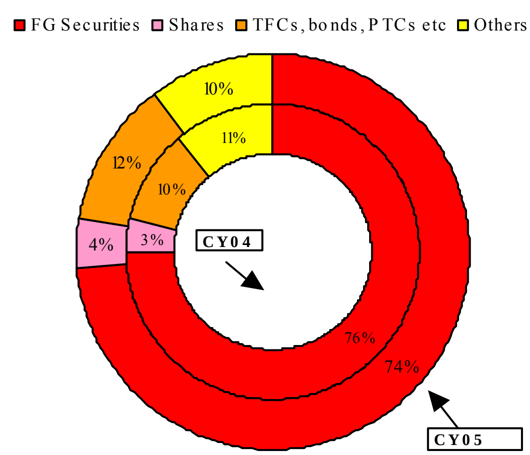
Figure-7.12: End-Use Distribution of



In a sharp contrast to CY04, **investments** portfolio of the banking system saw a significant rise in CY05. During the year, total investments of the banking system grew by 18.6 percent as compared to the fall of 14.3 percent in CY04. Resultantly, total investments of the banking system increased to Rs804.1 billion from Rs684.6 billion in CY04. The possible reason for the reversal of downward trend owes to relatively slower growth in loans and attractive return on the government securities following SBP's efforts to control inflationary pressures as well as high inflow and increase in capital. This is visible by the sharp growth in the portfolio of government securities. By growing at a rate of 15 percent, investment in government securities increased to Rs591.3 billion from Rs514.1 billion in CY04. The government securities, which occupy the largest chunk of banks' overall investment portfolio (see **Figure 7.13**), contributed 65 percent of the growth in total investments. However, the growth was not restricted to investment in government securities. It was across the board and other components like investment in shares and TFCs also witnessed substantial growth. This is evident by increase in their respective shares in total investments.

The break-up of the government securities shows that MTBs played the key role in their growth. With an increase of Rs112.9 billion, MTBs managed to offset the decline witnessed by PIBs and FIBs. Resultantly, the share of MTBs in the total government securities of the banking system increased to 64.3 percent from 52 percent in CY04. On the other hand, PIBs' share declined to 25.9 percent from 31.2 percent in CY04. The contrasting trend in the two securities is because of the absence of any auction of PIBs for a considerable period now, thus leading to a steady downward movement in the PIBs holding of the banking system. Finding limited alternatives, banks resorted to heavy investments in MTBs. However, the auctions of PIBs in future are expected to increase the banks' portfolio of these securities.

Figure-7.13: Break-Up of Investments



Group-wise, LPBs and FBs were in forefront in giving boost to investment in government securities. LPBs registered a growth of Rs39.2 billion while FBs followed them closely with a growth of Rs36.9 billion. Considering their overall size vis-à-vis LPBs and PSCBs, the contribution by FBs looks extraordinary. The slower growth in their loans appears to be the main reason. Moreover, FBs have traditionally been more inclined to investing in the government securities and the rise in yields in recent times have made them an attractive avenue for deploying funds as FBs tend to be cautious in lending activities. SBs were also very active in this area as they increased their holding of the government securities by Rs8.5 billion. PSCBs, however, witnessed a decline of Rs7.4 billion during the year.

8 Overseas Operations of Pakistani Banks[8]

The strengthening in the financial condition of Pakistani banks as well as the increasing competition in the domestic market has been encouraging the Pakistani banks to explore the international market. During CY05 two new banks branched out into the international market, raising the number of internationally active banks to eight. However, the three large banks hold the largest share of system's overseas assets which constitute around 7 percent of the system's total assets (see **Figure 8.1**). Pakistani banks have presence in almost all the regions of the world barring Latin America, however, 60 percent of Pakistani banks overseas assets are concentrated in Middle East (see **Figure 8.2**).

Figure-8.1: Bank-wise Share in Overseas Assets-CY05

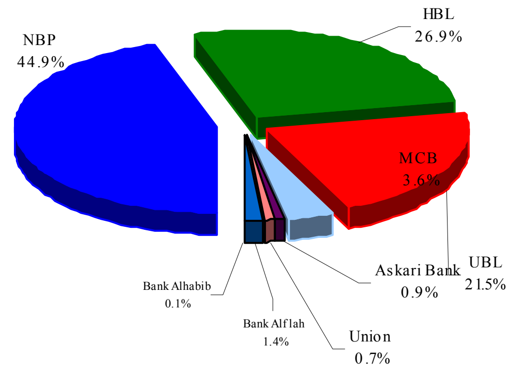
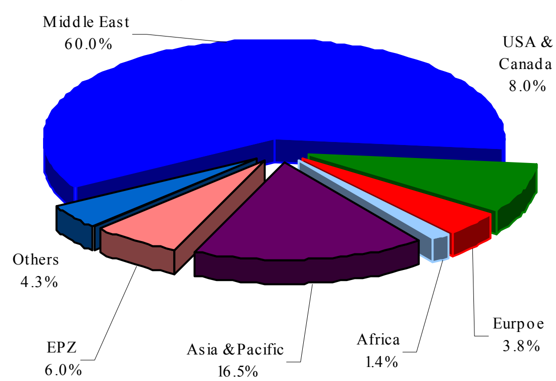


Figure-8.2: Geographical Distribution of Banks' Overseas Assets, CY05



Pakistani banks in overseas markets are pursuing relatively more conservative banking strategy where lending activity remains passive while bank balances and interbank placements constituting the major chunk of the balance sheet footing (see **Table 8.1**). This conservative strategy eventually reflects in the modest pre-tax ROA of 1.8 percent as compared with commercial banks' overall pre-tax ROA of 2.9 percent. The asset quality indicator for the overseas operations, on the other hand, does not correspond with this conservative business strategy. NPLs to Loan ratio of 18.8 percent for overseas operations is quite higher than then commercial banks' global ratio of 6.7 percent. These NPLs are however adequately covered with Net NPLs to Loans ratio of 3.8 percent, and have some peculiarities with regard to specific banks and countries of operations. The operations in Export Processing Zone (EPZ) and UAE account for three forth of the total overseas NPLs while they contribute around 40 percent of total loans portfolio.

Table-8.1: Composition of Overeas Assets & Liabilities

(Percent of Total Assets)	CY01	CY02	CY03	CY04	CY05
Cash and Bank Balances	48	39	38	45	41
Lending to Financial Institutions	1	1	0	0	1
Investment	11	15	16	15	18
Loans	28	30	34	32	35
Other Assets	12	15	11	6	5
Total Assets (Billion Rs)	255	230	216	261	252
Deposits	63	61	67	69	70
Borrowings	8	8	7	4	1
Other Liabilities	23	23	15	17	17
Capital	7	8	11	10	12

Since the banking regulations, scope of operations and resultant performance indicators vary from country to country depending on level of its economic development, the forthcoming paragraphs dilate upon the overseas operations of Pakistani banks in developing and developed markets.

[8] Branch operations

Developing Markets

The overseas operations of Pakistani banks to a great extent are concentrated in developing markets which contribute four-fifth of the total overseas assets. These markets are emerging economies and present promising business opportunities and provide a number of competitive advantages. They have a number of untapped sectors which hold ample growth potential, less-matured banking system, relatively lenient regulatory requirements, and a sizeable Pakistani community, especially in the Middle East.

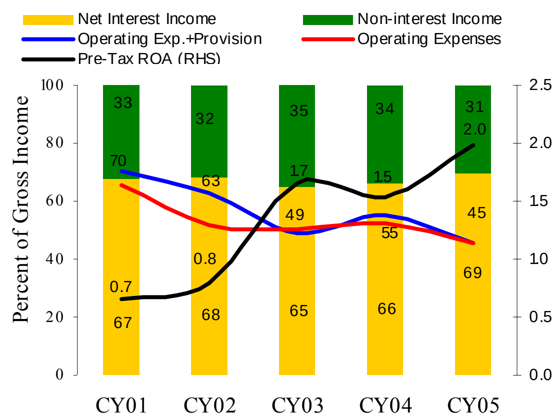
Generally, Pakistani banks in the developing markets are following more of a conventional banking approach with greater focus on loans and advances which constitute 39 percent of the total assets and show a persistently growing trend over the years (see **Table 8.2**). The individual banks' strategy as to target clientele is quite disparate ranging from focus on Pakistani blue chips to selective targeting of mid segment customers and consumer banking.

Table-8.2: Composition of Overeas Assets & Liabilities in Developing Markets

(Percent of Total Assets)	CY01	CY02	CY03	CY04	CY05
Cash and Bank Balances	48	37	38	39	38
Lending to Financial Institutions	1	1	0	1	1
Investment	13	17	18	17	18
Loans	31	32	37	39	39
Other Assets	6	12	8	5	4
Total Assets (Billion Rs)	208	185	176	195	208
Deposits	66	64	69	71	73
Borrowings	10	10	9	5	1
Other Liabilities	19	18	12	14	14
Capital	6	8	10	10	12

This business strategy reflects in the income composition and the bottom line ROA of this segment. The net interest income contributes the dominant share of the gross income which is well supported by non-interest incomes. The income structure has been showing a stable composition and following a gradually rising trend. On the expense side, improvements in operating efficiency and better risk management practices are giving contained operating expenses and loan loss charges. Both these expenses consume less than half of the total gross income, leaving an ample profit margin. A pre-tax ROA of 2.0 percent, which is well above the developed markets' ROA of 1.1 percent, depicts the overall strengthening in profitability (see **Figure-8.3**).

Figure-8.3: P&L Composition in Developing Markets



Developed Markets

The Pakistani banks' operations in developed markets are passive in nature and form only one fifth of overseas assets portfolio. These markets offer constrained growth opportunities as these are characterized by tough competition, stiffer regulatory requirements, and fully matured economic system which entail few opportunities to build lending clientele. Therefore, Pakistani banks mainly focus on interbank placements and lending remains minimal. The overall asset base also shows more or less a stagnant position. Though total assets registered a significant growth last year, this was transitory in nature relating to SBP's

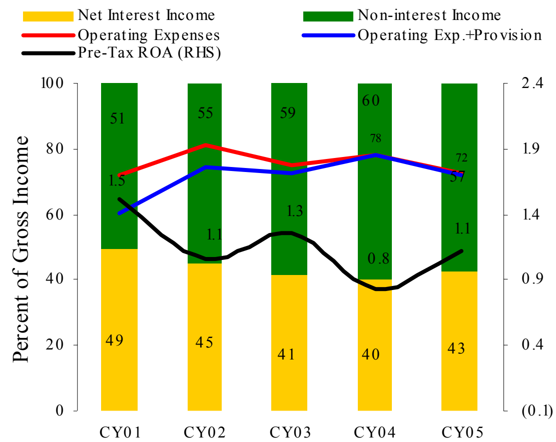
Table 8.3: Composition of Overeas Assets & Liabilities in Developed Markets

(Percent of Total Assets)	CY01	CY02	CY03	CY04	CY05
Cash and Bank Balances	46	43	40	66	55
Lending to Financial Institutions	-	-	-	-	-
Investment	2	6	9	11	17
Loans	14	22	23	13	19
Other Assets	37	28	28	10	9
Total Assets (Billion Rs)	47	45	40	66	44
Deposits	49	45	60	65	54
Borrowings	1	1	1	2	3
Other Liabilities	40	44	25	23	28
Capital	10	10	14	9	15

deposits for onward payment to bilateral agencies (see **Table 8.3**).

The conservative business strategy of subdued lending activities also translates into the income composition of the banks. Non-interest income forms more than half of the total gross income while the contribution of net interest income remains low. And mainly due to constrained income base, the cost-income ratio remains high at 72 percent (see **Figure 8.4**). The low profit margin however remains immune from loan loss charges as the mute lending activities in developed markets result in remarkable asset quality.

Figure-8.4: P&L Composition in Developed Markets



The Pakistani banks in the overseas markets are focusing on limited areas and have not yet fully exploited the potentials both in terms of income generation and establishing a significant presence in the global market. The recent benign years at home have added to their strength and enhanced their capacity to venture into profitable venues. They are now in a better position to enter the promising areas of the global financial market which are fast growing and are yet to be fully tapped. This will not only benefit these banks but will also boost the foreign trade of the country and help in maintaining the prevailing high level of economic activity.

9 Performance of Islamic Banking

Islamic banking continued to show impressive growth during the period under review. This is reflected by growing branch network of Islamic banks (see **Table 9.1**). Growing at a rate of 59.1 percent, total number of branches increased to 70 in CY05 from 44 in CY04. Two foreign banks having 5 Islamic Banking Branches (IBBs) are also part of this overall improved position.

The growing interest in Islamic banking is also evident by the entry of new Islamic banks. In addition to existing full-fledged Islamic banks namely Meezan Bank, AlBaraka Bank, three new Islamic banks namely Bank Islami Pakistan Limited, Dubai Islamic Bank Pakistan Limited and Emirates Global Islamic Bank Limited were granted licenses to start their operations in the CY05, out of which Bank Islami Pakistan Limited and Dubai Islamic Bank Pakistan Limited have since started their operations in the first quarter of the CY06. SBP has also recently issued license to First Dawood Islamic Bank Limited. As far as the expansion of existing operational institutions is concerned, the two full-fledged Islamic and six conventional banks have since been granted licenses for 27 and 17 branches respectively to be opened during CY06. This will further increase their outreach.

Table-9.1: Islamic Banking Players

	Dec-02	Dec-03	Dec-04	Dec-05
No. of Islamic Banks (IBs)	1	1	2	2
No. of Branches	6	10	23	37
No. of conventional banks operating Islamic Banking Branches	-	3	7	9
No. of Islamic Banking Branches (IBBs)	-	7	21	33

In view of expanding branch network, the balance sheet footing of the Islamic banking industry kept on increasing. The total assets growing at a very healthy rate of 62.0 percent reached to Rs71.5 billion in CY05 from Rs44.1 billion in CY04 (see **Table 9.2**). Since the assets of the country's banking industry as a whole also grew at a very impressive rate of 20.2 percent, the share of Islamic banking assets as percentage of overall banking assets increased to 2.0 percent from 1.5 percent last year. Likewise, the other two important components of the balance sheet i.e. deposits and financing as percent of overall deposits and financing of the banking system increased to 1.8 percent and 2.3 percent in CY05 from 1.3 percent and 1.7 percent respectively in CY04. The prominent position of deposits as main source to finance the assets can not be overemphasized. In absolute terms, deposits grew by Rs19.7 billion to Rs49.9 billion from Rs30.2 billion in CY04 and its share in overall sources remained around 70 percent. On the asset side, financing continued to remain the main activity. The major chunk of funds was deployed for core business activity of financing, thereby increasing its share in overall assets from 62.4 percent to 64.0 percent. The share of investments, on the other hand, registered a decline from 4.5 percent to 2.6 percent, which may be due to lack of Shariah compliant investment products and comparatively faster pace of growth in financing activities.

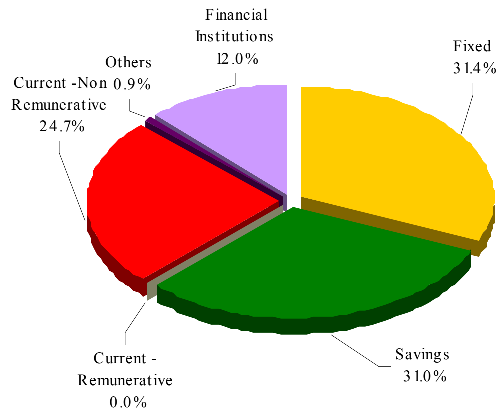
Table-9.2: Sources and Uses of Funds (Million rupees)

	2003		2004		2005	
SOURCES:	Amount	Percent	Amount	Percent	Amount	Percent
Deposits	8,397.1	65.0	30,184.8	68.4	49,931.8	69.8
Borrowings	1,899.0	14.7	6,559.1	14.9	9,005.8	12.6
Capital & other funds	1,993.7	15.4	5,123.1	11.6	7,811.0	10.9
Other liabilities	624.8	4.8	2,276.1	5.1	4,744.8	6.6
	12,914.6	**100.0**	**44,143.0**	**100.0**	**71,493.4**	**100.0**
USES:						
Financing	8,652.2	67.0	27,535.5	62.4	45,786.2	64.0
Investments	1,242.3	9.6	2,007.0	4.5	1,854.2	2.6
Cash, bank balance, placements	1,978.5	15.3	11,899.7	27.0	19,314.3	27.0
Other assets	1,041.7	8.1	2,700.8	6.1	4,538.7	6.3
	12,914.6	**100.0**	**44,143.0**	**100.0**	**71,493.4**	**100.0**

Because of the dominant position of advances on asset-side, the credit to deposit ratio was around 90 percent. This at the same time exposes the industry to a fairly high degree of credit risk. But given the consistent low infection ratios, the possibility of financing going bad is remote in near future. On the liquidity front, they are consistently meeting their CRR and SLR requirements and significant amount is kept as cash and balances with other banks.

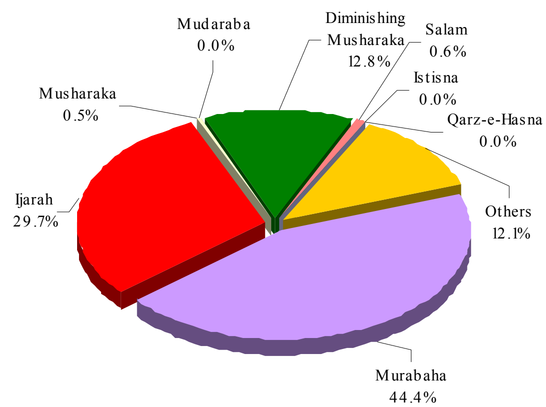
The deposit structure depicts major changes; the share of saving and current-non remunerative deposits have declined from 40.7 percent and 25.8 percent in CY04 to 31.0 percent and 24.7 percent respectively in CY05 (see **Figure 9.1**), whereas the share of fixed deposits and financial institutions deposits increased from 28.3 percent and 4.1 percent last year to 31.4 percent and 12.0 percent respectively this year. The shifting deposits mix is indicative of customers' growing trust in the Islamic banking products as they are becoming more eager to engage in long-term relationship with Islamic banks.

Figure-9.1: Composition of Deposits



The break-up of financing as per various Islamic modes shows the continuous predominance of Murabaha and Ijara financing, having their share of 44.4 percent and 29.7 percent respectively (see **Figure 9.2**). However, as compared to last year the share of Murabaha has decreased by 12.7 percentage points and that of Ijara has increased by 4.9 percentage points. The Diminishing Musharaka has also started to increase its share, which shows the eagerness on the part of Islamic Banking Institutions (IBIs) to diversify their financing portfolio.

Figure-9.2: Modes of Financing



The peculiar trends in the funding and financing structures also had their impact on the key performance indicators. Since the capital of the Islamic banking system grew at a lesser rate of 52.5 percent as compared to the assets growth, the capital to total assets ratio slightly decreased to 10.9 percent from 11.6 percent. The ratio, however, is still more than double the generally accepted benchmark of 5 percent. The capital coverage ratio[9], which reflects the position of capital after accounting for the uncovered portion of non-performing financings (NPFs,) also slightly deteriorated to 10.8 percent from 11.5 percent. Net NPFs to capital ratio remained contained at 1.2 percent due to more prudent credit policy being pursued and strong profitability during the period under review. Capital adequacy ratios for the Islamic banking branches (IBBs) and Islamic banks at 13.1 percent and 13.7 percent respectively are also well above the generally accepted benchmark of 8 percent.

[9] Capital (free of net NPFs) to total assets.

With the growing operations and fast expanding financing portfolio, the occurrence of non-performing financing is inevitable. During the year, NPFs increased from Rs258.3 million to Rs480.3 million resulting into an increase in ratios of NPFs to total financing and net NPFs to net financing to 1.0 percent and 0.20 percent in CY05 (see **Table 9.3**) from 0.9 percent and 0.17 percent[10] respectively in CY04. But these ratios are still very low and do not carry significant threat to the financial soundness of IBIs. Moreover, IBIs have to exercise extra safety measures for the financing portfolio, keeping in view the fact that Shariah-based modes of financing require that any late payment fee recovered from clients could only be used for charitable purposes.

Table-9.3: Key Performance Indicators

Indicator	2003	2004	2005
NPFs to total financing	0.7%	0.9%	1.0%
Net NPFs to net financing	0.0%	0.2%	0.2%
Provision to NPFs	100.0%	82.3%	80.6%
Net Markup Income to total assets	1.7%	1.4%	2.3%
Non Markup Income to total assets	2.2%	1.4%	1.7%
Operating Expense to Gross Income	54.6%	65.3%	49.9%
ROA (average assets)	2.2%	1.2%	1.7%
Growth in Assets	84.5%	241.8%	62.0%
Growth in Deposits	64.6%	259.5%	65.4%
Growth in Financing	147.0%	218.2%	66.3%

The Islamic banks have also started to produce very healthy profits. In view of higher volume of business, profitability indicators have also improved markedly. In fact, the rate of growth in profits, 185.1 percent in CY05, outstripped the high growth witnessed in total assets. The surge in profits is reflected in an improved ROA of 1.7 percent from 1.2 percent in CY04. This is also apparent from the ratio of net mark-up income to total assets, which improved to 2.3 percent from 1.4 percent in CY04. Resultantly, the share of non-mark up income, despite an increase in total non-interest income, declined to 38.1 percent in CY05.

The common sized income statement shows that profit after tax in terms of mark-up income slightly reduced mainly due to increase in the share of interest and tax expenses, and decrease in non-mark-up income (see **Table 9.4**), but in absolute and growth rate terms the figures show promising results.

Table-9.4: Income Statement

(Million rupees)

	2003		2004		2005	
	Amount	Percent	Amount	Percent	Amount	Percent
Markup Income	406.4	100.0	1,081.0	100.0	3,164.3	100.0
Markup Expense	188.5	46.4	483.7	44.8	1,542.3	48.7
Net Markup Income	217.9	53.6	597.2	55.2	1,622.0	51.3
Provision Expense	(15.8)	(3.9)	36.0	3.3	175.6	5.5
Non Markup Income	287.4	70.7	596.0	55.1	1,206.6	38.1
Operating Expense	276.0	67.9	779.0	72.1	1,410.5	44.6
Profit Before Tax	245.0	60.3	378.2	35.0	1,242.6	39.3
Tax	27.0	6.6	36.2	3.4	265.2	8.4
Profit After Tax	218.0	53.6	342.0	31.6	977.4	30.9

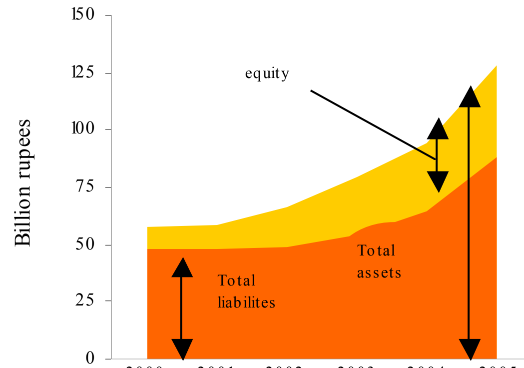
The overall performance of the Islamic banking industry remained encouraging and the key indicators depicted healthy trends in CY05, auguring well for the future growth prospects. However, the industry will have to focus keenly on the proper appraisal and monitoring of its financing portfolio in the wake of rapidly rising financing to stop any further rise in the NPFs considering its negative connotations for the industry's profits and solvency. While the systems will have to be strengthened further, human capital will also require to be trained in Islamic banking products to exploit the great potential of the market.

[10] This slight deterioration is mainly attributable to the inherited infections of some of the branches of conventional banks.

10 Development Finance Institutions

In line with the general trend of the financial markets, the performance of DFIs improved substantially during the year under review. The major variables depicted strong growth over the year, and there appeared to be increasing dynamism in the activities of major DFIs.

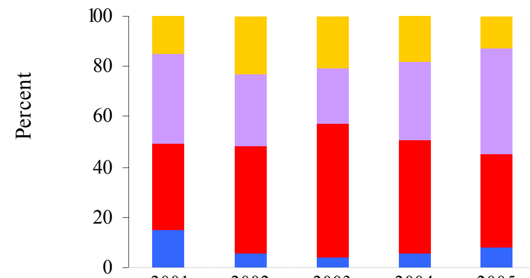
Figure-10.1: Balance Sheet Expansion



	2000	2001	2002	2003	2004	2005
Total Assets	58	59	66	79	95	128
Total liabilites	48	48	49	54	65	88

Total assets exhibited sharp growth by 35 percent or Rs33 billion during the year **(see Figure 10.1)**. In this respect, reclassification of certain institutions also affected the assets structure of DFIs[11]. By isolating the impact of these institutions for both years, we find that the remaining DFIs still performed well in terms of growth in their assets. Total assets of the remaining DFIs grew at a rate of 29 percent, which is even higher than the impressive growth of 19 percent in CY04. Such an extraordinary surge in total assets portfolio of DFIs was underpinned by outstanding growth in deposits as well as in equity.

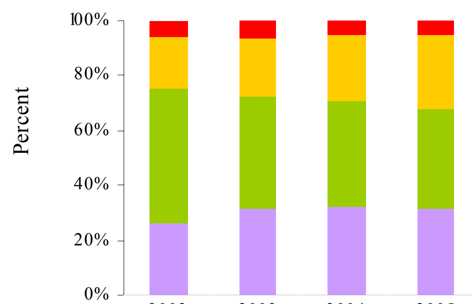
Figure-10.2: Composition of Assets



	2001	2002	2003	2004	2005
Other Assets	15.1	22.8	20.5	17.9	12.5
Loans	35.7	29.0	22.3	31.1	41.9
Investments	34.5	43.0	52.8	45.8	37.7
Cash & Bank Balances	14.7	5.2	4.4	5.2	7.9

The asset mix also shows positive trend with the persistent rise in loans share on the back of increased appetite for loans due to growing economic activities (see **Figure 10.2**). The share of loans in total assets increased to 41 percent (38 percent isolating the impact of reclassification), displacing investment from the dominant position.

Figure-10.3: Share of Sources of Funds



	2002	2003	2004	2005
Other Liabilities	6	6	5	5
Deposits	19	21	24	28
Borrowings	49	41	39	36
Total Equity	26	32	32	31

The liability side also displayed encouraging trend as the share of deposits increased to 28 percent of total assets depicting a growth of 54 percent over the year (see **Figure 10.3**). Historically, DFIs have remained hamstrung in mobilizing deposits because of the absence of level playing field, limited market for COIs and small branch network. The strong growth this year calls for sustaining of the trend, as DFIs will have to be more aggressive in marketing campaign not only to hold on but also to build on the achievements of

[11] While one institution, following its restructuring, was ranked among the specialized banks, another public sector housing finance company was classified as DFIs. The inclusion of this bigger sized institution also underpinned the strong growth in total assets of DFIs.

CY05. This is because of the fact that the share of deposits is still slender despite the substantial improvement during the year.

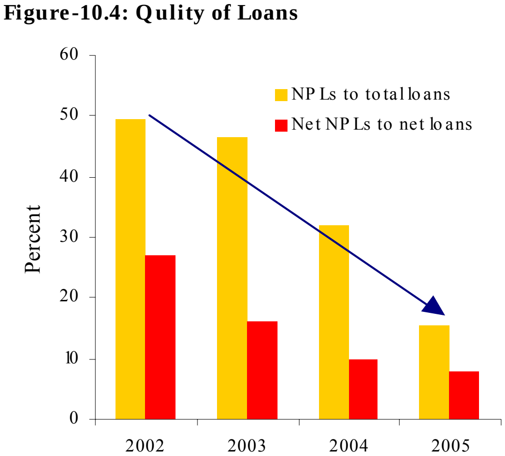
The borrowings despite losing a few percentage points continue to remain the main source of funds. Notwithstanding the fall in share, total borrowings in absolute terms increased by Rs14 billion. In fact, the major part of this increase is on account of the inclusion of new institution. The rest of DFIs recorded an increase of Rs4 billion, which does not appear very significant if we look at the growth in deposits. The high share of borrowings implies higher cost of funds for DFIs, and amidst the rising interest rate scenario overly dependent DFIs may possibly compromise their future earnings streams. The developing macroeconomic environment signals relatively higher liquidity pressures in future, and hence DFIs' ability to generate funds at favourable rates may come under pressure. This can pressurize the balance sheets of DFIs causing a squeeze in their operations. Therefore, DFIs need to diversify their resource base to reduce reliance on borrowings.

While over-dependence on borrowings generates pressures, the rapidly rising capital provides some mitigating effects. With the rising profits and capital injections, total capital of DFIs grew at the rate of 33 percent in CY05. This has not only proved salutary for the expansion of DFIs' business but has also helped in improving their solvency profile. The rising capital has helped DFIs in checking any significant erosion in capital adequacy ratio (CAR) in the wake of fast expansion in their high risk-weighted assets. The CAR and tier-1 capital to risk-weighted assets ratio stood at 32 percent and 29 percent respectively, considerably higher than the benchmarks.

As a result of improvement in clientele, multiplication in financial products menu, efficient marketing coupled with sharp rise in demand for loans relating to consumer, leasing and project financing, the loans portfolio of DFIs increased at a very fast pace. A growth of 52 percent, isolating the impact of reclassification, by all means is very impressive and indicates that DFIs are coming out of the logjam they were in, a couple of years back.

In the past, poor quality of assets used to characterize DFIs operations. However, they have seen significant turn around in recent years. This is evident by very low infection level against fresh loans. Against the rise of Rs14 billion in loans, gross NPLs have increased merely by Rs0.2 billion[12] indicating strengthening credit appraisal and monitoring standards. Including the impact of reclassification, the overall NPLs position shows a decline of Rs3 billion over the year. With the decline in total NPLs and rapid growth in loans of all DFIs, NPLs to loans ratio declined to 15 percent in CY05 against 32 percent in CY04. Likewise, net NPLs to net Loans ratio has also shifted downwards to 8 percent against 10 percent in CY04 **(See Figure 10.4)**. Though the credit quality does not arouse the same concerns as it used to a few years back, there still is a need to further reduce these ratios to minimize NPLs

Figure-10.4: Qulity of Loans



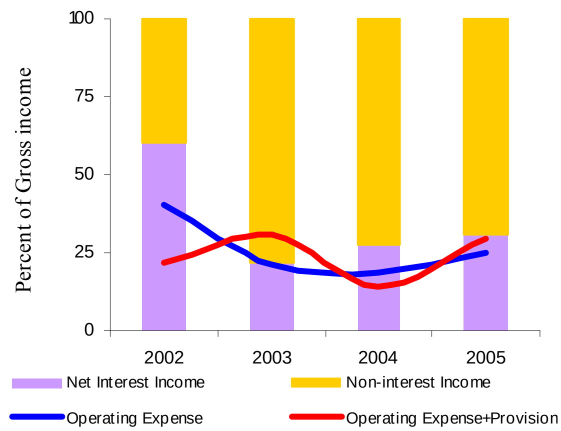
[12] Isolating the impact of reclassification.

overhang.

The liquidity position of DFIs remained satisfactory as is evident from liquid assets (including investments) to total assets ratio, which inched up to 63 percent, compared to 60 percent in CY04. Credit to deposits plus borrowings ratio by increasing to 66 percent from 60 percent in CY04 almost mimics the trend within commercial banks. However, since the DFIs hold significant amount in equity markets that can certainly provide cushion to them in case of odd circumstances.

Helped by expanding operations, DFIs improved their profits in CY05. Total profits before tax of DFIs registered a welcome growth of 9 percent. Likewise, the profits after tax posted the growth rate of 15 percent. Majority of income originated from non-mark up avenues. In fact, it was marked increase in capital gains that helped the DFIs achieve an ROA (after tax) of 5.3 percent. The heavy capital gains were linked to the sharp rise in share prices, which enabled DFIs to fully capitalize on their significant equity investments (see **Figure 10.5)**. The sharp growth in loans during CY05 could not push up significantly the core earnings of DFIs. This was because of rapid rise in interest expenses possibly on account of high cost of borrowings. Hence, the net mark up income of DFIs remained relatively low. The over-reliance on capital gains shows uncertainty regarding the future earnings of DFIs. The cost of funds also remains very high and should be brought down to become fully viable in the highly competitive environment dominated by large commercial banks.

Figure-10.5: P & L Structure of DFIs



A glance back at the performance of DFIs during CY05 shows improvement in their performance in terms of growing diversity in their business operations. Increasing share of loans and deposits is a welcome sign and should help them compete in the growingly challenging financial environment. The solvency profile is expected to improve if DFIs remain on track to inject more capital in compliance with the enhanced MCR. However, their earnings are susceptible to the behaviour of capital markets and any adverse movement there might significantly undermine their profitability outlook. The concern exacerbates in view of very low NIM on account of very high interest expense. This calls for tapping low cost sources of funds. Moreover, DFIs are required to tailor developmental strategies by complementing the established banking institutions to meet financing requirements of the changing economy. To meet this end, they need to enhance the range of facilities through product and service innovation and taking initiatives in resource mobilization.

11 Performance of Micro Finance Banks

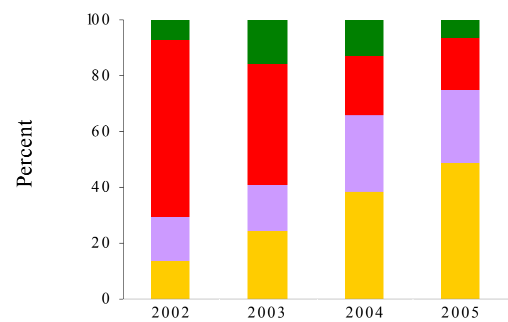
CY05, being the International Year for Micro Credit (IYMC), brought about a new wave of events and further boosted the collaborated efforts at the international forums. SBP, appreciating the importance of microfinance in the overall context of poverty alleviation in the country, participated at these forums and assimilated learning from the experiences of other developing countries which have been active in this area for years. In Pakistan, microfinance is still in evolving stage and has a long way to go. However, during CY05, some momentum has been built up, which is fairly reflective from the increasing number of microfinance participants. Also a promising and comprehensive policy regime is in place allowing the provision of micro credit from both regulated and unregulated players, hence experimenting with plurality and diversity.

Table-11.1: Micro Finance Outreach

	2002	2003	2004	2005
Institution Age (Yrs)	2	3	4	5
No. of Branches	39	56	75	91
Total No. of Borrowers	56,939	95,090	177,648	248,091
No. of New Borrowers	56,939	38,151	82,558	70,443
Total No. of Depositors	2,773	10,150	18,589	32,577
No. of New Depositors	2,773	7,377	8,439	13,988
Average Loan Size (Rs)	6,232	7,969	7,340	9,450
Average Deposit Size (Rs)	23,231	38,625	25,229	20,867

Currently three nation-wide and two district-wide Micro Finance Banks (MFBs)[13] are providing financial services to this sector in Pakistan. During the year under review, the outreach of these micro finance banks experienced significant expansion. Their branch network continued to grow, with the number of branches standing at 91 in CY05 compared to 75 in CY04 (see **Table 11.1**) hence increasing the overall outreach of these banks. This is manifested by the 40 percent increase in borrowers and 75 percent increase in depositors over the year. With the licensing of one new nation-wide MFB viz. Pak Oman Micro Finance Bank[14] in early CY06, the sector is expected to get further boost in near future. It is interesting to note that the commercial banks are increasingly realizing the potential market that exists in this relatively untapped sector; however, their drive for entering this market will be purely based on business considerations. In this regard, guidelines[15] to facilitate the commercial banks to venture into micro finance business will be issued shortly.

Figure-11.1: Asset Structure of MFBs



	2002	2003	2004	2005
Cash and Balances	6.8	15.9	12.6	6.5
Investment	63.7	43.1	21.7	18.5
Advances	16.0	16.6	27.1	26.7
Other Assets	13.5	24.4	38.6	48.3

As three more banks came into microfinance stream during the year, the overall balance sheet footing of the MFBs recorded an expansion of 49 percent to Rs8,458 million from Rs5,673 million in CY04. The asset composition of these banks shows that most of the funds resided in other assets category (see **Figure 11.1**). This is mainly because of the high operating fixed assets owing to the expansions in MFBs during the year and increase in receivables from donor agencies. Even though the share of both investments and cash and balances declined, the share of advances also came off, however slightly. This owes much to one of the banks which did not extend advances as it started its operations in the later part of the year. Excluding that bank, the share of advances increased to 29 percent in the total assets.

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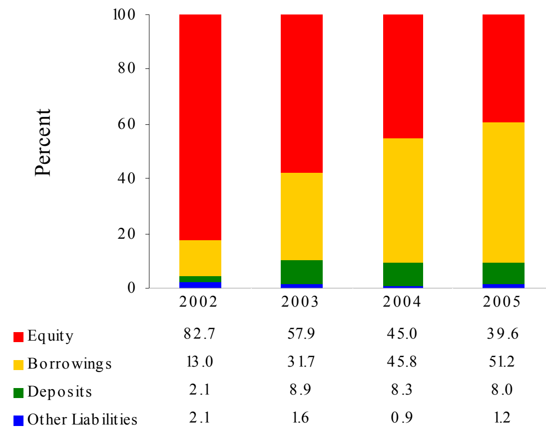
[13] Khushhali Bank, First Micro Finance Bank, Tameer Micro Finance Bank, Network Micro Finance Bank and Rozgar Micro Finance Bank

[14] The bank is yet to start operations

[15] Draft of guidelines has been prepared

Corresponding to the improvement in the asset mix towards a more conventional one, the composition of sources of funds also changed (see **Figure 11.2**). A look at the sources reveals that borrowings continued to provide major support to assets followed by shareholders' equity. A major chunk of these borrowings represent the loan from Asian Development Bank. Since the biggest MFB has not yet started taking deposits, the share of deposits remained miniscule at 8 percent, despite the growth of 45 percent over the year.

Figure-11.2: Funding Structure of MFBs



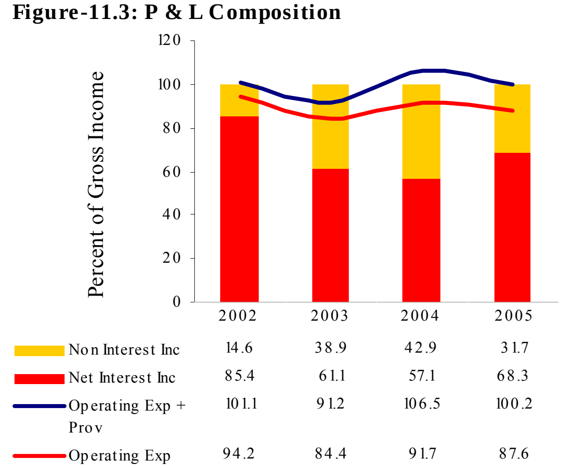
The key performance indicators of the MFBs improved further (see **Table 11.2**). Despite noticeable growth in advances, prudent lending decisions coupled with enhanced provisioning and better cash recoveries further improved the asset quality indicators of the MFBs. However, it should not let the complacency to set in as the international standards for asset quality are even more stringent. As the commercial banks would also emerge in the microfinance scene, steaming the competition, the true test of credit quality of MFBs would come with time.

On the profitability front, the advances continued to lend greater support to the interest income of MFBs. Also the growth in average earning assets was quite impressive at 80 percent, which is reflective from the improved share of net interest income in gross income (see **Figure 11.3**). Although the income from core activities was dominant, its share still needs to be enhanced. Asset composition of MFBs showing predominance of non earnings assets provides explanation for this low share. However, as three of the microfinance banks started their operations in CY05, investment in such assets in the initial years is rather obvious. As regards interest expenses, the sources of funds that continued to remain equity dominated two years back, are now rationalizing with the share of interest bearing borrowings being the largest. Resultantly, the increase in interest expenses is noticeable. As for the non core incomes of the bank, their share in gross income stands reduced, however, there is still wide scope for the further strengthening of core income activities. Most of the non core incomes are gain on sale of investments and grant income. The non recurring nature of such income necessitates the MFBs to enhance their earning assets. The operating expenses of MFBs in terms of gross income though slightly came off in comparison to the previous year; they still stood high at 88 percent. As these banks are undergoing expansion in branch network resulting into fresh recruitments, administrative costs were rather

Table-11.2: Key Performance Indicators

Percent	2002	2003	2004	2005
NPLs to Advances	1.59	7.57	7.20	4.40
Net NPLs to Net Advances	(2.94)	2.72	1.33	0.73
Provisions to NPLs	356.76	65.02	78.27	84.08
Net NPLs to Capital	(0.58)	0.81	0.84	0.52
Growth in Advances	346.84	49.26	108.79	46.92
Net Interest Margin	8.39	6.94	6.75	7.79
Non Interest Income to Avg Assets	1.19	3.46	3.81	3.21
Non Interest Exp to Avg Assets	7.68	7.50	8.13	8.84
Operating Exp to Gross Income	94.16	84.36	91.66	87.60
ROA	0.02	0.63	(0.49)	(0.20)
Operating Sufficiency	91.40	75.83	71.90	84.06
Financial Sustainability	45.35	39.33	42.27	51.49

Figure-11.3: P & L Composition



obvious to remain high. Furthermore, operating costs associated with the micro financing structure are usually high. Taking into account the provision expenses as well, the ROA for CY05 too remained negative. The operating costs of MFBs, despite their structure and expansionary phase that they are in, are considered very high by international standards. There is a wide scope for developing cost effective delivery mechanism to bring these costs down. This will strengthen the profitability of MFBs and hence improve their operational self sufficiency[16] and financial sustainability[17].

[16] Operating Sufficiency= (Total Income less Income from Donations etc.) / (Total Operating Expense plus Actual Cost of Funds)
[17] Financial Self-Sustainability (Total Income less income from donations etc.) / (Total Operating Expenses plus Actual Cost of Funds plus implicit cost of subsidized funds plus Implicit Cost of Equity; computed at SBP discount rate)

Box – 11.1

SBP Initiatives towards the Development of Microfinance in Pakistan

Recognizing the need for focused supervision and promotion of the Microfinance Sector, SBP has established a dedicated department viz. Small and Medium Enterprise Department. The prime focus of the department would be on issues concerning Micro and SME financing in the country. The department has been staffed with personnel having rich experience in regulating the banking industry and with in-depth knowledge of all aspects of micro financing, including conceptual as well as business. SBP, being cognizant of the importance of capacity building and skill enhancement for effective regulation, supervision and growth of the microfinance sector, has adopted a focused approach to build microfinance related capacity. In this regard, a chain of events comprising training programs, workshops, exposure and field visits has thus far been arranged as part of ongoing assistance program for capacity building with Swiss Agency for Development and Cooperation (SDC). The program is expected to enable central bank in developing sector-friendly policies while ensuring effective supervisory oversight of MFBs.

SBP has created a ***Microfinance Consultative Group*** (MFCG) comprising microfinance stakeholders and donor agencies to work as an advisory body for SBP for MF related policies formulation. As part of the regular quarterly meetings under the MFCG, SBP is engaged in the continuous review of its legal, regulatory and supervisory framework in consultation with the stakeholders to ensure their responsiveness to the peculiar nature of micro financing. During the year, draft ***guidelines for commercial banks*** to venture into microfinance business have been prepared in order to promote institutional diversity, enhance microfinance outreach and ensure a competitive environment for MFBs. The draft guidelines present four business models to the commercial banks alongwith their related issues and requirements and will be instrumental in boosting the microfinance industry in Pakistan. Recognizing the need for revising the existing classification criteria for micro loans, SBP has made certain amendments aimed at bringing the existing classification/provisioning/write-off criteria for micro loans in line with the international best practices while keeping in view the local conditions and the evolving phase of MFB industry. During the year, separate ***On-site Inspection and Offsite Surveillance Manuals*** have been developed by the international consultants. The manuals are in the process of finalization. To test the key microfinance inspection procedures as suggested by the manual, a special model inspection of one of the MFBs was also conducted during the year. Draft inspection report, will be sent to ADB for review, once finalized.

SBP actively participated at international forums to celebrate CY05- the International Year of Micro Credit (IYMC). In order to initiate different activities to be undertaken with respect to the international microfinance year celebrations, a National Committee comprising representatives from SBP, Pakistan Microfinance Network (PMN), Pakistan Poverty Alleviation Fund (PPAF), SDC, Khushali Bank and KASHF Foundation was formed with the director, SMED being the Chairman. ***MF exhibition***, ***Global Micro Entrepreneurship Award 2005***, ***Media Strategy Awareness Program***, development of ***IYMC Website***, research on ***MF in low density areas*** and an ***i***nternational microfinance conference, ***Microfinance in Pakistan-Innovating and Mainstreaming-*** are thus far been the activities organized under this committee. This microfinance awareness program through active acquisition and dissemination of information will be instrumental in establishing the distinct status of micro financing as an effective poverty alleviation tool, enhancing intellectual capital development and resolving the perplexity of the issues at the grass root level. Concerning the recent earthquake in Pakistan, an Emergency Livelihood Restoration Program (ELRP) has been proposed on the directive of Government of Pakistan (GoP) to provide support to the earthquake survivors. In this regard, concurrence from Asian Development Bank (ADB), GoP and SBP has been taken and an Emergency Livelihood Restoration Fund (ELRF) of USD38 million has been proposed for Community Group Formation, Community Infrastructure, Equity support and Operational Cost Support to Khushhali Bank (KB) to restore productive capacity of affected households. ELRF shall be executed through KB under ELRF Rules 2005 and monitored by ELRF Committee established at SBP.

12 Performance of Exchange Companies

With the replacement of Authorized Money Changers with Exchange Companies, in Mar-02, a significant improvement in their operations and performance can be witnessed. The system has made significant progress towards the ultimate objective of curbing the unauthorized activities of the moneychangers and unifying the exchange rates. Now their activities are more regularized and documented. The licensing, registration, capital and statutory liquidity requirement of 25 percent of capital with SBP in the form of unencumbered approved government securities has strengthened their solvency indicators. The more structured network in the form of branches, currency exchange booths all over the country at public places such as airports, hotels etc., and franchise arrangements has further extended their operations and allowed them to offer a complete range of services that an exchange company is authorized to offer. Moreover, the provision of modern communication facilities like telephone, fax, Telex/SWIFT, hardware/software and electronic cash register is likely to produce healthy results in the form of better and quick transmission/transfer of funds. The role of SBP to regularize the exchange companies' business and their operations is very critical as the compliance of different regulations, instructions, directives, circulars and other communication issued by SBP is compulsory. The remittance through Hundi/Hawala has been dropped to a negligible level.

Before the establishment of exchange companies, authorized moneychangers were the main players of money transfer in the kerb market. The sharp movements in the exchange rate in the kerb market made it more volatile. Moreover, the scope of moneychangers was limited to the extent of sale and purchase of foreign currency notes and coins. Now the same has been broadened with the permission to deal in bank drafts, travelers' cheques and transfer beside the routine sale and purchase of currency notes.

There were almost 470 authorized moneychangers in the country before the evolution of exchange companies in Pakistan. The discontinuation of authorized moneychangers forced them to either form Exchange Company "A" or "B" or to make franchise arrangements with Exchange Company "A".

At present, 28 exchange companies "A" with 102 branches, 294 payment booths and 8 currency booths are in operation in Pakistan. Moreover, 218 franchise arrangements are also available for the sale and purchase of foreign currency. However, the number of exchange companies "B" dropped from 33 to 31 with the reduction in branch network from 249 to 223 (see **Table-12.1**).

Table-12.1: No.of Operational Exchange Companies	2004	2005
Exchange Companies-"A"	25	28
Branches of Exchange Companies-"A"	79	102
Franchise Arrangement with Exchnage Companies-"A"	218	218
Payment Booth-"A" Exchange Companies	-	294
Currency Booths-"A" Exchange Companies		8
Exchage Companies-B	33	31
Branches of Exchange Companies-B	249	223

The asset base of exchange companies has increased from Rs2.4 billion in CY04 to Rs4.4 billion in CY05 thereby showing 85 percent growth over the last year (see **Table 12.2)**. The increase in asset base is supported by corresponding increase in capital/equity as the same has grown by 61 percent in the same period. This increased equity is backed by regulatory requirement of Rs100 million as a minimum paid-up capital which is to be raised up to Rs200 million within a period of 3-years from the date of incorporation.

Table-12.2: Financial Highlights of Exchange Companies "A" (For the Year ended June)

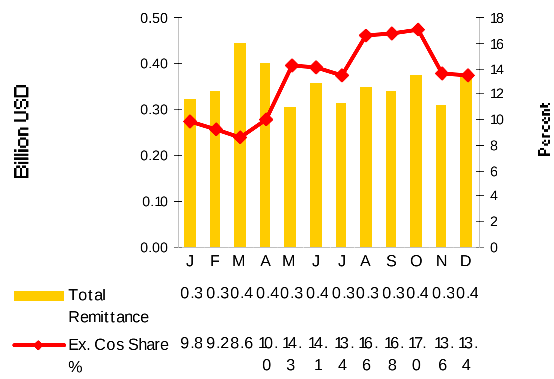
(Million Rs)

	2003	2004	**2005**
Total Assets	1,775.6	2,395.8	4,433.1
Total Liabilities	438.7	248.4	976.8
Capital	1,336.9	2,147.4	3,456.3
Profit Befor Tax	17.1	70.0	(53.7)
Profit After Tax	7.8	39.6	(81.7)

The exchange companies have shown a net loss of Rs82 million in CY05. This is mainly because of the increased operational expenses. The increased branch expansion cost will bear fruits in the coming years, which is expected to positively impact the profitability. As compared with the improved return on equity and assets in CY04, there is significant deterioration in CY05.

During CY05, the performance of exchange companies witnessed remarkable improvement. During the year, the home remittances through the exchange companies have increased from USD235 million in CY04 to USD548 million in CY05 **(**see **Figure 12.1)**. In percentage terms, the share of remittances flowing through exchange companies increased sharply to 13 percent in CY05, against merely 6 percent in CY04 and 4 percent in CY03, depicting a remarkable growth in flow of remittances through officially institutionalized channels. This shows that the exchange companies are playing an important role in providing precious foreign exchange through documented channels.

Figure-12.1: Share of Exchange Companies in Home Remittances-2005



Formalized and institutionalized system of remittance flow in the form of Exchange companies has offered an efficient channel to transact business. Now the funds through and by all sources can safely and easily transfer in and out of country. It is further expected that the performance of these companies is going to improve in the future.

Box – 12.1
Regulatory Development for Exchange Companies

The revised procedure for export of foreign currency other than USD through Jinnah International Airport was implemented in the month of Apr-05. As per the revised procedure, any exchange company desirous of export of FCYs will be required to report to SBP-Custom's Joint Booth at least 4-hours prior to the scheduled departure time of the flight through which the export of currency is intended to be made. The representative of Exchange Company will be required to approach the booth with the FCYs consignment. A covering letter in triplicate containing the particulars of the export transaction and a declaration/certificate containing the details of the denomination and amount of FCYs will also be presented. The foreign currency brought to SBP booth will be opened and counted in the presence of Exchange Company's representative and custom official and verified by SBP official as to details from the accompanying documents filed by the Exchange Company. Once the FCY is counted and verified on the declaration, same shall be packed by SBP/BSC staff using the vacuum packing machine. The vacuumed packed bundles can not be tempered with. Any attempt to temper the wrapping would result in dissipation of the vacuum and bundle automatically becoming loose. Further, the date and SBP codes would automatically be embossed on plastic wrapping of each bundle during packing. Packed bundles of currency shall thereafter be combined manually in the form of a bigger bundle of suitable size in a plastic wrap which will be sealed from all sides. Each seal will be signed and stamped by the two SBP/BSC officers and Customs official present at the booth. The consignment duly packed, sealed and signed shall be handed over to the representative of the Exchange Company. Thereafter, the consignment shall be treated as cleared for export for the purposes of SBP & Customs.
The booth operates for 16 hours each day, 7-days a week on a two shifts basis each being for 8 hours. Timing of shifts would be from 3.00 A.M to 11.00 A.M and from 2.00 P.M to 10.00 P.M. Most of the flight schedule is covered by these shifts.

With respect to outward/inward remittances of FCY through Franchisees, SBP restricted the Franchisees, who have been allowed by their respective franchisers, under necessary approval from SBP, must route their remittance transactions only through their respective franchisers and not directly from their FCY accounts and PKR accounts. Franchisees are only allowed to deposit/withdraw cash from their respective foreign currency accounts. Moreover, Exchange Companies are authorized to effect outward remittances only on personal account of individuals i.e. personal financial transactions and not those related to an individual's trade or business requirements. Further, as per F.E Circular No.9 of July 30, 2002, corporate clients may approach for remittances only on account of payment of royalty, technical/franchise fee, provided NOC to this effect is provided to the Exchange Companies from the designated Authorized Dealers.

13 Impact of Banking Sector Reforms from Customers' Perspective

In early 1990s, banking system in Pakistan was characterized by a number of structural drawbacks viz. the dominance of public sector banks, inefficiency of the banking system in terms of operating cost, high interest rate spreads, huge infected loan portfolios and inefficient service delivery mechanism. To address these issues, comprehensive and broad based banking sector reforms were initiated at that time viz. giving autonomy to SBP, allowing new commercial and investment banks in the private sector, privatization of public sector banks, enhancing financial disclosure and transparency and strengthening corporate governance. These reforms brought about a noticeable improvement in the banking scenario in Pakistan, primarily in terms of its efficiency and stability. Though most of the expected outcomes of the reforms have already materialized, which is amply reflected from improved solvency of the banks, reduced concentration, enhanced participation of private sector, and increased market efficiency, the ensuing paragraphs approach this issue from a different perspective viz. the reasons for the introduction of reforms and most importantly assess the impact of the banking reforms from the customers' perspective and determine whether and to what extent these reforms have served the interests of a common customer.

The banking sector of the country has shown remarkable performance over the last few years largely allaying the concerns about its fragility. The financial soundness of the banking system improved significantly (see **Table 13.1**). With the privatization of major public sector commercial banks, around 80 percent of the banking system's assets are now controlled by the private sector banks. This change in the structure of banking system coupled with consolidation drive to develop a vibrant banking system comprising only sound banks has resulted in merger and acquisition of a number of financially weaker banks which could have posed systemic risk to the sector. This has naturally enhanced the confidence of stakeholders over the banking system, primarily that of the depositors. During this period, profitability of the banking system improved considerably owing much to the improved efficiency of banks. Also with the reduction of operating expenses, banks were able to minimize the impact of passing such costs on to the borrowers.

Table 13.1: Financial Soundness and Efficiency

(Percent)	1999	2004	2005
Capital adequacy ratio	10.9	10.5	11.3
NPLs to Loans (net)	15.3	3.8	2.1
ROA (after tax)	-0.2	1.2	1.9
ROE (after tax)	-3.9	19.5	25.8
Credit to deposit ratio	62	65.8	70.2
Intermediation cost	3.5	2.7	2.7
Operating expense to gross income	75.8	52.0	41.5
Provision to Gross Income	14.1	11.1	9.8
Weignted average lending rate	14.4	5.92	9.53
Weighted average deposit rate	6.18	1.78	4.23
Spread (lending and deposit rate)	8.22	4.14	5.3

This improvement in financial soundness and efficiency of the banking system has benefited the ordinary customer in a variety of ways. These include increased access to financial services, new distribution channels and products viz. consumer financing, SME financing, micro financing etc., availability of better quality services and competitive lending rates. In this regard, the reduced overhang of NPLs also enabled the banks to focus on fresh lending. Whilst the avenues for consumer credit access have been enhanced, whereby the credit cards, debit cards, personal loans and consumer durables are catching up fast, this has been instrumental in raising the standard of living of mostly middle-income group borrowers primarily through forced savings. As for agricultural sector, the agriculturists too have a number of options to avail credit facilities. They can get credit not only from the traditional banks but also from the commercial banks. This has resulted in the availability of cheap and easy credit to them as commercial banks have deep penetration in the form of large branch network and lower cost of funds. The SME sector also witnessed considerably improved credit access in recent years. On the whole, the number of borrowers evidenced a substantial increase from 1,804 thousand in CY02 to 4,247 thousand in CY05 (see **Table 13.2**). The consumer sector benefited the most followed by agriculture and SME. The enhanced credit provision to these sectors is quite encouraging due to their forward and backward linkages with the rest of the domestic economy, to the international trade and poverty alleviation.

Table 13.2: Access to financial services

(No. in units)	1999	2004	2005
No. of banks	46	38	39
No of branches per 10,000 adults	1.09	0.83	0.84
No. of online branches	322*	2,475	3,265
Online branches per 10,000 adults**	0.04*	0.29	0.38
No. of ATMs	206*	786	1,217
ATMs per 10,000 adults	0.03*	0.09	0.14
No. of depositors	29,710,720	27,383,337	26,405,832
Deposit Accounts Per 10,000 adults	4,089	3,227	3,053
No. of borrowers	1,804,604√	3,398,190	4,247,306
Loan Accounts Per 10,000 adults	226√	400	491
Corporate Sector	14,256√	19,333	19,881
SME Sector	67,520√	106,248	161,316
Consumer	252,156√	1,619,207	2,407,806
Agriculture	1,339,961√	1,503,827	1,534,502
Commodity operations	1,458√	3,207	6,730
Others (including staff)	129,253√	146,368	117,071

* Figures for 2000 √ Figures for 2002

**15 years and above

Besides the easy access to credit, the borrowers also enjoyed affordable rates (see **Table 13.1**). The average lending rates witnessed considerable decline from 14.4 percent in CY99 to 9.5 percent in CY05. However, the return on deposits also shrank during this period. As a result, spread between lending and deposit rates came off significantly. Some explanation for the decline in the deposit rates comes from the fact that the interest rates are primarily determined by the market forces. However, a number of other factors are also responsible for this; including the increasing weight of current deposits in the overall deposits of the banking system, which rose to 29 percent in CY05 from 22 percent in CY00, and the huge inflow of funds over the last few years that made the system fairly liquid resulting into a changed scenario of competition. The banks with excess liquidity have been competing for loans instead of deposits. However, the depositors benefited from the reform process in terms of safety of their deposits being placed with the financially sound banking system instead of fragile and vulnerable. This is affirmed from the fact that the number of banks not meeting capital adequacy requirements and their share in banking sector's customer deposits has came down significantly from 10.9 percent in CY00 to 0.9 percent in CY05.

The quality of service delivery mechanism has also noticeably improved in recent years as the banks have made substantial investment in IT. The number of ATMs rose to 1217 in CY05 from just 206 in CY00. These ATMs provide its beneficiaries not only cash withdrawals facility but also the ease of payment of their utility bills without waiting long standing in queues. Progress in creating automated or online branches of banks has also been quite significant so far. There is a big surge amongst the banks to upgrade their online banking services. Accordingly, most of the banks are now providing facilities for transfer of funds including payment of utility bills electronically through internet, providing cost effectiveness and efficiency benefits to the customers. Despite all these facilities, the number of depositors reduced during the period under review (see **Table 13.3**). The possible explanation

Table 13.3: Size-wise Distribution of Depositors

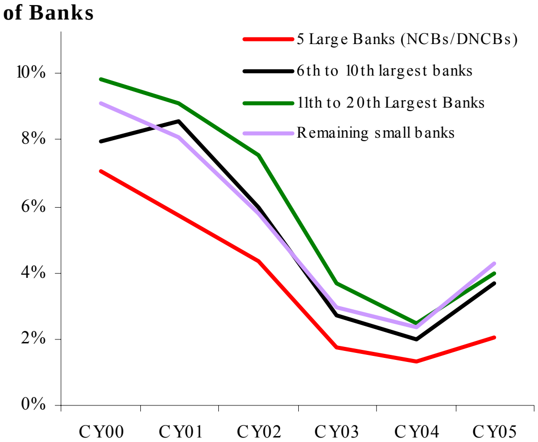
(No. in units)	1999	2004	2005
less than 5000	5,534,841	4,875,987	5,096,433
Rs. 5000 to Rs. 10000	8,738,366	3,023,093	2,430,554
Rs. 10000 to Rs. 20000	8,554,428	5,621,259	4,715,117
Rs. 20000 to Rs. 30000	2,558,148	3,437,734	2,776,385
Rs. 30000 to Rs. 40000	1,013,967	2,185,637	2,143,025
Rs. 40000 to Rs. 50000	613,459	1,618,331	1,579,817
Rs. 50000 & above	2,697,511	6,621,296	7,664,501
Total	29,710,720	27,383,337	26,405,832

for this reduction may be the enhancement of minimum balance limit by banks, as small depositors account for the entire reduction.

While the financial reforms have transpired into marked improvement in the quality and delivery of services offered by the banking system, there is also a perception that the benefits of reforms have not been distributed equally across different segments. Particularly, depositors are appeared to be having a raw deal because of very low return being offered on their savings. There is a growing resentment over banks' policy of not sharing their huge gains with depositors, who are providing them the essential funds to expand their businesses. Adding insult to injury, the returns on various National Saving Schemes, which used to be an attractive avenue for savers because of considerably high return, have also been slashed significantly to provide a level playing field to banks and reduce the burden of debt on the government. Consequently, banks appear to be prospering at the expense of savers. In addition to the low return on their savings, depositors also have to incur additional expenses in case they are not able to meet the minimum balance limits.

Yet another perception is that the financial reforms have not been equally advanced across different sectors. Capital markets have not been able to come up with the competitive instruments as an attractive alternative to banks' products. Despite the growing interest in stock markets because of their prolific rise, their penetration has remained restricted. This has provided banks with an open field to exploit the conditions to their advantage. With the easy availability of funds, banks have also been lacking in product innovation. Moreover, there is still a considerable scope to further improve the quality of financial services being offered to bank borrowers. Initiatives on the part of banks are required to carryout objective analysis of the customer expectations and to efficiently meet these expectations. Another most important area demanding immediate attention is strong customer protection regime. The industry is expected to introduce minimum standards for the protection of customer's interests and set high ethical norms. There is still a large segment of population, which remains untouched by financial services. Additionally, the lending rates being charged on loans to consumers, SMEs, microfinance and agriculture sectors are exorbitantly high and depict banks' prejudice against such borrowers.

Figure-13.1: Cost of Remunerative Deposits by Size of Banks



Looking dispassionately at these weaknesses, we find that fault does not lie with the financial reforms but with the peculiar structure of the system with five large banks dominating the financial scene. Until recently, the response of these banks to fast changing financial environment has been slow and with their vast geographic presence they continued to enjoy the luxury of low cost deposits (see **Figure 13.1**) and took advantage of the ignorance of customers of the less developed areas regarding the rising standard of financial services in more advanced cities of the country. The lethargic attitude, a remnant of public sector era, also crippled their abilities to be innovative in product development. However, things have changed significantly. They are now feeling the heat of competition from the medium sized private banks and their share has been declining gradually. With the privatization of four of these five large banks and growing competition put up by the second tier banks, the quality of services offered by these banks is expected to improve in future.

Moreover, banking sector in Pakistan is still in its evolutionary stage. Banks are consolidating their positions both in terms of operational capacities as well as financial soundness. The recent increase in profits has largely been capitalized to meet the enhanced capital requirements. A sound and vibrant banking system is expected to deliver the expected benefits in the coming years not only in the form of higher returns to depositors but also by providing new products and services that would adequately plug the existing gaps in the overall financial structure

To sum up, the overall impact of financial reforms has been positive despite showing certain weaknesses. Going forward, banking sector reforms should focus on promoting more competition as it will ultimately pressurize banks pricing policies, giving rise to lower spreads and even higher efficiency so that not only the benefits could be passed on to customers, both borrowers and depositors but also the ultimate objective of reforms to build a sound and resilient financial system could be achieved.

14 Initiatives towards Financial System Stability

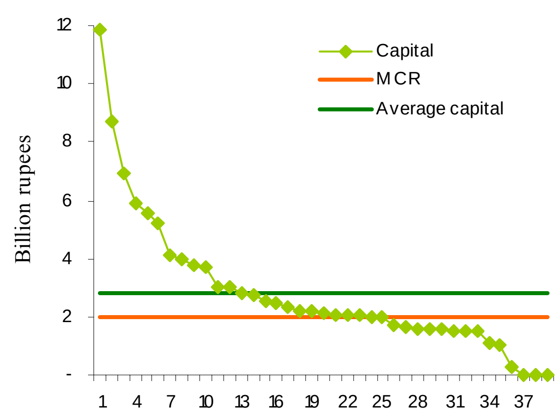
14.1 MCR Enhancement and Variable Capital Adequacy Ratio

Capital serves as a measure of stability and soundness of the financial system. Well-capitalized financial institutions add to the confidence of market players. SBP, in its efforts towards strengthening the financial system, has been taking measures to improve and fortify the capital base. After pursuing the privatization policy, wherein the banks with large deficits and significantly deteriorated capital base were managed to have adequate capital, the policy of gradual enhancement in Minimum Capital Requirement (MCR) has been actively tracked for strengthening the capital base of banks and DFIs. Adoption of capital standards based on Basel Capital Accord (Basel I) in CY97 was a first move towards aligning the regulatory capital requirement with the international standard, when capital charge for credit risk was introduced initially. In CY04, capital charge for market risk was also introduced to become fully compliant with Basel I requirement and institute a true risk based capital adequacy framework.

Now, banking system is far more resilient & sound, and quite capable to meet the new requirements as compared with the fragile and poor financial condition in early 90s. In a sharp contrast to the public sector dominated banking system in CY97, the private sector now holds control of around 80 percent of the banking assets. While it has introduced competition and efficiency in the system, the introduction of new comparatively complex products, deregulation and the growing competition in the market has also given rise to a host of risk factors. This calls for a concerted response on the part of SBP and banks to further fortify their systems and solvency profile to counter any adverse twist of events.

Realizing this, SBP has defined a two-pronged strategy to further strengthen the solvency of banks/DFIs. One deals with the enhancement in minimum capital requirement while other takes care of Capital Adequacy Ratio (CAR) of the banks and DFIs. In this regard, the banks and DFIs were asked to maintain minimum capital (net of losses) of Rs2 billion by the end of December 31, 2005. As regards the banks, 24 banks meet this requirement by the end of December 31, 2005 **(**see **Figure 14.1.1)**. Of the remaining 15, most of the banks are expected to meet the MCR by the end Jun-06 through the issuance of bonus or right shares whereas some are in the process of mergers. As for DFIs, 4 out of 7 are meeting this enhanced MCR while two are expected to meet by the end of Jun-06 and one has been given extension till its privatization **(**see Figure **14.1.2)**.

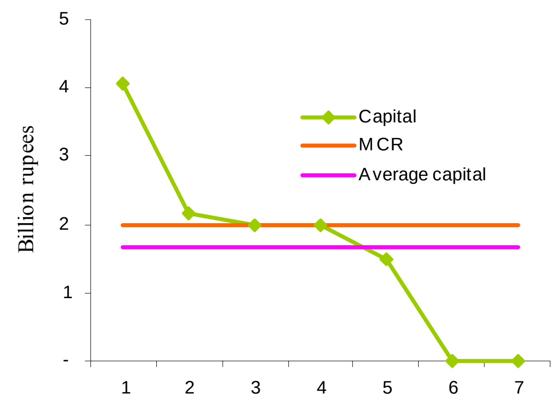
Figure-14.1.1 Position of MCR of Banks-Dec-05



In a strategic plan onwards, in CY05, SBP has delineated a long-term strategy of strengthening the capital base of banks and DFIs by 1) increasing MCR in a phased manner to Rs6 billion 2) aligning the CAR with the risk profile of the banks and DFIs.

As for the enhancement in MCR, the existing minimum paid up capital requirement for locally incorporated banks/DFIs of Rs2 billion for Dec-05, has been raised to Rs6 billion (net of losses) to be achieved in a phased manner till the Dec-09. The branches of foreign banks operating in Pakistan would also be required to increase their assigned capital to Rs6 billion within the timelines prescribed for the locally incorporated banks/DFIs. However, those branches of foreign banks whose Head Offices hold a minimum paid up capital of USD100 million (net of losses) and have a CAR of 9 percent (determined as per Basel-I or Basel-II Accord) can be allowed to continue to maintain the minimum assigned capital of Rs2 billion (net of losses). All such branches of foreign banks shall, however, be required to seek specific permission from SBP to maintain the minimum assigned capital (net of losses) of Rs2 billion effective from 31st December 2005. This measure is aimed at reducing the concentration in the banking system and encouraging a competitive environment. The analysis shows that top 20 banks own around 94 percent of the advances portfolio of the banking industry and the remaining 19 banks assume only 5 percent. With the more capital coming into the business, banks/DFIs would add to their business in terms of achieving economies of scale and availing the leverage.

Figure-14.1.2 Position of MCR of DFIs- Dec-05



On the capital adequacy front, in contrast to maintaining a uniform requirement for CAR i.e. 8 percent minimum for all banks/DFIs, irrespective of the strength of the institution, the variable CAR has been introduced based on Institutional Risk Assessment Framework (IRAF) Rating assigned by SBP to each bank and DFI. This framework introduces variable CAR for banks and DFIs, which ranges from 8 percent to 14 percent for the stronger and weaker banks/DFIs respectively, to be achieved in a phased manner till Dec-06 (For Dec-05, this range is from 8 percent to 12 percent). IRAF deals with the assessment of a bank/DFI on four major areas namely; compliance with standards, codes & guidelines; supervisory & regulatory information; financial performance & condition and market information & intelligence. This concept of Institutional Risk Assessment Framework (IRAF) is meant for ensuring proactive monitoring of the risks the banks/DFIs are exposed to.

The study shows that generally the banks are compliant with the enhanced MCR and this change in variable CAR is not expected to materially impact the capital position of the banks/DFIs. However, it triggers the banks to improve their overall rating by institutionalizing the risk management framework with in the bank/DFI to get maximum benefit of this variable CAR. Now, when the banking system is enjoying good capital base and the healthy profitability every year, setting aside a cushion in the form of additional capital in the present benign conditions would help preserve the resilience of the banking system towards any future shocks.

14.2 Resolution of Problem Banks

As a banking sector regulator/supervisor, SBP's core task is to ensure the soundness and stability of the banking system as a whole and of the individual institutions in particular. SBP fulfils this core responsibility by systematically supervising/monitoring the performance of every bank to assess its operational and financial health, risks faced/assumed and coverage thereof and compliance with the applicable banking rules and regulations. However, despite best efforts of SBP to properly license, supervise and regulate banking institutions, the likelihood of emergence of banking problems cannot be ruled out. These problems may range in size from moderate to severe and may be restricted to one or few institutions or be systemic. It is therefore important to have well-defined policies and procedures for timely identification of problem banks and effective resolution of their problems.

Effective implementation of well-tailored and multi-pronged policies by SBP coupled with readiness of banks/DFIs in adopting these policies has successfully resolved the problem banks in the country. Total number of problematic banks as well as their share in the banking industry is reducing over the period, currently leaving only one financial institution. This bank is in dismal shape, and its operations characterize persistent losses, poor asset quality, and crippled asset base. Consequently, the key financial soundness indicators render the bank insolvent for all practical purposes. While the bank carries little systemic risk because of its insignificant share i.e. 0.21 percent, SBP nevertheless is committed to restructure and rehabilitate this only public sector problem bank.

Therefore, after evaluation of available options, the decision of restructuring of the institution to prepare it for privatization has been taken. In this connection, noticeable developments have taken place, where the Standing Committee of National Assembly for Finance & Revenue has cleared the Corporatization Bill, which is now lying with Parliament for approval. Once the Corporatization Bill is get passed, a new public limited company will be incorporated under the Companies Ordinance 1984 and licencesed under BCO 1962 to takeover the assets and liabilities, business and staff of this bank. In addition to it, Finance Division will issue Vesting Order specifying the effective date for transfer of assets & liabilities, business, staff and other details to new company. Sale of the institution including any required reconstruction, change in management etc. will also be managed by SBP after the Corporatization Bill is passed. It has been planned that the institution's equity will be restored to the level as required by SBP's regulations by converting its outstanding borrowings from GOP & SBP into share capital/subordinated loan. The actual amount required for building the institution's equity will be determined at the time of its actual corporatization.

To further deepen the financial sector and protect the system from future policy reversals, the process of privatization and legal reforms needs to be continued. Progress achieved thus far can be solidified if the process of restructuring, privatization and corporatization of this only public sector problem institution and other low performing institutions is accelerated.

14.3 Payment System – Update

Efficient and well functioning payment and settlement system is instrumental for financial stability and smooth functioning of financial markets. Being aware of the crucial role of payment and settlement systems, SBP has introduced numerous reforms including gradual shifting from traditional paper-based, end-of-the-day settlement system to the electronic payment system through the initiation of the project of Real Time Gross Settlement System (RTGS) named Pakistan Real time Interbank Settlement Mechanism (PRISM). The RTGS is using Globus as an interface and is based on Society for Worldwide Interbank Financial Telecommunication (SWIFT) topology.

The PRISM is at the advanced stage of implementation and is expected to replace the existing system by the end of CY06. In this regard, RTGS awareness program has been put in place comprising informative sessions and trainings for the stakeholders supplemented with the surveys and visits of banks/ DFIs to assess their level of preparedness for execution. Once implemented, PRISM will provide support to all the various activities that are carried though the current account of banks and DFIs maintained with SBP including not only the interbank fund transfers, but also the settlement of open market operations (OMOs) and settlement of government securities in primary and secondary markets. Such settlements will be essentially based on Delivery vs. Payment mechanism, thus minimizing the risks involved in securities trading through reduction in settlement lag. Also the positions of the participants will be known instantly during the processing day as two functions of interbank fund transfer system viz. the transmission of information about the payment and actual settlement thereon will occur concurrently. As the payments will be settled without lags, the commitments on the basis of these payments will no longer be fictional. PRISM will also bring in efficiency in the intercity and intracity clearing between the banks as the clearing results provided by NIFT will be settled on real time basis in PRISM. The implementation of PRISM will change the payment system scenario as all the transactions will be settled on real-time gross basis hence the participants will be aware of various risks more precisely resulting into proactive management of financial risks viz. credit, liquidity and settlement risks in general and systemic risks in particular.

On the enforcement front, a separate legal framework well-suited to the peculiar nature of electronic transactions was indispensable. Accordingly, Payment Systems and Electronic Funds Transfer Act 2006[18] has been drafted. The proposed Act provides minimum standards for the protection of customers and addresses issues like operation of payment systems, including the clearing and settlement obligations of the parties involved, powers of SBP in this regard, documentation requirements, liabilities of parties and any legal proceedings in case of any conflict. Once enacted, the Act would place payment systems on sound legal footing while also ensuring conformance to the Bank for International Settlements (BIS) core principles for Systematically Important Payment Systems (SIPS).

[18] The draft Act has been reviewed by the Banking Law Review Commission and Ministry of Finance and necessary amendments have been incorporated

14.4 Corporate Governance

The corporate governance essentially defines the relationship among management, the board of directors, shareholders, and other stakeholders. This relationship is achieved by promoting corporate fairness, transparency and accountability, by specifying the distribution of rights and responsibilities of the board, managers, shareholders and other stakeholders, and by spelling out the rules and procedures for making decisions on corporate affairs.

Unlike other businesses, the banking business is highly risky because most of the funds belong to depositors and the failure of a bank affects not only its own stakeholders, but it may have a systemic impact on the stability of the banking system which may adversely affect the economy as a whole. Public trust and confidence in the banking system is considered a key component of banking sector stability which can not be achieved without effective corporate governance practices. Therefore, the financial sector supervisors have keen interest in promoting sound corporate governance in the banks as these may affect the bank's risk profile if not implemented effectively. Hence, the keenness on the part of SBP for implementing effective corporate governance in banks is quite understandable. In Pakistan, the reforms on corporate governance started a few years back. A set of regulations/policies has been issued by SBP and the Government to promote the culture of corporate governance in banks and DFIs. Banking Companies Ordinance (BCO), 1962, states the rules for BOD appointments/dismissal (in case of banking companies, SBP has the power of removing directors or any person at a managerial position of the company), disclosure of share ownership, dividend policy, appointment of external auditors etc. Prudential Regulations (PRs) define the Responsibilities of the Board of Directors and management. The guidelines on risk management specifically put the overall responsibility of policy formulation governing risk management and its successful implementation on BOD. Code of Corporate Governance issued by Securities and Exchange Commission of Pakistan (SECP), where there is no conflict with SBP's Directives, has also been adopted by SBP. Fit and Proper Test for Chief Executive Officers (CEO's), Board Members and key Executives have been laid down. A Handbook on Corporate Governance for Banks/DFIs containing International Best Practices and SBP's Instructions on the subject has also been formulated and disseminated. In order to enhance transparency and disclosure, SBP has made compulsory to include a "Statement on Internal Controls" and comprehensive paragraph under the heading "Risk Management Framework" in the Directors' Report in their Annual Accounts. Besides annual accounts, the Banks and DFIs have also been mandated to publish their Quarterly Accounts and credit rating assigned to them by independent credit rating agency.

Effective internal control system is an integral part of an ideal risk management framework. SBP has also issued guidelines on Internal Controls which encompass five broad areas viz, suitability of the control environment in which the system operates, risk assessment and management system including risk identification and evaluation of the factors that cause them, control activities and segregation of duties, accounting, information and communication systems to ensure that the policies and procedures are clearly communicated and understood and self assessment and correcting deficiencies.

In addition to above mentioned regulatory and supervisory measures, SBP has also enhanced direct interaction with the Board of Directors and Senior Management of banks and DFIs. Regular high-level meetings are arranged with banks / DFIs having satisfactory supervisory rating but more frequently with those having unsatisfactory ratings. Such meetings help the banks and DFIs to share with the regulators the different challenges facing their respective organizations, provide a good forum of interaction to the Board members of banks / DFIs with senior management of SBP and help bring commitment of BOD to ensure compliance to the significant issues of their institution discussed in the meetings. Securities & Exchange Commission of Pakistan – SECP initiated a proposal for establishing Pakistan Institute of Corporate Governance (PICG) with the major stakeholders viz SBP, chambers, stock exchanges, academia, associations etc being the initial subscribers. Being the sole regulator of the banks and DFIs, SBP appreciated the idea and objectives of the PICG and is amongst the founding members.

SBP, in collaboration with International Finance Corporation and PICG, also held a "Conference on Corporate Governance in Banks" on May 29, 2006. The scope of discussion was the international reference points for building sound corporate governance framework, legal and regulatory environment, corporate governance issues specific to banks in Pakistan, practical aspects of implementing good corporate governance. The Board members, CEOs of banks, DFIs, MFBs attended the conference.

Various measures and efforts to strengthen the corporate governance at banks has started to produce positive results. This is reflected by the banks growing enthusiasm in up-grading their systems and employing international best practices. Now most of the policies are framed and decisions are taken in light of the instructions issued by the regulatory authorities. The participation of the stakeholders in the affairs of banks has increased substantially. The boards of directors of banks are far more active, meet regularly and take important decisions to set strategic direction for their respective institutions. Managements at majority of banks are equipped with professional acumen and competence. Because of the intense competition among the market players, the decisions are taken in the best interest of banks. The external influences have almost come to naught. Financial reporting standards have improved greatly, leading to enhanced disclosure and transparency. Therefore, the corporate governance standards as inherent in SBP's regulations have disciplined the market players, improved risk management practices, increased investments in human resource and information technology, and has resulted in a more stable banking system with enhanced role in economic system.

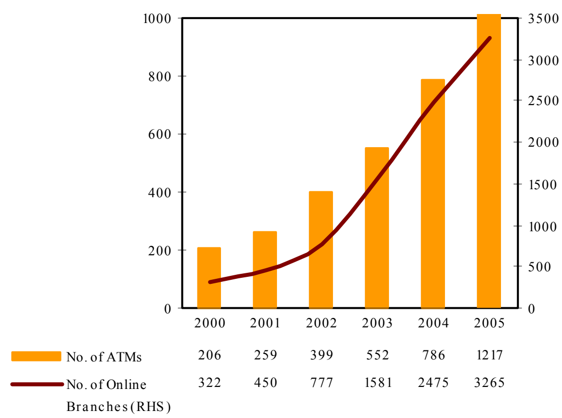
15 Issues and Developments in the Banking System

15.1 Electronic Banking and Technological Developments

Traditional banking featuring paper based operations, large branch network, limited products and physical interaction with customers for the execution of banking transactions has moved forward towards modern banking based on plastic money, state-of-the-art technology, smart and customized solutions and accessibility to wide range of innovative services. There is no doubt that tremendous developments in the electronic banking have played a significant role in changing banking environment in recent years.

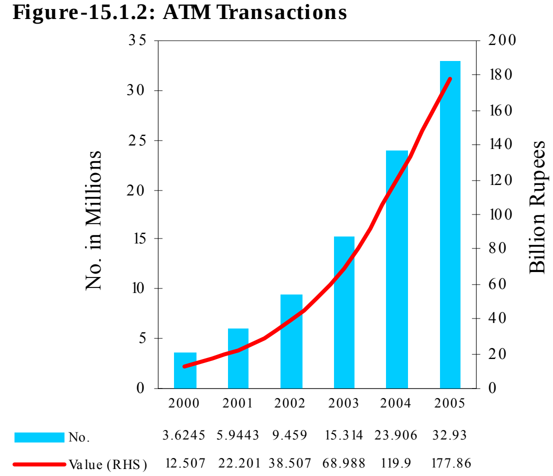
The CY05 witnessed appreciable expansion in automated teller machines (ATMs) and online branch network, growth in number and volume of electronic transactions, increase in number of cardholders and availability of an array of e-banking products.

Figure-15.1.1: E-banking Infrastructure



During the CY05, total number of ATMs increased by 55 percent, surpassing the growth of 42 percent in CY04 **(**see **Figure 15.1.1)**. In addition to inter connectivity of two switches, 1 LINK and MNet, this phenomenal increase in the ATM users is attributed to the availability of variety of services like real time fund transfer, cash deposit, payments of utility bills, cash withdrawal insurance against theft or robbery and enhanced security features.

Figure-15.1.2: ATM Transactions

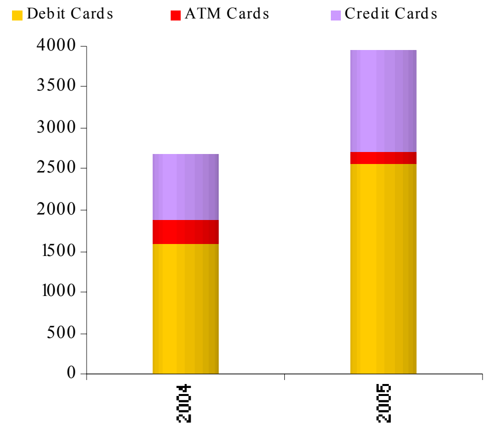


To provide maximum coverage of e-banking facilities to their customers, the banks are increasing their online branch network rapidly. By growing at the rate of 32 percent, online branches as a percentage of total branch network attained level of around 45 percent in CY05. This ongoing growth in the number of online branches would help a large number of current and prospective banking customers to expedite their banking transactions in a hassle-free and reliable environment; that, in turn, will have positive bearing on the overall economic activities.

In CY05, number of transactions made through ATMs rose by 38 percent and volume of those transactions increased by 48 percent over the last year **(**see **Figure 15.1.2)**. This reflects that availability of variety of facilities through ATMs has its positive impact on the banking habits of customers.

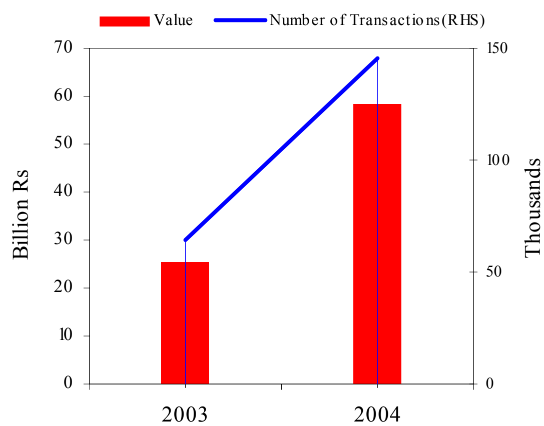
The growing use of plastic money reflects that e-banking products have gained further acceptability in our society. Total number of cards registered an impressive growth of 47 percent in CY05 **(**see **Figure 15.1.3)**. Debit cards share major chunk of total cards whereas ATM cards as percentage of total cards declined to 3 percent. This happened because some of the banks have converted ATM cards into debit cards or smart cards because they are equally good for ATM as well as for point of sale transactions. The introduction of smart cards in CY05 is another important step in making electronic transactions more secure and safe. In view of the security concerns of the customers, it is expected that this new product featuring enhanced security will gain further popularity in the days ahead.

Figure-15.1.3: Cardholders in the Banking System



Our prospering economy requires that customers should be provided with swift, safe and low cost channels to transfer their funds. Growing online banking is an answer to their needs. Massive growth of 360 percent and 197 percent has been observed both in volume and value respectively of online banking transactions during the period **(**see **Figure 15.1.4)**.

Figure-15.1.4: Monthly Average of Online banking



Owing to the increasing competition in the banking sector, banks are engaged to offer innovative products and services to fulfill the changing requirements of their customers. They include mobile banking, call centre banking, PC banking, internet banking, salary transfer for corporate customers, cross border e-banking transactions and payment to third party to name a few. Presently, share of those services and products in overall e-banking business is limited; however, it is worthwhile that banking sector in Pakistan is shaping itself to provide customized solutions to a large spectrum of customers.

Role of SBP in promoting e-banking business for the maximum benefits of all stakeholders while managing risks arising therein has remained in line with supervisory requirements. While encouraging banks to expand their e-banking business; SBP has required them to adopt proper mechanism to ensure adequate I.T. related security and controls. The implementation of Real Time Gross Settlement System (RTGS) and enactment of the "Payment System and Electronic Funds Transfer Act, 2006" will be an important step in promoting its initiatives for sound, secure and swift e-banking system responsive to ever changing needs of the customers.

Despite increasing acceptability of e-banking, much more needs to be done to promote e-banking culture in all strata of our society. It is appreciable that banking sector is engaged in capacity building necessary for meeting the e- banking related challenges in coming years.

Initiatives taken by SBP for Risk Mitigation in E-Banking Business

Benefits of e-banking can not be sustained if appropriate policies and procedures are not formulated and implemented to mitigate the risks inherent in the e-banking operations. In this connection, SBP has recently issued "Information Systems: Guidelines on Audits and System Switchover Planning". Under these guidelines banks are required to go through risk based Information System audit by internal/ third party auditors to ensure that information technology and systems are adequately secured and controls are in place. The banks are encouraged to establish an independent internal Information System audit function for regular monitoring of I.T. organizational set up and activities. Banks are also encouraged to upgrade systems and related controls to improve upon the focus and quality of management information system while ensuring compatibility with internal controls and supervisory requirements. Banks are required to prepare a well-defined implementation plan before introduction of new I.T. driven processes and systems for launching new products. It would be aimed at to ensure that the new or changed activities due to new products or system conversions are evaluated for operational risk prior to going online. It means that banks are to ensure smooth transition from existing to new software while managing all imminent risks during switching.

One of the major reasons for customers to resort to banking system for execution of their financial transactions has been convenience and security. To remove inconvenience to customers in using ATM machines, SBP issued detailed "Guidelines for Standardization of ATM Operations". To make transactions secure and safe through ATM cards and debit cards, comprehensive guidelines have been issued for the card users requiring them to take certain precautionary measures in managing and using their cards. In order to improve accuracy and avoid repeated errors, a "Master Circular" was issued by consolidating all previous instructions and capturing data relating to new variables of all the electronic delivery channels and ATM Switches.

Success of these policy measures depends on implementation of those guidelines in its true spirit as it will help in further development of risk free, convenient and reliable e-banking system in Pakistan.

15.2 Strengthened Role and Scope of Credit Information Bureau

From the risk management and supervisory perspectives, the importance of Credit Information Bureau (CIB) needs little emphasis. Ever since its inception in 1992, the CIB in Pakistan has been playing a vital role in gathering, organizing and disseminating critical information relating to credit-worthiness of borrowers to assist financial institutions in their lending decisions and forestalling the occurrence of default.

With the growing complexities and emerging challenges on the financial landscape, the role of CIB has become even more critical. The CIB at SBP has responded positively to new challenges. From the earlier simple, manually operated data system, the CIB at SBP has evolved into a very sophisticated and hi-tech entity using state-of the-art technology to perform its crucial functions more efficiently. The strengthened capacity and improved operational efficiency has enabled the CIB to enlarge significantly the scope of reporting by doing away with the minimum limit of Rs500,000. The purpose is to capture the diverse categories of borrowers in view of growing exposure of banks to consumers, agriculture and SMEs.

The revamped CIB, named eCIB, after undergoing a parallel run for six months has become fully operational since May-05. The eCIB has overcome the limitations, such as restricted information on borrowers, relatively low safeguards, low speed and reliability, low number of borrowers i.e. 0.2 million, etc which characterize the existing system. The rejuvenated CIB will be practicing matching standards being pursued in more advanced finance centers around the world. In the neighborhood, India is the only country to have put in place a system on similar lines. However, what is significant about the revitalized CIB at SBP is that it relied entirely on indigenous skills and expertise.

The improved capacity and scope of the CIB is expected to deliver the following benefits:

- It will greatly expand the outreach to a large number of borrowers who until now remained untapped because of the floor of Rs 500,000/- for reporting purposes. This has important implications with regard to credit expansion to low-value borrowers of SMEs, agriculture and consumer finance sectors. The financial institutions' access to credit profile of these borrowers will not only encourage them to grant loans more willingly to worthy borrowers but also would help assess their overall credit risk exposure. This, in turn, will serve to reduce the system's vulnerability to financial instability.
- The number of individuals in the data base will rise up to 3-5 million from the existing very low level of 0.2 million. In addition to the higher number of individuals, it will also be possible to generate product-wise loan information.
- Increased speed, reliability and security of data will contribute immensely towards higher efficiency. This will help establish the credibility of the new system, and thus of the data generated, to the stakeholders.
- Host of new functions offered by the eCIB will also help users get information in a variety of ways depending upon their specific needs.

As is evident by the foregoing lines, the new look CIB, will be another milestone in SBP's efforts to uplift the country's financial system to the standards recognized internationally, and to promote the financial stability. It has made possible for banks to meet the credit needs of the emerging sectors on sustainable basis by applying prudent and objective analysis of borrowers' credit profiles. This will also be a boon to those borrowers, who could not access bank lending because of lack of adequate collaterals. The strengthened CIB will also help in further boosting the supervisory capacities with greater access to more reliable and detailed information. All in all, the reinvigorated CIB is all set to spell benefits to all the stakeholders viz. financial institutions, borrowers and regulators to the ultimate good of the financial system.

15.3 Anti Money Laundering

Money laundering is not a new phenomenon - the criminals have always tried to conceal the funds originating from their criminal activity. The policy makers, regulators and financial institutions have, in recent times, awaken to the threats posed by money-laundering activities because of their potential connection with serious crimes like drug trafficking, corruption, financial crimes, organized crimes, etc. In this context, a group of countries (G-7) formed Financial Action Task Force (FATF) which framed its famous Forty Recommendations to combat Money Laundering and Nine Special Recommendations to combat Terrorist Financing. These special recommendations together with 40 recommendations on money laundering provide the basic framework to follow for preventing, detecting and suppressing both money laundering and terrorist financing.

The FATF recommendations have been implemented by a number of countries and accordingly appropriate changes have been introduced in their legal / regulatory regimes. This new regime has been internationally recognized as AML/CFT (Anti-Money Laundering / Combating Financing of Terrorism) regime which in turn prescribes legal, law enforcement, and regulatory requirements to combat money laundering and terrorist financing.

To address the issue of money laundering, Pakistan has taken a number of measures which include necessary legislation and amendments in the laws. In late CY05, the Government drafted AML Bill 2005 and the same is now pending with the concerned Committee of the Parliament. While a comprehensive law on terrorism has already been enacted that specifically criminalizes financing of terrorism and money laundering emanating from the proceeds of terrorism related activities.

Cognizant of the sensitivity of the issue, SBP, in consultation with internal and external stakeholders, has also taken number of steps to address the challenges of money laundering. In this respect, SBP has adopted a multi-pronged approach and its salient features are:

- Introduction of comprehensive regulatory regime in line with international standards on AML/CFT regime viz. KYC/CDD, Suspicious transactions, Correspondent banking, record retention requirements, Sanctions, etc

- Development of enforcement capacity within the banks/DFIs and exchange companies through technology, training and development.
- Cooperation with domestic law enforcement agencies and other regulatory bodies.
- Ongoing interactions with regional / international AML/CFT bodies.
- Assigning clearly identifiable responsibilities to various institutions
- Increasing the incentives for documenting the economy and reducing cash transactions
- Making greater use of the banking system for payments and settlement and bringing the informal money changing business into the formal sector supervised by regulators

In addition to the above, the Government and SBP have taken following steps in support of their overall strategy;

- In order to document the economy SBP encourages the banks to make greater use of ATMs, credit cards, e-banking.
- Capacity building of Investigation agencies like NAB, Anti Narcotics (ANF) and Federal Investigation Agency (FIA)
- Close coordination between SBP and SECP has been ensured to address the common supervisory issues.
- Stringent application of PRs on AML/CFT is ensured through SBP's on-site inspection and off-site surveillance mechanism. Besides, AML/CFT unit in Banking Policy Department keeps a watchful eye on the ML/FT activities in the banking sector.
- As a part of its ongoing efforts to encourage banks/DFIs to adopt robust risk management practices, SBP has prepared detailed Guidelines on Internal Controls.
- SBP has issued directives to all banks to freeze the accounts of individuals and entities involved in terrorist activities in compliance with UN Security Council resolutions.
- Furthermore, money changers have been replaced with Exchange Companies to bring them under regulatory ambit and document their activities.

Realizing the regulatory role, SBP has directed all banks/DFIs to devise a comprehensive policy on *Know Your Customer* (KYC) and its subsequent dissemination at branch level. The identification of true identity of the prospective customer, proper introduction, minimum set of documents required for opening of new account, setting up of compliance unit, system to be put in place for monitoring of transactions, updated information on records, effective MIS, imparting suitable training to bank staff have been greatly emphasized in the PR on KYC. Banks/DFIs have also been mandated to keep records of transactions for at least five years so as to avoid any set back on legal and reputational front. The Banks/DFIs are also required to ensure that all the relevant regulations are strictly adhered to and their business is conducted in conformity with high ethical standards, procedure be established for obtaining the current status and the source of income of the customer, the transactions, which are inconsistent with normal routine transactions should attract special attention. Additionally, the overseas branches or subsidiaries of Pakistani banks in foreign countries have been directed to follow the regulations set by SBP or the relevant regulations of the host country, whichever are exhaustive. The banks/DFIs have also been advised to gather sufficient information about their correspondent banks in order to be fully aware of their nature of business and AML and KYC practices, while they are prohibited to establish correspondent banking relationship where there are deficiencies in KYC policies or where correspondent has no physical presence. Attention has to be paid in continuing relationships with banks located in jurisdiction that have poor KYC standards or have been identified by FATF as "non-cooperative" in the fight against money laundering. Implementation of above regulations is ensured through on-site examination specifically verifying the adequacy of KYC policies and other Anti-money laundering safeguards. Serious enforcement action is taken against banks/ DFIs who are found deficient in compliance of regulations.

Pakistan, being member of Asia Pacific Group on Money Laundering, regularly participates in the APGML's conferences and workshops, so as to keep abreast with the global developments as well as to get an opportunity to interact with the regional partners with regard to AML/CFT areas. SBP is making continuous efforts in imparting trainings to its officers in the field of AML/CFT and related supervisory matters. At the international level, SBP keeps close interactions with organizations who impart trainings on AML/CFT. As a result, a good number of SBP officers have since obtained foreign trainings in this field. Moreover, at the domestic level, SBP regularly interacts with IBP and NIBAF to arrange specific trainings on AML/CFT for its own staff as well as for other banks/DFIs.

In March CY05, a two-day International Seminar on AML was arranged at Islamabad by SBP, in which, interalia, the Chief Executives and Compliance Officers of banks were persuaded to report suspicious transactions to SBP. With the view to create awareness and sharing of international experience about the risks and issues in the context of money laundering and terrorist financing, a lecture on the subject of "Risk and Issues in the Context of Money Laundering and Terrorist Financing" was arranged on 22 February, 2006.

Going forward, it is anticipated that a Financial Monitoring Unit (FMU) will be established in SBP. Preliminary work on formation of FMU and study of best international practices in this regard is underway. FMU, after its establishment, would be responsible for receiving Suspicious Transaction Reports (STRs), analyzing them and referring to law enforcement agencies those STRs requiring further investigation.

15.4 Basel Capital Accord II - Update

The Basel II capital accord provides a comprehensive and more risk sensitive capital allocation methodology. This will enable banks to optimize their resources in terms of their risk exposures. Its implementation, however, has become a very challenging task for the regulators around the world keeping in view the fact that it prescribes significant up-gradation of risk management standards and technological advancement within banks. In this respect, SBP has taken effective steps, and issued a clear-cut roadmap on 31st March 2005 for the implementation of Basel II in Pakistan. Under the roadmap, banks are initially required to go through a parallel run of one and half year for Standardized Approach starting from 1st July 2006. To ensure a smooth transition to the new regime, a number of steps have been taken by SBP and the banking system to provide a solid foundation for the launching of the parallel run.

In pursuance of the roadmap, banks submitted their individual plans mentioning the specific approach (Standardized or IRB), they intend to adopt and their internal arrangements for its implementation. Majority of the banks have expressed their intention to first adopt comparatively simple Standardized Approach keeping in view the requirement of more sophisticated systems for the advanced approaches. However, some foreign banks might go for IRB Approach in view of the strategy adopted by their head office abroad. For this, they, however, will first have to seek the approval of SBP. A comprehensive review exercise on the part of SBP culminated in a more specific bank-wise internal plans. To streamline the implementation process and to ensure better coordination, each bank deputed their respective coordinators at group head level along with formulation of Basel II units.

Recognizing the inherent constraints of the majority of banks, the roadmap envisages the Standardized Approach to such banks in the initial period. However, those equipped with sophisticated risk management capabilities and sufficient data would subsequently be allowed to adopt IRB. Under the Standardized Approach, the capital requirement against credit risk would be determined on the basis of risk profile assessment by rating agencies recognized by regulators as External Credit Assessment Institutions (ECAIs). To ensure transparency in recognition process, eligibility criteria for recognition of ECAIs was devised in consultation with all stakeholders on the basis of broad guidelines described in Basel II. Scrutiny resulted in the granting of ECAI status to two rating agencies namely PACRA and JCR-VIS as both were meeting the minimum requirements laid out in the criteria. The recognition implies that the banks would use ECAI's risk assessment rating of their portfolio for calculation of capital requirement under Basel II. Mapping of ratings with the appropriate risk weights has also been finalized in consultation with recognized ECAIs.

Circulation of draft for proposed circular on minimum capital requirements under new capital accord was another step in the right direction. This capital adequacy framework will apply on banks and DFIs operating in Pakistan on stand alone and consolidated basis. The comprehensive document envisages detailed instructions and definitions of capital, minimum capital requirement, measurement of capital adequacy, risk management framework, different approaches while quantifying risk based capital requirements and reporting requirements, to name a few. Comments were solicited from all stakeholders on this document and in their light necessary amendments would be made, if necessitated.

Guidelines issued for gradual enhancement of minimum capital requirements along-with the introduction of variable capital adequacy ratio on the basis of Internal Risk Assessment Framework (IRAF) is a significant step forward towards implementation of Basel II. Noncompliant banks would have to face different repercussions ranging from imposition of restrictions on acceptance of deposits and lending to cancellation of banking license. Enhanced disclosure requirements against fraud and forgeries will support in meeting the Pillar I requirements. Issuance of instructions to banks for inclusion of a comprehensive paragraph on risk management framework in the directors' report of their annual accounts will help in bridging the requirements under supervisory review (Pillar II) requirements. To reduce gap between hitherto disclosure practices and requirements under market discipline (Pillar III) of Basel II, guidelines for circulation of financial statements to all stakeholders and publication of their abridged version in the press were issued. Implementation of Reporting Chart of Accounts

(RCOA) would support in meeting the disclosure requirements under Pillar II and Pillar III of the new capital framework.

Implementation of Basel II poses tremendous challenges for the banking system in Pakistan. To meet the gigantic task, the banks and SBP are engaged in capacity building in terms of upgrading their IT systems and enhancing expertise of human resource base. SBP conducted a number of seminars and workshops on new capital accord and risk management techniques for internal and external stakeholders and remained engaged in improving its IT systems to get extensive regulatory reporting in line with the maximum disclosure requirements under Basel II. Banking sector has been taking concrete steps in this direction so as to meet the minimum requirements for implementation of Basel II. Some of the banks have initiated establishing internal rating framework required for adoption of advance approach in next four to five years.

Meanwhile, the Basel Committee on Banking Supervision (BCBS) also revised the new capital adequacy framework (Basel II) in November 2005 after incorporating additional guidelines set forth in the committee's paper "The Application of Basel II to trading Activities and the Treatment of Double Default Effects".

SBP is set to launch parallel run from 1st July 2006 that will ensure smooth transition to Basel II framework. It will help the stakeholders to better understand the implications of Basel II and resolve issues that may arise during transformation.

Presently, a high number of clients availing credit facilities from the banking system are unrated. Thereby, major concern in the implementation of Basel II may be that the banks with substantial number of high worth but unrated clients would not get the benefit in determining capital requirement as they would be treated at par with the banks having less worthy and unrated clientage in assignment of risk weights to their portfolio. Further, the level of commitment of board of directors of individual banks would be a very important factor in determining the level of ease in the implementation of Basel II in our banking system.

15.5 Derivative Business Volume

By far, one of the most noticeable trends in finance during the past few years has been the development and expansion of financial derivatives. In Pakistan, though derivatives have been a relatively new concept until recently, the derivative volume has increased manifold amidst the changing market and regulatory environment. In response to the changing market dynamics and in order to develop an Over the Counter (OTC) financial derivatives market in the country, SBP issued Financial Derivatives Business Regulations in November 2004. Prior to this, the banks were allowed to undertake the business of financial derivatives after getting specific approvals from SBP. However, with the issuance of these guidelines, the banks/ DFIs that besides meeting the eligibility criteria specified therein, also obtain Authorized Derivatives Dealer (ADD) or Non Market Maker Institution (NMI) status from SBP; have been allowed to undertake derivatives business. The grant of such status is based on the capacity of the applicant to undertake derivative transactions based on both onsite and offsite analysis. At present, three banks have been granted the status of Authorized Derivatives Dealer. The regulations allow three types of transactions viz. Interest Rate Swaps (IRSs), Forward Rate Agreements (FRAs) and FX options.

During the last one year, derivative transactions grew manifold owing to the growing interest of the market players. Resultantly, the derivatives players in OTC derivatives market reported outstanding derivatives contracts with a notional value of Rs115.5 billion as of March-06, a measure that has grown manifold compared to Rs14.5 billion in March-05 (see **Table 15.5.1**). Most of these derivative transactions were under the IRS category. So far, foreign banks have been quite active in carrying out derivative transactions as their major chunk lies with such banks. As for the FX options, around Rs18 billion have been booked with major currency being the Euro against US Dollar. Most of the IRS have also been undertaken by the foreign banks with both their corporate and financial sector clients. Since the FRAs are essentially short term in nature, outstanding FRAs stand as nil. Whilst the banks can undertake derivative transactions both for hedging and market making, most of such transactions were assumed for hedging purposes up till now. However, with greater sophistication of the market, the transactions for the latter are also expected to grow in future.

Table-15.5.1: Outstanding Derivative Transactions
(Rs in Million)

Derivative	Mar-06	Mar-05
FX Options	17,869	5,971
IRS	97,660	8,521
FRAs	-	-

15.6 Deposit Insurance

The significance of an effective Deposit Insurance System (DIS) in enhancing the confidence of depositors cannot be overemphasized. Whilst it provides safety and liquidity to the depositors, it also protects against bank runs without overburdening the taxpayers. However, DIS has certain downside risks too as in the presence of DIS it is more probable for the banks to assume excessive risks. However, in the context of Pakistan's banking scenario where a major chunk of deposits lie with private banks (CY05: 70 percent) the introduction of DIS becomes quite logical. Moreover, the banking system has made noticeable improvements in recent years which is reflected from enhanced financial stability of the individual banks and improvement in the service quality due mainly to the intense competition within the banking system. This fairly dispels the chances of complacency on part of the banks.

Considering the importance of DIS as well as its related risks, SBP has proposed a Depositors' Protection Scheme (DPS) in line with the international best practices. The DPS has been so designed as to check the various risks associated with DIS through the insertion of restrictive features such as limited coverage and exclusion of interbank deposits. However, the proper implementation of the DPS requires certain amendments in the legislation. Accordingly, SBP is in the process of making such amendments which entails among others, recommendations for establishment of a separate entity to take care of the matters concerning DPS. Once enacted, the Act shall empower SBP to properly enforce DPS in true spirit while safeguarding the interests of all the stakeholders.

15.7 Scope for Mergers and Consolidation

A sound and fundamentally strong financial system is essential to the growth of a vibrant economy. In this regard, to promote efficiency and productivity, not only the environment of healthy competition but also the financial health of every single institution is of utmost importance. In the pre-reform era, five large public sector banks, with more than 90 percent share in the asset base, dominated the banking scene. In view of this, the early 1990s saw the introduction of policy reforms aimed at promoting competition amongst the banks in Pakistan. This had a very positive impact as a number of commercial and investment banks emerged in the private sector. Whilst a few banks in the private sector played a very impressive role in developing a competitive edge over their counterparts by significantly enhancing their market share, which also led to a sharp fall in the share of erstwhile public sector banks; a couple of other banks could not keep pace with this competitive stream. These weaklings are a source of regulatory concern as they not only highlight segmentation in the industry but also render them uncompetitive in an environment of stiff competition and growing burden in the form of increasing regulatory requirements.

While the regulators have achieved some degree of success in reducing segmentation and increasing competition as well as encouraging the emergence of strong banks, the number of banks declined to 39 in CY05 from 46 in CY97. However, the Herfindahl[19] indices for the industry show persistent decline indicating an increased contestability and scope for further mergers without impairing the system's competitiveness (see **Figure 15.7.1**). There are around twenty banks, which hold mere 9 percent share in banking system. While large 20 banks are improving their performance and converging on bottom-line performance indicators under increased competition, these small banks are gradually losing ground on operational efficiency (see **Figures 15.7.2 & 15.7.3**). With such a low share these banks would find it very hard to survive amidst growing competition and the regulator's efforts to develop a robust and resilient banking system by increasing capital adequacy requirements and tightening prudential norms. Moreover, they are not fully equipped to meet the

Figure 15.7.1: Herfindahl Indices for the Banking System

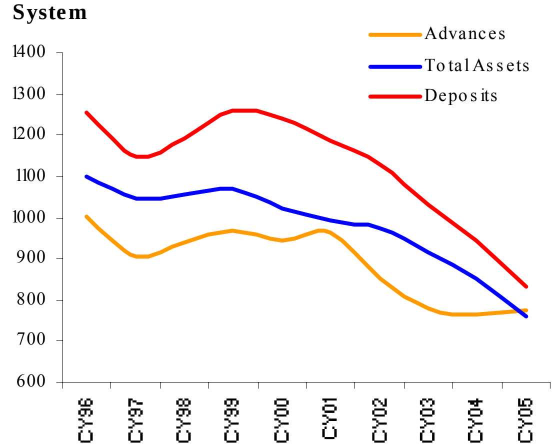


Figure 15.7.2: Intermediation Cost by Size of Banks

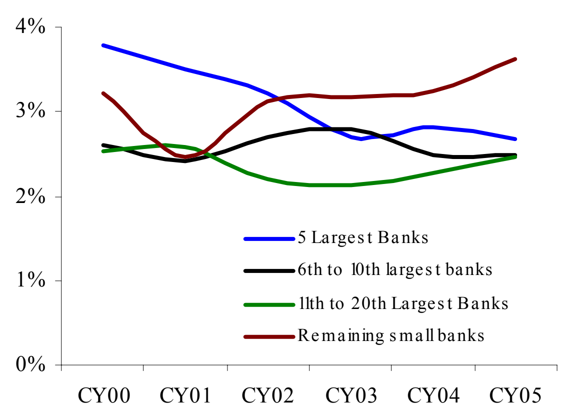
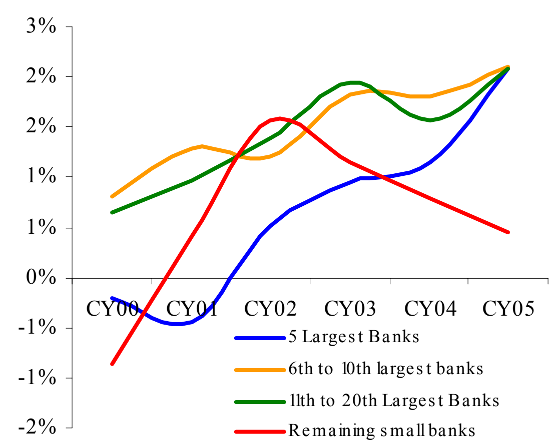


Figure 15.7.3: ROA by Size of Banks



[19] *Herfindahl Index is defined as sum of squares of the market share of all banks. The maximum value that the index can assume is 10,000 i.e. only one bank holding 100 percent market share – an example of absolute concentration. Authorities over the world use the index to measure and control market concentration. Sometimes H below 1,000 is considered relatively limited concentration, and H above 1,800 indicates significant concentration*

increasing demand on resources for technology and infrastructure.

To remove the bottlenecks for further consolidation of the banking system, more focused regulatory measures are being taken. In this regard, the capital standards for the banks have been raised in line with the international standards that would naturally attract further mergers of banks. With the minimum capital requirements to be raised gradually to Rs6 billion by 2009, there are expectations of faster pace of consolidation in the days ahead. Moreover, the market dynamics, with the growing awareness among the banks customers, rapid pace of globalization and changing outlook of the 21st century bank, enhanced transparency and disclosure requirements, would also force these banks to explore merger options. On the operational side too, the banks recognize that the efficiency gains are closely related to their size hence with higher penetration of technology, financial products and services could be produced on a massive scale cost effectively, while at the same time offering greater maneuverability in enhancing their business volume and productivity. From consumers' perspective, this will not only provide a greater sense of protection to the depositors due to fewer but larger and stronger banks but also the competition amongst the market players on an equal footing would result in provision of improved quality financial products and services.

In this regard, it must be appreciated that fundamental features like portfolio, level of non performing assets, capital adequacy, models and strategies, products and services and staff issues should be carefully considered. Even though the consolidation would serve the banks as a quick step to acquire competitive edge and offer them an opportunity to share markets and reduce their cost of product development and delivery, these mergers should be based on the inherent strengths and weaknesses of the participants involved.

While riding on the wave of mergers and consolidation, the regulators will also have to be careful of the downside risks of this strategy. Hence, the supervisory structure is also evolving concomitantly to cope with the emerging complexities in the financial system on the back of greater consolidation.

16 Developments in Banking Supervision

16.1 Guidelines Issued During the Year

16.1.1 Stress Testing

Risk management is the key to ensure soundness and stability of the financial system. Financial institutions as well as supervisors have been increasingly employing sophisticated statistical models to measure, manage and control these risks ranging from market (i.e. interest rate, exchange rate and equity price risks) to credit risk (the probability that borrower will default) and the operational risk (probability of fraudulent activity, system failure). However, such models are the simplification of reality and do not capture all of the risk scenarios. Moreover, the dynamic models are based on set of assumptions which may not prevail in reality. To address the limitation of such risk assessment models, the managers have developed a technique known as stress testing. Central banks and financial regulators, around the globe, have been increasingly employing the stress testing to assess the resilience of the financial system to large but plausible shocks. It is a process, which provides information on the behavior of the financial system under a set of exceptional, but plausible assumptions.

In a sharp contrast to the pre-reform period, when the banking system in Pakistan was dominated by weak and vulnerable banks, majority of the institutions were under-capitalized, carrying a huge burden of infected loan portfolio, now in CY05, we have well capitalized financial institutions meeting the international benchmarks and adopting the best international practices. Presently, our banking system is far more resilient and sound and the operating performance of the banking industry is also robust. In addition to the noteworthy improvement in the operating performance of banks, financial environment has also undergone a striking change. As against the public sector dominated banking system in 1997, the private sector now holds control of around 80 percent of the banking assets. While it has introduced competition and efficiency in the system, the introduction of new comparatively complex products, deregulation and the growing competition in the market has also given rise to a host of risk factors.

This calls for a concerted response on the part of SBP to provide a framework to the financial institutions to help them build their own understanding about measuring and monitoring their risks, thereby, controlling them in a better way. In this regard, as an extension to the efforts for risk management in banks and DFIs, a set of Stress Testing Guidelines were issued in 2004.

In these guidelines, keeping in view the divergence of skill level and available resources among banks and DFIs, the scope of the stress test is limited to simple sensitivity analysis. However, with the increasing capacity building and availability of more data, the model will undergo further refinement. Five different risk factors namely; interest rate, forced sale value of collateral, non-performing loans (NPLs), stock prices and foreign exchange rate have been identified and used for the stress testing. Moreover, the liquidity position of the institutions has also been stressed separately. The levels of shocks to the individual risk components have been specified in the Guidelines considering the historical as well as hypothetical movement in the risk factors.

These guidelines require the banks and DFIs to institutionalize a framework for stress testing, which should equally be flexible enough to adopt advanced models for stress testing. This also requires them to have a well constituted organizational structure to assess the resilience of their institutions towards different risk factors, an effective management information system (MIS) that ensures flow of information and a mechanism for ongoing review of the results of the stress tests and last not the least, to develop their own stress test models according to the nature, size and complexity of their business.

16.1.2 Criteria for Setting up a Commercial Bank

The financial sector in Pakistan was opened to private sector (both for local and foreign investment) in 1989 as a part of Federal Government's policy of deregulation and privatization of financial sector. Till the end of 1994, a good number of commercial banks and NBFCs were given authorization/licence to commence business. Therefore, in order to consolidate and strengthen the banking sector, as a first step, a moratorium was placed on setting up of commercial banks owned 100% by the local sponsors, which is still continuing. However, under World Trade Organization commitments undertaken by Pakistan, foreign financial institutions/entities either directly or in collaboration with local partners/sponsors, are permitted to open commercial banks. In this connection, SBP has issued detailed guidelines and criteria for setting up of a new commercial bank in Pakistan, both by local as well as foreign institutions/entities/strategic investors in line with Basle Core Principle No. 3. The guidelines state that the proposed bank must be public limited listed company with a minimum of 50 % share holding with general public. In addition to it, these guidelines specify minimum paid up capital, minimum capital adequacy ratio as prescribed by SBP, minimum capital to be subscribed personally by sponsor directors and the minimum number of sponsor directors. Furthermore, these guidelines encompass the areas like, remittance of dividend on foreign shareholding, fit and proper test for board of directors and chief executives. These guidelines decide two major categories, which can conduct banking business in branch mode and prohibit a group to own more than one commercial bank. In addition to it, these guidelines spell out information/ documents required for processing of application for establishment of commercial bank and estimated time for processing of applications. In addition to it, time frame for validity of licence and processing fee etc has also been specified in these guidelines.

16.1.3 Islamic Modes of Finance

In order to ensure compliance with minimum Shariah standards by the banks conducting Islamic banking in Pakistan, the Commission for Transformation of Financial System set up in SBP approved essentials of Islamic modes of financing. These are model agreements which have been approved in line with the Supreme Court Judgement on Riba. These include Musharaka, Mudaraba, Murabaha, Musawama, Leasing, Salam and Istisna. These model agreements are expected to facilitate the existing Islamic banking sector in creating awareness about Islamic banking products and to develop such products. These model agreements, however, can be modified, in conformity to the products designed by the banks conducting Islamic banking business. But in order to bring any change in these model agreements, banks conducting Islamic banking operations, will seek approval of the Shariah Board of Islamic Commercial Banks or Shariah Adviser of banks having Islamic banking branches, ensuring that such changes are consistent with the principles of Shariah. After comprehensive review and approval by Shariah board, the essentials of Islamic modes of financing have been circulated through the banks conducting Islamic banking business in Pakistan as guidelines. These guidelines are expected to evolve into prudential Regulations for Islamic banks in due course.

16.1.4 Accountholders Using Debit, Credit and Smart Cards

In the modern world, payment systems have evolved into highly sophisticated and speedy electronic payment systems. However, there are severe security related challenges facing the modern electronic payment systems, making it more vulnerable to various types of risks. There was, therefore, an immediate need to take measures to strengthen security on one hand, and to create awareness on the adoption of new practices to mitigate risks arising out of deployment of new technologies. In this connection, SBP in consultation with commercial banks has developed "Guidelines for Account Holders using Debit/Credit Cards" which will facilitate the various stakeholders to disseminate basic information on e-banking practices to their customers. These guidelines are minimum set of information and may be customized by the bank to meet their specific requirements. These guidelines carry general instructions and precautions which encompass the areas like, choosing PIN, keeping the PIN a secret, choosing and using ATM, leaving ATM etc. Furthermore, these guidelines also carry precautionary measures to be adopted while using Point of Sales, doing internet transactions and checking statements etc. In these guidelines some important signs of ID theft and fraud have been discussed and some problem resolution procedures have been presented.

16.1.5 Higher Education Financing Scheme

Education is crucial to sustained economic development of every country as it develops a strong and skilled human resource. SBP maintains that an unbendable resolution and concerted efforts are needed to accelerate the pace of improving the level and standard of education for sustained economic development in order to alleviate poverty. Commercial banks/DFIs should play a leading role, as a national priority, for development of human capital. SBP believes this can be done on a commercially viable and sustainable basis. In order to facilitate the banks/DFIs in this activity, SBP has devised guidelines for promotion of Higher Education. The objective is to provide term loans to needy and meritorious students through formal banking channel for pursuing further/higher/professional studies within the country or abroad in different disciplines in order to promote and enhance the level of higher education in the country. These guidelines encompass the areas like, eligibility criteria for students, eligible subjects and educational institutions, area of study, maximum amount of loan, and procedure for disbursement of loan, security for the loan, repayment of loan and provisioning requirements etc.

While framing terms and conditions of their schemes, banks/DFIs are required to keep these guidelines in view. The banks/DFIs are encouraged to develop their own products/scheme based on the aforesaid guidelines and get these approved from their Board of Directors/competent authority (in case of foreign banks). This Higher Education Financing Scheme (HEFS) is in addition to and separate from the existing Students Loan Scheme (formerly Qarz-e-Hasna Scheme) for students administered by the National Bank of Pakistan.

16.1.6 Introduction of Basic Banking Account

SBP allowed the banks to levy service charges on deposit accounts vide BPD Circular No. 23 of 2003 providing that charges are indicated in their half yearly Schedule of Charges (SOC). The decision was made pursuant to the representations received from banks regarding the costs being incurred by them for providing various services to their account holders as also to impress the quality of services. The following categories of account holders were exempted from levy of service charges (i) Students; (ii) Mustahiqueen of Zakat; and (iii) employees of Government/ Semi-Government institutions for salary and pension purposes including widows/ children of deceased employees eligible for family pension/ benevolent fund grant etc.

The banks, subsequent to above instructions, introduced charges (Rs25-200 per month) on maintenance of deposit balances below Rs5,000-10,000/-. The increased account maintenance charges started raising a number of complaints from small depositors for being deprived of their hard earned moneys, resulting in public outcry and strong criticism in print and electronic media. Consequently, these depositors opted for to closing their accounts, as they cannot afford to pay Rs25-200/- as monthly charges. In terms of numbers, the account holders having balance less than Rs10,000/- decreased from 12 million in 2003 to 7.5 million in the CY05.

In order to address the neglect of the small depositors, SBP in November, 2005 advised all banks to mandatory introduce Basic Banking Account(BBA), with limited features, for affording basic banking facilities to the lower strata of the population. Similar practice is being followed in number of countries like USA, UK, Singapore etc. The main features of BBA are as under:-

a) Will be non-remunerative account.
b) No limit on minimum balance. In cases, where balance in BBA remains 'nil' for a continuous six-month period, such accounts will be closed.
c) No fee for maintaining BBA.
d) Maximum two deposit transactions and two chequing withdrawals are allowed, free of charge, through cash/clearing per month.
e) Unlimited, free of charge, ATM withdrawals from the banks' own ATMs. In case of withdrawal from BBA through the ATM machines of other banks, the respective/other bank may recover charges for such transactions.
f) For the existing banking accounts, banks may get the consent of all their customers whether they wish to maintain a BBA with them or a regular full service banking account with its accompanying terms and conditions. In case an account holder does not give his/her consent for a BBA, his/her account will be treated as a regular full service banking account.
g) Statement of account will be issued once in a year

The above features represent the minimum set of services which the banks shall provide to their BBA customers. The banks were allowed to add more features/facilities if they wish. All the banks were advised to introduce and publicize the above facility and report compliance to SBP latest by February 28, 2006.

In terms of the compliance received, all the banks have introduced BBA except the banks which are either practically inactive or are under amalgamation/restructuring/ privatization/winding-up process.

The above initiative of SBP has resulted in addressing the problems being faced by the small depositors as well as improving the reach of basic banking services to all strata of the economy and depositors have opportunity to open free-of-charge basic banking accounts. Since introduction of BBA, a large number of BBA have been opened in banks.

16.2 Market Discipline through Enhanced Disclosure

With the rapid pace of liberalization and deregulation for over a decade or so, the global financial market place has become more and more complex. The ensuing intense competition among the market players to grab the largest pie of financial assets has led to product innovation, radical improvement in work processes and ever-increasing reliance on technology; which appears to have become the decisive factor in facilitating the banks to establish financial supremacy by staying ahead of the technology curve. While information technology and liberalization has given a quantum jump to the role of market forces to shape the financial activities, it has also given rise to more frequent episodes of financial instability. This has led the supervisors and policy makers around the world to devise means to ensure market discipline to achieve the goal of sustained financial stability.

Market discipline, a market-based incentive scheme in which investors in banks' liabilities punish banks for greater risk-taking by demanding higher yields on those liabilities, is the core theme of the Pillar 3 of the Basel II. While Pillar 2 of the Accord attempts to strengthen supervisory oversight, the Pillar 3 recognizes the limitations of supervisory resources in a market based system and takes into account the necessity of enhancing bank disclosure to strengthen market discipline. This helps in shifting the burden of supervisory oversight to market discipline to serve an effective check on excessive risk-taking by banks.

SBP has not remained oblivious of the fast changing global financial landscape, and has been resolute in evolving a regulatory regime, which accommodates the new realities, and nurtures the domestic financial system at par with the international best standards. In this connection, SBP set out a comprehensive roadmap for the implementation of Basel II in 2005. However, smooth and seamless transition to Basel II requires development of necessary risk-management practices and technological up gradation at banks, and further strengthening of the supervisory capacities to meet new challenges. To cater these requirements SBP has already issued a complete set of risk-management guidelines to banks.

SBP is among the few supervisors around the world, which have clear and categorical instructions on the proper disclosure. To further make the soil fertile for the implementation of Basel II and also to promote transparency through adequate disclosures, SBP revised the existing forms of Accounts and Balance Sheets of banks in February 2006. Banks will be required to prepare the amended returns with effect from December 31, 2006. The amendments are in line with the Pillar III requirements of market discipline under Basel II. This is not only an important step forward in inducing market discipline through greater transparency and comparability of information but also would help fill the lingering gaps in financial reporting.

In addition to meeting the Basel II requirements, the enhanced disclosure will also facilitate the stakeholders to take informed decisions while conducting business with banks, as banks would not be able to withhold necessary information pertaining to their health. This will help to leverage the influence of other market players in the day-to-day decision making of banks; this will not only prevent banks from excessive risk-taking to the detriment of depositors' interests but also will serve as a constant check upon their operations. This entails further improvement in operating efficiencies of the banking system in the days ahead. As the enforcement of market discipline though enhanced disclosure would expose the banks to a stricter vigilance by their stakeholders, SBP, helped by the automatic system of checks and balances, would get an opportunity to devote greater resources to further strengthening of its supervisory capacities to meet the challenges of Basel II.

No doubt, SBP has made substantial headway in promoting market discipline through greater disclosures, and this will be useful for supervisory authorities and other stakeholders, there is also a strong need to develop the expertise and ability of the general public and market analysts to accurately comprehend and interpret the disclosed information. This is important keeping in view the fact that disclosure alone is not sufficient in ensuring transparency unless the key players and stakeholders possess the requisite skills to effectively use such information. Moreover, the authorities will also have to ensure that too much disclosure do not cause information overload with adverse consequences for the financial position of bank.

16.3 Reporting Chart of Accounts

The Reporting Chart of Accounts (RCOA) has been introduced to streamline the data reporting to SBP by Reporting Institutions (RIs), enhance uniformity, transparency and reliability of that data. Besides these broad objectives, it also aims at eliminating duplication & redundancy and reducing the reporting burden on RIs. Entailing no change in the accounting systems of the reporting institutions, the RCOA is somewhat different from the existing reporting system. Compartmentalization and duplication of data submission through various returns was the hallmark of the previous system whereas under RCOA the information is being centrally submitted and available to different departments at SBP. Under frequency wise submission of various statutory returns to SBP, banks used to extract information from their general ledger and operating data (subsidiary systems) whereas RCOA operates as middleware between information system of reporting institutions and the reporting requirements. Under RCOA, the RIs have to submit the data online in a single document through their authorized administrators under different frequencies instead of 180 different returns. Further, RCOA has been made flexible to add and remove variables whenever required.

To transform the data under the existing system to the new system of online deposit under RCOA, a series of activities took place during CY05. Extensive rounds of deliberations took place among the stakeholders to review the first, second and third drafts of reporting chart of accounts and after incorporation of their recommendations, the final version of the RCOA was released. This document, covering all data variables sought by different departments of SBP with detailed decomposition of each data with distinct code numbers, definitions and reporting instructions was handed over to the Data Ware House (DWH) team. The document contained validation checks which were placed to ensure the accuracy of data submission. Those validation checks also enable the RIs to validate data before reporting.

Since the single RCOA document contained all variables for all different frequency of time for all reporting institutions, it was decomposed into Data File Structure (DFS) by categorization of reporting institutions into banks, DFIs and MFBs and those were instructed to submit data under different time frequencies like daily, weekly, biweekly, monthly, quarterly, half-yearly or yearly. This was done to facilitate the RIs keeping in view the fact somewhat different information was being sought from those institutions under different time frequencies. For example, data submitted under quarterly and yearly frequency is much detailed and contain large number of data lines and it would have been cumbersome for RIs to submit different reports through single document. The data file structure was released to RIs for their views and comments. Data Ware House team developed Banking and Money Module on SBP DWH Portal to integrate DFS. The authorized administrators of RIs were given online access to submit the frequency-wise data through the Data Acquisition Gateway. The administrators were provided with a detailed User Guide and a workshop was arranged for the reporting institutions to cover business and IT related issues. The user friendly guide was distributed to help the administrators to navigate, manage accounts and deposit data through DWH Portal. Help Desk has been established at SBP for addressing the queries of RIs. The banks are advised to map RCOA with their reporting systems that will add to their efficiency. However, knowing that mapping requires substantial technological up-gradation, investments and time, the RIs have been provided with the option to submit their data online by using spreadsheets. At present, most of the reporting institutions are submitting the data using spreadsheets.

To ensure smooth transition from data submission through different returns to RCOA and test the robustness of the system, it was thought appropriate, initially, to have parallel run by setting deadlines for data submission under various frequencies. During the parallel run, commenced from October, 2005, the RIs were required to submit their various data returns simultaneously through hard copies as they were already doing and online through the DWH Portal. The RIs are being encouraged to raise their queries pertaining to both business and IT related issues which are being duly addressed on ongoing basis. It enabled the RIs to better understand and implement the whole mechanism in its true spirit. This buffer was utilized to have close liaison with RIs to ensure the compliance of scheduled reporting on data file structure, verification of periodic returns submitted to different departments of SBP with DFS data submitted online, development of several generic and customized output reports required by various departments of SBP and their analysis and application of additional validation checks if necessitated.

Initially, the parallel run was to continue till January, 2006; however, considering the difficulties faced by some RIs in implementing RCOA at their end, the parallel run has been extended till March 2006 as success of ROCA demanded that all RIs should be on equal footing in submission of data through SBP Portal. This span enables all the stakeholders to improve their comfort level with the RCOA and resolve issues arising in the transformation phase.

Success of any major initiative depends on belief in the new system and close coordination of all stakeholders. Ever changing banking scenario demands that reporting institutions should upgrade their systems not only to comply with regulatory requirements but to utilize their resources in more productive jobs. It is significant that the RCOA has emerged from drawing board to practical reality where both RIs and end users at SBP are working for improving comfort level with online data submission and acquisition system.

16.4 Supervisory Developments

The banking sector of Pakistan has witnessed a marked change over the last decade. The emergence of banks in the private sector and privatization of nationalized banks has completely changed the outlook. This was accompanied by change in the business practices and regulatory approaches which moved away from direct to more market based, indirect ones. While this phenomenon has infused efficiency into the system and added value to the customers; the parallel increase in complexity and competition in the banking system has made the role of SBP even more challenging. SBP's has so far quite successfully fulfilled its responsibilities of ensuring financial stability. The bank's supervisory framework over these years has evolved into a matured system which is responsive to the changing environment and compliant with the internationally acknowledged practices of banking supervision.

16.4.1 On-Site Examination

During the year under review, SBP continued to direct its on-site examination resources to high risk areas. The on-site examination involves a detailed and comprehensive evaluation of all areas of a bank. The examination shows an overall assessment of banks' financial health, adequacy of strategies, policies and management system, compliance with applicable rules and regulations, and quality of reporting to the off-site supervision function.

The methodology comprises comprehensive assessment of stability and strength of capital, asset quality, earnings, quality of management, liquidity, sensitivity to market risks, and the adequacy of the systems to assess and manage all significant risks. These factors are abbreviated into CAMELS-S and a bank/DFI is rated on each of these components from 1 (strong) to 5 (unsatisfactory); accordingly an overall rating is derived for the institution. The on-site examination reports not only provide an objective assessment of an institution's overall strength, but also point out major lacunas and suggest necessary actions that institution should take to redress the concerns. The quality assessments of on-site examinations and active enforcement thereof has inculcated a strong discipline into the banking system and led to a marked improvement in the performance of banking system. The weak banks have been gradually pruned out through mergers and takeovers while a couple of banks that were found not responsible enough in their business strategies and operations have been closed. And now, unlike 1998's scenario where 4 & 5 (marginal and unsatisfactory) rated banks were dominating the banking system, the banking system is largely made up of 3 (fair) rated banks. This development has been obvious from the change in market share by CAMELS-S ratings (see **Figures 15.3.1 and 15.3.2**). While proactive supervision has paved the way for the mergers/closures of weak banks that could pose threat to the stability of the banking system, banking system has also shown quite strong responsiveness to the supervisory initiatives of SBP. Most of the banks that were performing marginally in 1998 have improved their workings over the years. The systemically most significant improvement in this regard has come from the five

Figure-15.3.1: Rating-wise market share of Banks in terms of Total Assets - 1998

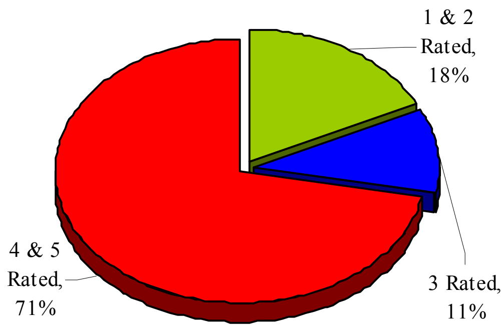
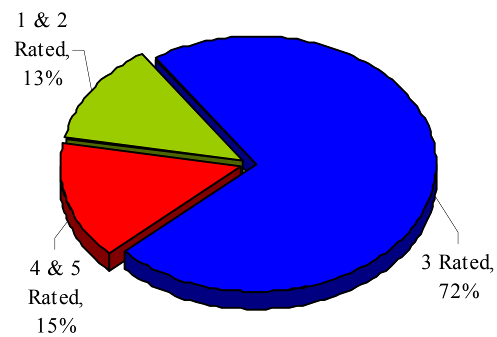


Figure-15.3.2: Rating-wise market share of Banks in terms of Total Assets - 2005*



** Latest available On-site Inspection ratings*

large banks, which were performing marginally. Resultantly, the weighted average CAMELS-S rating for the banking system has improved from 4 (marginal) in 1998 to 3 (fair) in 2005.
Since reformation and subsequent privatization of the large banks in recent years has been instrumental in this turn around, there are bright prospects for further improvements in the coming days as well. Specialized banks have been persistent laggards. Their poor performance can be attributed to the special nature of their business as well as the high costs involved in their restructuring. The policy makers have taken a number of initiatives for restructuring and revitalizing these institutions to enable them play more meaningful role in the economic development of the country. It is expected that these institutions will achieve the expected performance levels in near future. The impact of SBP's supervision has been equally instrumental in case of DFIs too. These institutions were also in critical situation at the inception of risk-based examination by SBP in 1998. Since then a couple of less responsible institutions and their malpractices were unearthed during on-site examination and these institutions were either liquated or reconstructed in orderly and timely fashion before they could pose threat to the stability of the financial system. Presently, all the DFIs are having improved on-site ratings. SBP is focusing its supervisory resources in more proactive, concerted, and risk focused manners. These efforts are likely to bring further improvements in the performance of the banking system and ensure financial stability in coming years also.

16.4.2 Off-Site Surveillance

The off-site surveillance function at SBP over the years has matured into a well-developed, proactive tool of supervision. The comprehensive approach involving the analysis both at individual institution and system level helps ensuring stability in the system by detecting problems at an early stage as well as promote transparency and market discipline and assesses the overall financial health of the system given the state of macro environment.

The individual bank analysis is based on the CAELS framework and works as guiding tool for better focusing the on-site examination resources. The function has become exhaustive and more refined with the introduction of more sophisticated indicators especially in the area of market risk. Besides the regular assessment of financial health of banks and DFIs, off-site surveillance carries out special studies to assess the impact of different changes in macro environment, and facilitates the decision-making process by providing objective impact analysis of the different policy initiatives.

Considering the importance of forward looking approach to risk management, SBP has instituted a framework of stress testing. The framework is based on single factor sensitivity and regression based analysis. Under the single factor sensitivity analysis exposures of all banks towards five major risks i.e. interest rate risk, credit risk, real estate price risk, equity price risk and exchange rate risk is being assessed after giving unusual but plausible shocks to the underlying risk factors. These exercises are helping in a great way to assess overall risk exposures as well as structural vulnerabilities in banks that could trigger potential externalities and market failures. Besides, in order to inculcate a sound risk management practices among the banks and DFIs and make the stress testing exercise more effective, consistent and focused, SBP has issued the guidelines on stress testing. These guidelines contain framework for regular stress testing, technique and scope of stress testing along with methodologies and calibration of shocks.

The liberalization and increased complexity in the banking system have impressed the need for the sophisticated tools to measure risks. SBP has also been working on the development of a model viz. Banking System Risk Assessment Model (BSRAM) which aims at quantification of value-at-risk for each bank/DFIs. The model will further strengthen the supervision function by prompting early warning signals where levels of credit, market, and operational risk of individual institutions shows increasing trend.

SBP has instituted an all-embracing framework viz. Institutional Risk Assessment Framework (IRAF) to further strengthen the existing supervisory mechanism and to mitigate the variety of risks banks are exposed to. The framework envisages a collaborative and seamless supervisory focus amongst various supervisory departments within SBP to ensure cohesive and proactive monitoring of risks within banks and DFIs. The framework, being highly technology driven, provides for the timely flow of information and enables SBP to institute more efficient and effective banking supervision and continuous monitoring both on the part of SBP and institution themselves, integrating off-site surveillance, on-site examination and current market information.

Besides monitoring the performance of individual institutions, SBP also keeps a watch on the performance and stability of the whole banking system. This analysis is primarily based on macro prudential indicators of the banking system and evaluates the system's performance and stability towards major environmental risk factors. This work is embodied in SBP's quarterly and annual reviews on the performance of the banking system. These reviews have been playing an important role in promoting the culture of transparency and strengthening the market discipline by disseminating the vital information about the health of the banking system to stakeholders at large.

16.4.3 Prudential Meetings with Board of Directors and top Management

The success of an organization is largely dependent upon the ability of its board of directors to give the organization an appropriate vision and ensure that the objectives are accomplished in most efficient manners. Realizing the importance of corporate governance and keeping the top-hierarchy of banks and DFIs informed of the regulatory issues, SBP has instituted regular meetings with Board of Directors and senior managements of the banks and DFIs that provide a forum for two-way communication between the regulator and regulatees. In these meeting Chief Executives and members of the Board of Directors could share with SBP the different challenges facing their organizations and their plans to overcome these challenges. These meeting also provides SBP a forum to convey its views in a more direct and effective manner on the various issues relating to individual banks and DFIs like business strategies and strategic plans, market positioning, corporate governance, risk management, capital adequacy, asset and liability management, and all the major issues observed during the course of on-site examination. Where supervisory issues are significant in nature and require speedy corrective actions, institutions are obliged to give specific action plans through formal memorandum of understanding. The frequent interaction with the board of directors and top management is contributing towards the strengthening of the financial system by ensuring early resolution of problematic issues.

17 Compliance with International Codes and Standards

Increased integration of financial markets and rising trend in cross border capital flows has enhanced the contagion risk globally. The financial crisis in one economy can easily transfer to other economies which has given rise a need to boost the immunity of national and international financial systems. To meet this end, international codes and standards were introduced as an important tool in a struggle to fortify the financial architecture both at domestic and international levels. This project encompassed some specific areas: Banking supervision, capital adequacy, monetary and fiscal policy transparency, accounting, corporate governance, securities, insurance, payment systems, anti-money laundering and creditor rights.

One mentionable development, in this connection, has been the introduction of financial sector assessment program (FSAP). Pakistan's financial sector's health was assessed in the light of compliance with Basel Core Principles for effective banking supervision (BCP), international organization of securities commission (IOSCO) objectives of securities regulations and IMF's code of good practices on transparency in monetary and financial policies. FSAP mission found Pakistan standing at a largely compliance level.

Of thirty Basel core principles and sub-principles for effective banking supervision, Pakistan was found fully compliant or largely compliant to all except four principles. These included capital adequacy, country risks, consolidated supervision and global consolidated supervision. However, out of these four, capital adequacy and country risks have been fully complied in the CY05 by implementing the capital charge for market risk and issuance of guidelines for country risk. SBP is committed to comply with the remaining two principles relating to consolidated supervision that certainly requires coordination with other national and international supervisors as well as amendments in relevant laws.

Pakistan's assessment of Anti Money Laundering and combating the financing of terrorism (AML/CFT) conducted by Asia Pacific Group (APG) on the basis of criterion set in FAFT recommendations has been outstanding. The laws and regulations pertaining AML/CFT, regulatory and supervisory systems and enforcement systems were reviewed. Financial sector of Pakistan was observed standing at exceptional compliance level. Besides, taking several policy measures, SBP developed and implemented comprehensive legal and institutional framework for AML/CFT. In this connection, two important prudential regulations were developed that are now in force: 'Know your customer' and 'Anti Money Laundering Measures'.

After finalization of new capital adequacy framework (Basel II), SBP responded efficiently and issued a circular containing road map and outline to adopt new capital adequacy regime. In the CY05 SBP also received detailed Basel II implementation plans from the banks. In addition to it, for the purpose of implementing Basel II in the country, SBP has recognized two domestic External Credit Assessment Institutions (ECAIs). As per the roadmap for the implementation of Basel II in Pakistan, Banks and DFIs are required to initially adopt standardized approach for credit risk from 1st January 2008 while Internal Ratings Based (IRB) Approaches from 1st January 2010. There would be a parallel run of one and half year for Standardized Approach and two years for IRB Approaches starting from 1st July 2006 and 1st January 2008, respectively. Another, worthwhile development has been the introduction of Institutional Risk Assessment

Framework (IRAF), and the capital requirements for individual banks/DFIs have been linked to their risk rating under this framework.

A robust and efficient payments infrastructure is essential to forestall and curtail systemic risks and therefore is essentially necessary for financial stability of the country. Real Time Gross Settlement (RTGS) has been successfully introduced and has replaced the manual book entry system. The foremost core principle for systemically important payment system calls for a well-founded legal base. SBP in its efforts to modernize the payment system and meet the deficiencies in the legal framework has drafted Payment System and Electronic Fund Transfer Act. Successful implementation of this act will help meeting the deficiencies in the payments infrastructure of financial sector of country.

Today's international financial arena is rapidly changing, bringing cross border mergers of different businesses and foreign direct investment growing than ever before. There is, therefore, a need of a single set of reliable, high quality accounting standards that can essentially meet the growing and diversified accounting needs of international financial community. International accounting standards is a one such set introduced by International Accounting Standard Board (IASB). Most of the international accounting standards have been formally adopted in Pakistan except few[20]. Of those that are not formally adopted, two[21] are currently not applicable to banks and are under SBP's consideration. While one[22] of the remaining two is not related to Pakistan and the other[23] is being considered by SECP. Furthermore, some of IASs have been amended by International Accounting Standard Board (IASB), however, amendments in these standards are yet to be incorporated into IASs in Pakistan. To bring further transparency in corporate sector of Pakistan the possibility of adopting international financial reporting standards (IFRS) is being evaluated. IFRS[24] are yet to be adopted by Pakistan and till their adoption IASs will remain applicable and effective.

[20] IAS 39, IAS40, IAS 29 and IAS41.
[21] IAS 39 and IAS 40 *are yet to be formally adopted*.
[22] IAS 29, *financial reporting in hyper inflationary economies.*
[23] IAS 41, *agriculture word for word.*
[24] IFRS 2 *share based payment*, IFRS 4 *insurance contracts* and a part of IFRS 5 *non current assets held for sale and discontinued operations* are new standards and are not the subject matter of IAS, therefore, they are to be incorporated in GAAP being applied in Pakistan

18 Resilience of Pakistan's Banking System to Stress Tests

Measuring, monitoring and controlling various types of risks is vital for ensuring the soundness and stability of an individual financial institution as well the financial system as a whole. Central banks and financial regulators, around the globe, have been increasingly employing sophisticated quantitative techniques to assess the vulnerabilities of the financial system. Stress testing is one such technique that generally accompanies the risk management models to assess the resilience of the financial system towards a set of exceptional but plausible shocks. SBP has also been employing this stress testing exercise to assess the resilience of the banks individually as well as the banking system as a whole.

Testing Approach

This stress testing exercise employs macro-prudential approach to assess the resilience of the banks towards univariate as well as multivariate shocks to the risk factors. The shocks have been devised in the light of different historical and hypothetical scenarios to measure the system's vulnerability in terms of deterioration in the quality of credit portfolio, adverse movements in exchange rate, interest rate, equity price and liquidity withdrawals. These stress scenarios have been classified in three types of instantaneous shocks i.e. credit quality, market and liquidity shocks (see **Box 17.1**). Market shocks have been further categorized under interest rate, exchange rate and equity price shocks.

Scope

The scope of the stress test has been extended to all commercial banks as against the previous studies, where the exercise focused on 12 largest banks only. Resilience of all the groups of the commercial banks, including Public Sector Commercial banks (PSCBs), Local Private Banks (LPBs), Foreign Banks (FBs) and all Commercial Banks (CBs) has also been assessed separately.

Calibration of Shocks

As for the credit and market risk, the impact of the stressed scenarios has been measured in terms of both the earnings and capital of the banks. The earning perspective is met by gauging the impact in terms of percentage change in the year end profits of the banks for CY05 whereas the impact on capital is translated into capital adequacy ratio of the banks. However, for the liquidity risk the impact is gauged in terms of the liquidity coverage ratio (ratio of liquid assets to liquid liabilities). The results of the stress tests have been summarized in the Box-17.2.

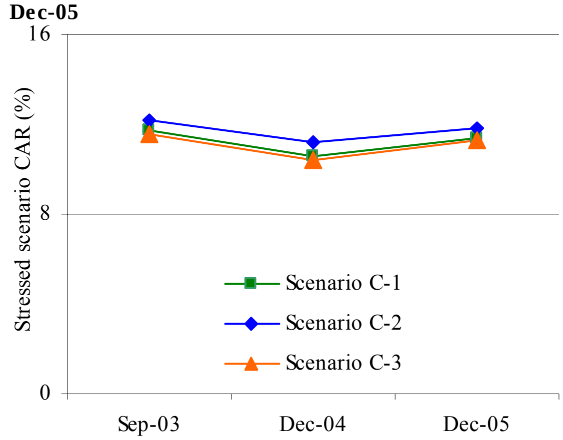
Analysis of the Results

The results of the stress scenarios in three types of shocks: credit, market, and liquidity shocks have been summarized as follows:

Credit Shocks

Improved capital has provided greater cushion to the banks to build their resilience towards both the univariate and multivariate shocks of asset quality of the banks **(see Figure 17.1 & 17.2)**.

Figure-17.1: Sensitivity to Credit Shocks Sep-03 to Dec-05



BOX 17.1
Reference Scenarios

Credit Risk

Scenario C-1 assumes a 10 percent increase in NPLs (with a provisioning rate of 100 percent).

Scenario C-2 assumes a shift in categories of classified loans (50% of the loans under substandard become doubtful, and 50% of the loans under doubtful become loss).

Scenario C-3 assumes a cumulative impact of both the shocks used in C-1 & C-2.

Scenario C-4 refers to the NPLs to total loans ratio, which would wipe out capital (with a 50 percent provisioning rate for additional NPLs).

Market Risk: Interest Rate Risk

Scenario IR-1 assumes an increase in interest rates by 100 basis points across all the maturities.

Scenario IR-2 assumes an increase in interest rates of outlying maturities (by 0, 100, and 200 basis points)

Scenario IR-3 assumes a shift coupled with flattening of the yield curve by increasing 150,100 and 50 basis points in the outlying maturities respectively.

Scenario IR-4 assumes a shift coupled with steepening of the yield curve by increasing 50,100 and 150 basis points in the outlying maturities respectively

Market Risk: Exchange Rate Risk

Scenario ER-1 assumes a depreciation of ER by 25 percent (around double of the change in the monthly average PRS/US$ exchange rate (12.83) over the period from Jan 1994 to Dec 2003, in September 2000).

Scenario ER-2 is based on the hypothetical assumption of appreciation of rupee by 20 percent.

Scenario ER-3 assumes a 10 percent depreciation of the rupee and deterioration in the quality of 10 percent of unhedged foreign currency loans with 50 percent provisioning requirement.

Scenario ER-4 assumes a 10 percent depreciation of the rupee and deterioration in the quality of 20 percent of unhedged foreign currency loans with 100 percent provisioning requirement.

Market Risk: Equity Price Risk

Scenario E-1 assumes the impact of a 20 percent fall in the index, based on largest percent change in the monthly Karachi Stock Exchange Index (KSE100 Index) over the period from Jan 2000 to Dec 2003, in May 2000 (19.2 percent), on the equity exposure of the banks.

Scenario E-2 assumes the impact with a 40 percent decline in the Stock Market Index.

Liquidity Risk

Scenario L-1 calculates the liquidity coverage ratio (excluding the Govt.Securities under Held to Maturity category) assuming a 5 percent decline in the liquid liabilities.

Scenario L-2 calculates the liquidity coverage ratio (excluding the Govt.Securities under Held to Maturity category) assuming a 10 percent decline in the liquid liabilities.

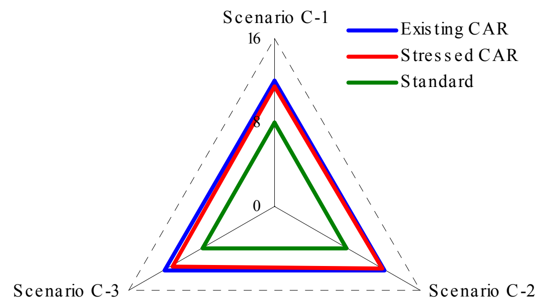
Scenario L-3 calculates the liquidity coverage ratio (not excluding the Govt.Securities under Held to Maturity category) assuming a 5 percent decline in the liquid liabilities.

Scenario L-4 calculates the liquidity coverage ratio (not excluding the Govt.Securities under Held to Maturity category) assuming a 10 percent decline in the liquid liabilities.

Lower levels of NPLs have also added to this resilience. Of the different *credit risk* scenarios envisaged in the exercise, ***Credit Scenario C-1*** (10 percent increase in NPLs with 100 percent provisioning requirements) put the highest strain on the banks' CAR. This shock may lower the CAR of all commercial banks to 11.7 percent from the existing 12.3 percent. Group-wise; all the banking groups are quite resilient towards this level of shock. FBs, mainly due to their low levels of NPLs and already high capital adequacy ratios, show highest resilience towards this shock followed by PSCBs. Bank-wise, all the banks preserve their CAR[25] above 8 percent against this shock.

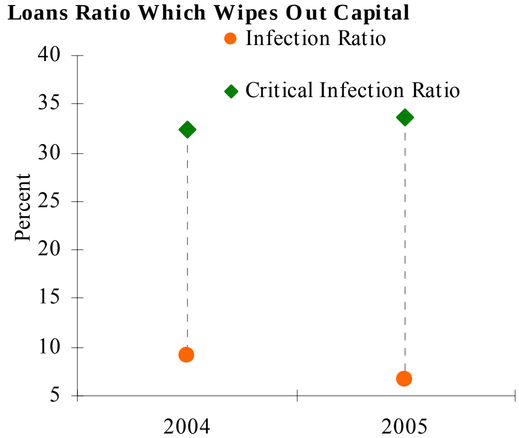
Credit Scenario C-2 takes into account an adverse shift in the NPLs categories. The impact of this 50 percent shift of NPLs in each category to its corresponding lower category would lower the existing CAR of the all banks to 12.1 percent. Group-wise, all banks would comfortably absorb the impact of this shock. Individually, CAR of none of the banks falls below 8 percent with this shift.

Figure-17.2: Impact of Credit Shocks on CAR, Dec-05



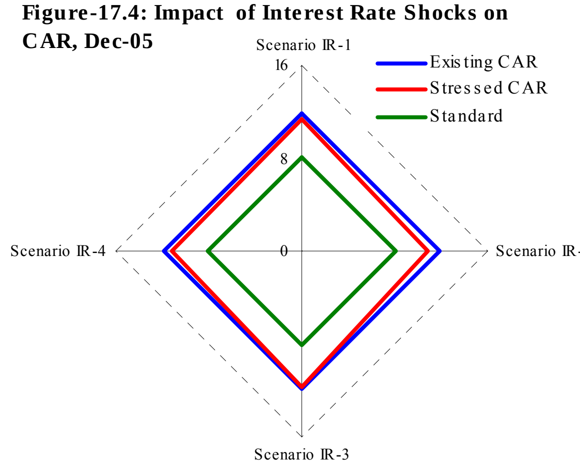
Credit Scenario C-3 combines the above two shocks calibrated under C1 and C2 and assumes a simultaneous happening of both the increase in NPLs as well as shift in NPLs. The results show that with this adverse move in the NPLs portfolio, the CAR of all the banking groups remains well above the acceptable benchmark of 8 percent **(Annex-3),** and all the individual banks have sufficient capital to absorb this level of stress.

Figure-17.3: NPLs to Loans Ratio Vs the NPLs to Loans Ratio Which Wipes Out Capital



Credit Scenario C-4 determines the level of NPLs to loans ratio, which would wipe out capital of the banks when 50 percent provisioning is required for additional NPLs. The existing NPLs to loan ratio of all commercial banks stands at 6.7 percent. The analysis shows that if this ratio increases to 33.5 percent the capital of all commercial banks would completely wipe out assuming the provisioning requirement of 50 percent on the additional NPLs portfolio **(see Figure 17.3)**. Foreign banks, with the lowest infection ratio, are enjoying a healthy margin followed by LPBs and PSCBs.

Figure-17.4: Impact of Interest Rate Shocks on CAR, Dec-05



Market Risk

Interest Rate Risk

[25] For this exercise, *the CAR of one bank has been calculated after adjusting for the amount that has been allotted as subscription towards future issue of right shares.*

Four different interest rate scenarios (IR-1 to IR-4) have been envisaged to see the impact of interest rate changes on the banks **(see Figure 17.4)**. ***Scenario IR-1*** assumes a parallel shift in the yield curve by 100 basis points. The analysis shows that with this change in interest rate, the net fall in the value of portfolio of all commercial banks if materialized on CAR of the banks, would remain on the lower side and CAR after shock comes down to 11.7 percent from 12.3 percent. Group wise, CAR of PSCBs experiences the highest decline of 0.9 to 14.2 percent. Bank wise, CAR of none of the banks falls below 8 percent with this shock.

Scenario IR-2 assumes steepening of the yield curve with 0, 100 and 200 basis points increase for all the three categories of three months, three-months to one-year and over one-year respectively. The results show that this change has slightly severe impact on the economic value of equity of all the banks. For all banks, the fall in value of portfolio may lower the CAR of commercial banks to 11.2 percent. Group wise, PSCBs experienced a greater fall in their CAR, however it can sustain a much larger shock due to its healthy CAR. Bank wise, the CAR of one bank comes down to below 8 percent, however the level remains around 7.8 percent.

Box 17.2

Results of "Stress Tests" of Pakistani Banking System

Single and multifactor sensitivity tests	**Dec-04**			**Dec-05**		
	Loss as %age of Gross Income	*%age Point Change in CAR*	*Revised CAR-After Shock*	*Loss as %age of Gross Income*	*%age Point Change in CAR*	*Revised CAR-After Shock*
Credit Shocks						
Scenario C-1 Deterioration in the quality of loan	-27.80	-0.79	10.60	-14.44	-0.54	11.73
Scenario C-2 Shift in categories of classified loans	-6.28	-0.18	11.21	-4.01	-0.15	12.12
Scenario C-3 Cumulative impact of all shocks in 1and 2	-34.09	-0.97	10.42	-18.40	-0.69	11.58
Scenario C-4 Level of NPLs to loans ratio where capital wipes out (i.e. 32.4% in Dec-04 and 33.52% in Dec-05)	-360.83	-11.39	0.00	-288.06	-12.27	0.00
Market Shocks; Interest Rate Shocks						
Scenario IR-1 Shift in the yield curve	-30.05	-0.85	10.54	-15.18	-0.57	11.70
Scenario IR-2 Shift and steepening of the yield curve (large shock)	-27.75	-0.80	10.59	-29.23	-1.10	11.17
Scenario IR-3 Shift & flattenining of the yield curve	-8.68	-0.24	11.15	-8.12	-0.30	11.97
Scenario IR-4 Shift and steepening of the yield curve	-21.26	-0.60	10.79	-22.14	-0.83	11.44
Market Shocks; Exchange Rate Shocks	0.00			0.00		
Scenario ER-1 Depreciation of Rs/US$ exchnage rate (double of the historical high)	15.13	0.42	11.81	13.60	0.50	12.77
Scenario ER-2 Appreciation of Rs/US$ exchnage rate (hypothetical)	-12.10	-0.34	11.05	-10.96	-0.41	11.86
Scenario ER-3 Depreciation in ER along with deterioration of quality of FX Loans (50 % Provisioning)	-0.50	-0.01	11.38	-0.21	-0.01	12.26
Scenario ER-4 Depreciation in ER alongwith deterioration of quality of FX Loans (100 percet provisioning)	-7.05	-0.20	11.19	-5.90	-0.22	12.05
Market Shocks; Equity Price Shocks				0.00		
Scenario E-1 Fall in the KSE index (historical high)	-10.66	-0.30	11.09	-0.63	-0.02	12.29
Scenario E-2 Fall in the KSE index (hypothetical scenario)	-21.46	-0.60	10.79	-8.64	-0.32	12.59
Liquidity Shocks						
Liquidity Coverage Ratio		*Actual*	*After Shock*	*Actual*	*Actual*	*After Shock*
Scenario L-1 5 Percent Fall in the Liquid Liabilities		-	-		36.3	32.9
Scenario L-2 10 Percent Fall in the Liquid Liabilities		-	-		36.3	29.2
Scenario L-3 5 Percent Fall in the Liquid Liabilities		40.1	37.0		39.4	36.2
Scenario L-4 10 Percent Fall in the Liquid Liabilities		40.1	33.5		39.4	32.6

Note: The results have not been adjusted for deferred tax benefits accruing on these losses.

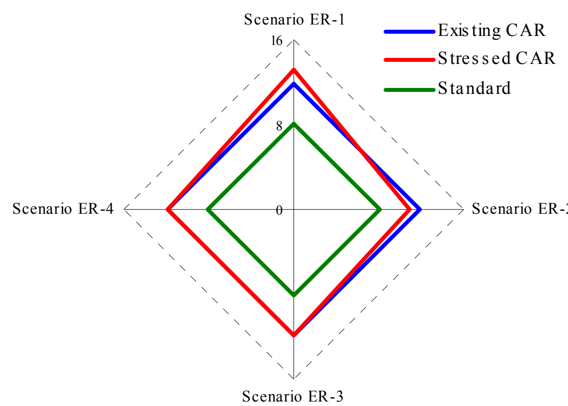
Scenario IR-3 assumes parallel shift along with flattening of the yield curve by 150, 100 and 50 basis points increase in the interest rates along the three maturity buckets of three months, three-months to one-year and over one-year respectively. The results show that this shock has a comparatively lower bearing on the value of portfolio. On cumulative basis, the CAR of commercial banks goes down to 12.0 percent with this shift in the yield curve. Group wise, the CAR of none of the groups falls more than 0.50 with this shock. Individually, none of the banks experiences dip in its CAR to below 8 percent with this shift in the yield curve.

Scenario IR-4 assumes parallel shift along with steepening of the yield curve. It takes into account 50, 100 and 150 basis points increase in the interest rates along the three maturity buckets of three months, three-months to one-year and over one-year. The analysis reveals that this shift in the yield curve may lower the CAR of the commercial banks to 11.4 percent. Group wise, PSCBs would experience a greater fall in their CAR to 13.69 percent from existing 15.11 percent. Bank wise, none of the banks experience dip in its CAR to below 8 percent with this shift in the yield curve.

Exchange Rate Risk

Four different scenarios (ER-1 to ER-4) have been calibrated to assess the exchange rate risk of the banks **(see Figure 17.5)**.

Figure-17.5: Impact of Exchange Rate Shocks on CAR, Dec-05



Scenario ER-1 assumes a depreciation of exchange rate by 25 percent. The results show that since foreign currency assets of the banks are greater than those of foreign currency liabilities, depreciation in exchange rate is not of concern for the banks because any depreciation in exchange rate will actually result in gains for the banks. In fact with this shock the CAR of all commercial banks increases by 0.5 percentage point.

Scenario ER-2 assumes appreciation of PKR by 20 percent. Since the banks generally have foreign currency assets well exceeding foreign currency liabilities, the appreciation in the rupee value would lower the value of their assets. Hence, this scenario poses greater threats to the profits of the bank. The analysis shows that if the impact of this change is calibrated on the CAR of the banks, the CAR of commercial banks would come down to 11.9 percent. Group wise, PSCBs are more susceptible to this shock and their CAR stands at 13.78 percent from the existing 15.1 percent. Bank wise, CAR of three banks may go below 8 percent.

Scenario ER-3 takes into account the direct as well as indirect impact of exchange rate changes on the banks portfolio. The direct impact tells about the net change in value if the exchange rate fluctuates, whereas indirect impact takes into account the impact of this change in the exchange rate on the credit quality. Depreciation in exchange rate would add to the value of a foreign currency asset but at the same time it may impair the repayment capacity of the loan borrower, hence indirectly affecting the credit quality of any portfolio. This scenario assumes a 10 percent depreciation of the rupee which may result in deterioration in the quality of 10 percent of unhedged foreign currency loans with 50 percent provisioning requirement. The analysis shows that since the foreign currency loans are not that large and the gains on depreciation are on higher side, the impact of this assumed scenario on the banks' portfolio is not significant. Group wise, only foreign banks may experience a fall in the value of their portfolio due to their greater exposure in foreign currency. Bank-wise, the impact is well absorbed by all banks except one bank whose CAR remains on borderline.

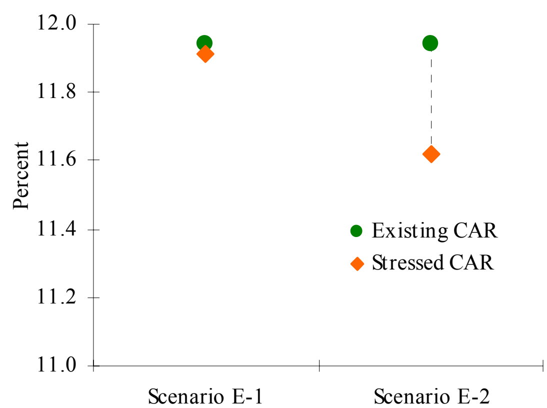
Scenario ER-4 again considers the direct as well as indirect impact of exchange rate changes on the banks portfolio but the shock has been slightly magnified. It assumes a 10 percent depreciation of the rupee and deterioration in the quality of 10 percent of un-hedged foreign currency loans with 100 percent provisioning requirement. The result of its impact shows that commercial banks except one foreign bank are fairly resilient to absorb this shock as well. The impact on foreign banks however, has slightly increased, yet the CAR of such banks remains above 16 percent.

Equity Price Risk

Two scenarios (E1 & E2) have been envisaged to look into the sensitivity of the banks towards equity price movements **(**see **Figure 17.6)**.

Scenario E-1 assumes the impact of a 20 percent fall in the stock market index. For simplicity, only the direct exposure of the banks in the equity market has been taken into consideration. The impact of this fall in the market prices of the banks' equity investments, assuming all the stock prices move in the same direction, is also not large. On overall basis, since the banks have sufficient cushion in the form of surplus (about 19 percent of their equity holdings) on their equity investments, the 20 percent fall in the equity prices would result in lower deficits. Bank wise, 13 banks have no threat with this shock as they do not have much exposure in equities while the remaining can also absorb the impact of this shock.

Figure-17.6: Impact of Equity Price Shocks on CAR-Dec-05



Scenario E-2 assumes the impact of a 40 percent fall in the stock market index. The study reveals that the 40 percent decline in the market value of the equity portfolio of banks would also not have significant bearing on the banks. Group wise, all groups show resilience towards this scenario. The CAR of commercial banks would remain at 11.9 percent. Bank wise, none of the banks' capital fall below 8 percent of the risk weighted assets with this shock.

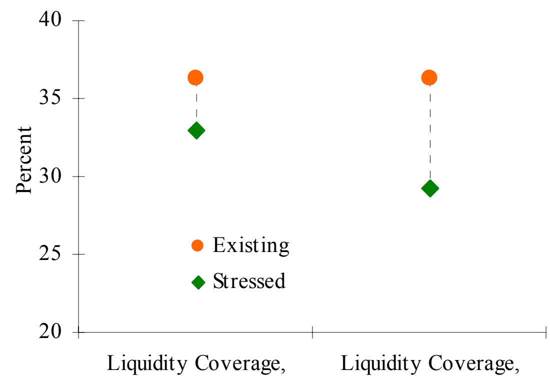
Liquidity Risk

Liquidity risk refers to the threat that the financial institution may not be able to meet its short term liquidity demands without impairing its profitability. One of the indicators of liquidity risk is the liquidity coverage ratio, i.e. liquid assets to liquid liabilities ratio. Since there is no international benchmark for this ratio, two levels of internal benchmarks have been used to assess the liquidity position of the banks. Since the statutory liquidity ratio is at 15 percent in addition to the cash reserve requirement of 5 percent for the banks, the benchmark ratios have been set at 30 percent for comfortable liquidity condition and 25 percent as minimum acceptable level of this ratio.

Moreover, the resilience to the liquidity shocks has been assessed assuming two broad definitions of liquid assets. Under Scenario L-1 & L-2 liquid assets do not include those Govt. securities, which have been categorized under Held to Maturity category by the banks themselves **(**see **Figure 17.7)**. However, for the sake of analysis, one may be interested in knowing about the level of stressed liquidity coverage ratio when the liquid assets include Govt. securities under Held To Maturity category. This has been captured under Scenario L-3 & L-4 **(**see **Figure 17.8)**. As per each of these two definitions, two levels of shocks have been identified to assess the resilience of the banks in terms of meeting their liquidity needs under stress conditions.

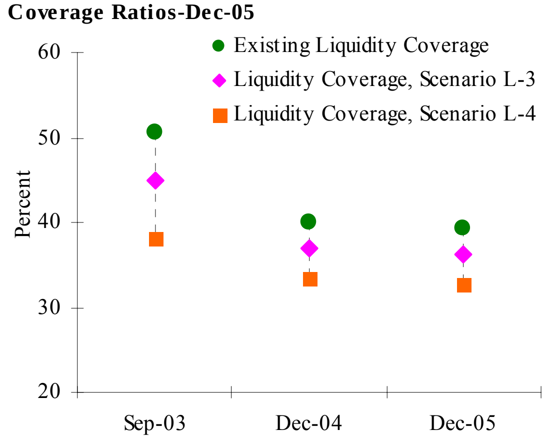
Scenario L-1 assumes a 5 percent decline in the liquid liabilities and its impact on liquidity coverage ratio is calculated after excluding Govt. securities under "Held to Maturity" category from liquid assets. The results of this exercise show that in this scenario, the liquidity coverage ratio of commercial banks declines to 32.9 percent from the existing 36.3 percent. LPBs would have a lower coverage ratio of 30.1 percent. Bank wise, 15 banks would have their liquidity ratio below 30 percent of which, 6 banks would have even lower than 25 percent.

Figure-17.7: Liquidity Coverage Ratio Calculated After Excluding HTM Portfolio-Dec-05



Scenario L-2 assumes a 10 percent decline in the liquid liabilities and its impact on liquidity coverage ratio is calculated after excluding Govt. securities under "Held to Maturity" category from liquid assets. The impact of this shock has remained significant. The liquidity coverage ratio of all commercial banks falls to 29.2 percent from the existing 36.3 percent. Group-wise, LPBs would experience the fall in their liquidity coverage ratio to 26.2 percent. Bank wise; 17 banks would experience their coverage ratio less than 30 percent.

Figure-17.8: Impact of Liquidity Shocks on Liquidity Coverage Ratios-Dec-05



Scenario L-3 assumes a 5 percent decline in the liquid liabilities and its impact on liquidity coverage ratio is calculated after including Govt. securities under "Held to Maturity" category in the liquid assets. The analysis reveals that since the level of liquid assets is increased the stressed liquidity coverage ratio of all banks stayed at 36.2 percent. Bank wise; 8 banks would experience their coverage ratio less than 30 percent.

Scenario L-4 assumes a 10 percent decline in the liquid liabilities and its impact on liquidity coverage ratio is calculated after including Govt. securities under "Held to Maturity" category in the liquid assets. The liquidity coverage ratio of all banks comes down to 32.6 percent with this level of shock. Group wise, coverage ratio of LPBs drops down to slightly below 30 percent. Bank wise, the liquidity coverage ratio of 11 banks falls below 30 percent.

Snapshot of the Results

The results of credit quality and market risk shocks under different scenarios show that the banking system is generally resilient towards the historical as well as hypothetical shocks of both the univariate and multivariate types. Among the credit and market risk scenarios, two shocks i.e. exchange rate shock of rupee appreciation by 20% (Scenario ER-2) and interest rate shock of steepening of the yield curve (Scenario IR-2) are likely to have the highest stress on the solvency ratio of the system, however the stressed CAR under both scenarios remains well above the 8 percent standard. The other scenarios like increase in NPLs, negative shift in the categories of NPLs, fall in the value of collateral, shift and movements in yield curve, and fall in stock market index would have a limited impact. Group wise; LPBs, though with a double digit CAR, are more susceptible to the large shocks due to comparatively lesser cushion in their CARs and the higher credit and market exposures. Nonetheless, in all the stress scenarios all the groups preserve the CAR over the required standard.

The results of liquidity shocks (Scenarios L-1 & L-2) are of concern since the system does not have enough cushions in the form of surplus liquidity. Since liquidity scenarios under this stress test exercise do not consider the chunk kept in Held to Maturity securities as liquid assets, situation aggravates for the banks which have not rationalized the distribution of their investments in the three categories according to their liquidity requirements. A 5 percent withdrawal in the liquid liabilities would squeeze the liquidity coverage ratio to 32.9 percent; it comes down to 29.2 percent if the shock level is increased to 10 percent. However, the two other scenarios, where the Govt. securities in Held to Maturity category has been included in the liquid assets (Scenario L-3 &L-4) shows less severity of the liquidity shocks to the liquidity coverage ratio of all banks as well as of groups. This reveals that the ability of the banks to categorize their investment portfolio in Held to Maturity category is questionable.

Financial Soundness Indicators

Annex-A

Indicators	1997	1998	1999	2000	2001	2002	2003	2004	2005
CAPITAL ADEQUACY									
Risk Weighted CAR									
Public Sector Commercial Banks	(1.3)	11.6	10.6	10.4	9.6	12.3	11.0	13.4	14.5
Local Private Banks	11.9	11.4	10.7	9.2	9.5	9.7	9.0	10.1	10.6
Foreign Banks	14.6	15.6	18.6	18.0	18.6	23.2	23.0	17.4	16.4
Commercial Banks	**6.0**	**12.5**	**12.2**	**11.4**	**11.3**	**12.6**	**11.1**	**11.4**	**11.9**
Specialized Banks	(6.2)	(1.4)	0.3	(3.3)	(13.9)	(31.7)	(28.2)	(9.0)	(7.7)
All Banks	**4.5**	**10.9**	**10.9**	**9.7**	**8.8**	**8.8**	**8.5**	**10.5**	**11.3**
Tier 1 Capital to RWA									
Public Sector Commercial Banks	(2.0)	8.3	7.7	7.7	7.1	8.6	8.2	8.6	8.8
Local Private Banks	11.4	10.2	9.3	8.1	8.4	6.6	7.0	7.5	8.3
Foreign Banks	14.4	15.4	18.4	17.9	18.6	23.0	23.0	17.1	16.1
Commercial Banks	**5.5**	**10.5**	**10.3**	**9.8**	**9.7**	**9.7**	**9.1**	**8.6**	**9.1**
Specialized Banks	(6.3)	(1.6)	0.3	(3.4)	(13.9)	(31.7)	(28.7)	(15.0)	(13.6)
All Banks	**4.1**	**9.1**	**9.2**	**8.3**	**7.3**	**6.2**	**6.5**	**7.6**	**8.3**
Capital to Total Assets									
Public Sector Commercial Banks	0.3	4.9	3.8	4.6	3.7	5.6	6.1	8.7	12.6
Local Private Banks	4.9	4.9	4.9	3.5	3.8	5.2	5.3	6.5	7.0
Foreign Banks	7.9	8.8	9.7	8.8	8.5	10.6	9.9	8.9	9.5
Commercial Banks	**3.1**	**5.6**	**5.0**	**4.9**	**4.6**	**6.1**	**6.1**	**7.2**	**8.4**
Specialized Banks	8.8	0.2	1.7	(1.1)	(10.3)	(23.0)	(10.0)	(9.4)	(8.1)
All Banks	**3.5**	**5.3**	**4.8**	**4.5**	**3.8**	**4.8**	**5.5**	**6.7**	**7.9**
ASSET QUALITY									
NPLs to Total Loans									
Public Sector Commercial Banks	30.8	29.0	30.7	26.3	25.9	25.5	20.4	13.3	10.0
Local Private Banks	10.2	11.1	15.5	15.4	16.3	15.4	11.3	9.0	6.4
Foreign Banks	5.0	5.3	5.1	4.7	4.3	3.8	3.1	1.6	1.2
Commercial Banks	**20.1**	**19.5**	**22.0**	**19.5**	**19.6**	**17.7**	**13.7**	**9.0**	**6.7**
Specialized Banks	50.6	47.2	51.6	52.4	53.0	54.7	55.6	54.1	46.0
All Banks	**23.5**	**23.1**	**25.9**	**23.5**	**23.4**	**21.8**	**17.0**	**11.6**	**8.3**
Provision to NPLs									
Public Sector Commercial Banks	52.9	55.6	48.8	59.2	56.6	57.1	65.8	77.0	86.8
Local Private Banks	57.8	53.3	35.0	36.9	40.5	58.6	62.7	69.9	76.4
Foreign Banks	65.9	75.0	63.4	65.9	74.1	73.3	78.7	101.9	145.9
Commercial Banks	**54.2**	**56.2**	**46.6**	**53.9**	**53.2**	**58.2**	**64.8**	**72.4**	**80.4**
Specialized Banks	22.8	65.3	54.2	58.1	59.2	66.9	61.5	64.9	64.8
All Banks	**46.6**	**58.6**	**48.6**	**55.0**	**54.7**	**60.6**	**63.9**	**70.4**	**76.7**
Net NPLs to Net Loans									
Public Sector Commercial Banks	17.0	15.0	18.5	12.7	13.1	12.8	8.1	3.4	1.5
Local Private Banks	4.6	5.5	10.7	10.3	10.4	7.0	4.5	2.9	1.6
Foreign Banks	1.8	1.4	1.9	1.7	1.1	1.1	0.7	(0.0)	(0.6)
Commercial Banks	**10.3**	**9.6**	**13.1**	**10.1**	**10.3**	**8.3**	**5.3**	**2.7**	**1.4**
Specialized Banks	44.1	23.6	32.8	31.6	31.5	28.5	32.5	29.3	23.1
All Banks	**14.1**	**11.1**	**15.3**	**12.2**	**12.1**	**9.9**	**6.9**	**3.8**	**2.1**
Net NPLs to Capital									
Public Sector Commercial Banks	2,081.0	119.9	212.0	124.5	160.2	83.4	50.0	16.2	5.5
Local Private Banks	43.3	51.4	103.5	153.5	125.2	54.8	39.1	24.3	13.0
Foreign Banks	10.0	7.1	9.9	9.0	5.8	4.7	3.2	(0.2)	(3.0)
Commercial Banks	**143.6**	**72.1**	**117.4**	**96.7**	**100.7**	**54.2**	**36.9**	**19.0**	**9.0**
Specialized Banks	380.0	11,139.0	1,502.3	-	-	-	-	-	-
All Banks	**183.8**	**92.6**	**149.8**	**131.3**	**150.5**	**85.5**	**54.4**	**29.2**	**14.3**

Financial Soundness Indicators

Annex-A

Indicators	1997	1998	1999	2000	2001	2002	2003	2004	2005
EARNINGS									
Return on Assets (Before Tax)									
Public Sector Commercial Banks	(3.4)	(0.4)	(0.4)	0.5	-	1.3	1.8	2.4	3.3
Local Private Banks	1.4	0.9	0.9	(0.1)	0.9	1.4	2.2	1.7	2.7
Foreign Banks	3.0	1.7	1.8	1.4	1.7	2.3	2.6	2.5	3.6
Commercial Banks	**(0.8)**	**0.4**	**0.3**	**0.4**	**0.6**	**1.5**	**2.1**	**2.0**	**2.9**
Specialized Banks	(0.2)	(9.4)	1.8	(2.3)	(8.4)	(10.2)	(3.3)	(0.4)	(1.0)
All Banks	**(0.8)**	**(0.3)**	**0.4**	**0.3**	**0.1**	**0.9**	**1.8**	**1.9**	**2.8**
Return on Assets (After Tax)									
Public Sector Commercial Banks	(3.1)	0.7	(1.0)	0.2	(0.5)	0.6	1.0	1.3	2.2
Local Private Banks	0.5	0.4	0.4	(0.7)	0.4	0.7	1.4	1.2	1.8
Foreign Banks	1.4	0.4	0.7	0.6	0.8	1.5	1.5	2.0	2.5
Commercial Banks	**(1.3)**	**0.5**	**(0.3)**	**(0.0)**	**(0.0)**	**0.8**	**1.2**	**1.3**	**2.0**
Specialized Banks	(0.2)	(9.4)	1.7	(2.3)	(8.8)	(12.1)	(3.7)	(0.8)	(1.2)
All Banks	**(1.2)**	**(0.1)**	**(0.2)**	**(0.2)**	**(0.5)**	**0.1**	**1.0**	**1.2**	**1.9**
ROE (Avg. Equity& Surplus) (Before Tax)									
Public Sector Commercial Banks	(272.7)	(14.6)	(9.6)	10.9	0.5	26.3	29.9	30.8	30.7
Local Private Banks	29.0	17.5	18.5	(3.2)	25.4	32.3	41.5	28.8	40.1
Foreign Banks	37.7	20.5	19.3	15.6	19.3	24.2	25.0	26.7	38.9
Commercial Banks	**(23.8)**	**8.0**	**6.5**	**8.8**	**12.2**	**27.5**	**33.7**	**29.0**	**37.2**
Specialized Banks	(1.8)	(211.0)	182.8	-	-	-	-	-	-
All Banks	**(20.2)**	**(6.4)**	**8.7**	**5.7**	**1.4**	**21.1**	**35.4**	**30.5**	**38.2**
ROE (Avg. Equity &Surplus) (After Tax)									
Public Sector Commercial Banks	(255.0)	24.0	(24.0)	4.9	(12.2)	11.5	17.3	17.2	20.9
Local Private Banks	10.9	7.3	8.1	(17.4)	10.3	17.3	25.8	20.2	27.2
Foreign Banks	17.2	5.1	7.1	6.1	9.1	15.2	14.8	21.5	27.1
Commercial Banks	**(36.2)**	**12.0**	**(6.2)**	**(0.3)**	**(0.3)**	**14.3**	**20.3**	**19.6**	**25.4**
Specialized Banks	(2.0)	(211.6)	179.1	-	-	-	-	-	-
All Banks	**(30.7)**	**(2.7)**	**(3.9)**	**(3.5)**	**(12.6)**	**3.2**	**20.0**	**20.3**	**25.8**
NII/Gross Income									
Public Sector Commercial Banks	36.1	58.6	56.5	61.8	69.9	69.5	64.1	63.7	71.3
Local Private Banks	50.2	54.9	53.4	63.2	72.1	65.5	55.9	62.0	73.0
Foreign Banks	56.1	50.1	50.0	54.0	59.4	57.5	55.3	57.7	61.5
Commercial Banks	**46.5**	**55.6**	54.3	**61.2**	**68.9**	**66.1**	**58.9**	**61.9**	**71.3**
Specialized Banks	88.5	85.1	71.7	78.6	86.7	78.0	62.2	81.9	87.7
All Banks	**48.7**	**59.3**	**55.6**	**62.3**	**70.4**	**67.1**	**59.2**	**62.8**	**72.0**
Cost / Income Ratio									
Public Sector Commercial Banks	140.0	92.1	84.7	70.1	62.3	56.9	43.9	39.5	34.3
Local Private Banks	60.9	73.8	76.6	80.9	67.3	60.0	53.2	56.2	43.1
Foreign Banks	43.6	55.5	57.0	59.4	54.5	45.4	48.2	49.0	42.2
Commercial Banks	**85.8**	**78.5**	**76.9**	**71.6**	**62.7**	**56.7**	**49.0**	**51.7**	**41.2**
Specialized Banks	74.6	32.2	62.2	70.5	59.0	84.7	67.5	57.8	47.8
All Banks	**85.2**	**72.7**	**75.8**	**71.6**	**62.4**	**59.1**	**50.5**	**52.0**	**41.5**
LIQUIDITY									
Liquid Assets/Total Assets									
Public Sector Commercial Banks	39.4	40.4	38.6	37.1	36.5	49.0	49.1	43.9	35.6
Local Private Banks	40.6	40.1	38.0	34.0	39.8	47.1	42.9	34.3	32.4
Foreign Banks	47.6	46.0	40.3	45.2	50.3	48.5	49.2	39.8	41.8
Commercial Banks	**41.4**	**41.3**	**38.7**	**37.5**	**39.9**	**48.1**	**46.1**	**37.0**	**33.9**
Specialized Banks	14.1	14.6	10.5	12.7	13.6	16.4	22.9	25.3	25.8
All Banks	**39.5**	**39.7**	**36.8**	**36.0**	**38.5**	**46.7**	**45.1**	**36.6**	**33.7**
Liquid Assets/Total Deposits									
Public Sector Commercial Banks	46.0	48.4	46.4	45.0	43.4	59.6	59.0	52.6	44.7
Local Private Banks	49.9	49.7	48.0	44.3	49.6	60.2	54.5	42.3	40.3
Foreign Banks	57.9	56.9	55.6	67.7	78.3	74.2	68.9	53.4	57.9
Commercial Banks	**49.4**	**50.3**	**48.2**	**48.0**	**50.3**	**61.5**	**57.8**	**45.7**	**42.7**
Specialized Banks	102.8	134.8	78.8	90.8	79.8	98.5	135.0	154.1	183.2
All Banks	**50.0**	**51.0**	**48.6**	**48.5**	**50.7**	**61.8**	**58.5**	**46.5**	**43.5**
Advances/Deposits									
Public Sector Commercial Banks	48.4	46.5	50.8	54.0	53.8	44.3	45.7	49.7	59.8
Local Private Banks	56.6	57.0	59.6	67.5	57.9	52.3	58.2	67.3	70.8
Foreign Banks	54.3	56.7	68.2	71.5	66.8	72.0	63.8	70.1	68.7
Commercial Banks	**51.8**	**51.2**	**55.9**	**60.5**	**56.9**	**51.0**	**53.6**	**63.6**	**68.4**
Specialized Banks	551.7	671.3	586.8	553.0	450.5	453.8	379.1	370.5	400.7
All Banks	**57.6**	**56.6**	**62.0**	**66.2**	**61.7**	**54.9**	**56.4**	**65.8**	**70.2**

Annex-B

Group wise Balance Sheets & Income Statements of Banks as of 31-12-2005

(Figures rounded off to nearest Million Rs)

	PSCBs		LPBs		FBs		SBs	
Financial Position	Amount	% age	Amount	% age	Amount	% age	Amount	% age
ASSETS								
Cash & Balances With Treasury Banks	82,329	11.4%	194,506	7.8%	46,103	13.6%	2,516	2.2%
Balances With Other Banks	43,192	6.0%	75,424	3.0%	11,949	3.5%	11,668	10.3%
Lending To Financial Institutions	26,742	3.7%	156,977	6.3%	28,138	8.3%	-	0.0%
Investments - Net	187,986	26.0%	523,287	21.1%	67,383	19.9%	21,380	18.9%
Advances - Net	345,537	47.7%	1,412,756	56.9%	168,226	49.6%	63,554	56.3%
Other Assets	27,145	3.7%	59,696	2.4%	13,984	4.1%	11,038	9.8%
Operating Fixed Assets	11,390	1.6%	52,881	2.1%	2,623	0.8%	2,258	2.0%
Deferred Tax Assets	90	0.0%	7,061	0.3%	831	0.2%	441	0.4%
TOTAL ASSETS	**724,410**	**100%**	**2,482,588**	**100%**	**339,237**	**100%**	**112,856**	**100%**
LIABILITIES	-		-		-		-	
Bills Payable	2,406	0.3%	34,900	1.4%	5,307	1.6%	384	0.3%
Borrowings From Financial Institution	20,768	2.9%	201,102	8.1%	39,082	11.5%	77,452	68.6%
Deposits And Other Accounts	578,060	79.8%	1,994,918	80.4%	244,955	72.2%	15,862	14.1%
Sub-ordinated Loans	-	0.0%	18,059	0.7%	-	0.0%	5,905	5.2%
Liabilities Against Assets Subject To Finance Lease	72	0.0%	473	0.0%	33	0.0%	22	0.0%
Other Liabilities	27,164	3.7%	56,005	2.3%	17,516	5.2%	22,336	19.8%
Deferred Tax Liabilities	4,683	0.6%	3,522	0.1%	143	0.0%	-	0.0%
TOTAL LIABILITIES	**633,153**	**87.4%**	**2,308,980**	**93.0%**	**307,035**	**90.5%**	**121,961**	**108.1%**
NET ASSETS	91,257	12.6%	173,608	7.0%	32,202	9.5%	(9,106)	-8.1%
			-		-		-	
REPRESENTED BY:			-		-		-	
Share Capital	9,773	1.3%	63,609	2.6%	23,111	6.8%	13,946	12.4%
Reserves	18,820	2.6%	45,573	1.8%	152	0.0%	1,468	1.3%
Unappropriated Profit	17,159	2.4%	36,418	1.5%	9,259	2.7%	(25,592)	-22.7%
	45,753	**6.3%**	**145,600**	**5.9%**	**32,522**	**9.6%**	**(10,178)**	**-9.0%**
Surplus/Deficit On Revaluation Of Assets	45,504	6.3%	28,007	1.1%	(321)	-0.1%	1,072	1.0%
TOTAL	**91,257**	**12.6%**	**173,608**	**7.0%**	**32,202**	**9.5%**	**(9,106)**	**-8.1%**
OPERATING POSITION			-		-		-	
Mark-Up/ Return/Interest Earned	41,867	107.5%	143,302	113.7%	21,886	100.0%	8,546	106.8%
Mark-Up/ Return/Interest Expenses	14,116	36.3%	51,217	40.6%	8,424	38.5%	1,527	19.1%
Net Mark-Up / Interest Income	**27,751**	**71.3%**	**92,084**	**73.0%**	**13,462**	**61.5%**	**7,019**	**87.7%**
Provisions & Bad Debts Written Off Directly	2,798	7.2%	9,927	7.9%	1,078	4.9%	5,270	65.8%
Net Mark-Up / Interest Income After Provision	**24,953**	**64.1%**	**82,158**	**65.2%**	**12,384**	**56.6%**	**1,749**	**21.9%**
Fees, Commission & Brokerage Income	5,285	13.6%	15,773	12.5%	5,082	23.2%	17	0.2%
Dividend Income	2,563	6.6%	2,850	2.3%	50	0.2%	27	0.3%
Income From Dealing In Foreign Currencies	1,314	3.4%	4,944	3.9%	2,000	9.1%	-	0.0%
Other Income	2,020	5.2%	10,408	8.3%	1,282	5.9%	941	11.8%
Total Non - Markup / Interest Income	11,182	28.7%	33,975	27.0%	8,414	38.5%	986	12.3%
	36,135	**92.8%**	**116,133**	**92.1%**	**20,799**	**95.1%**	**2,735**	**34.2%**
Administrative Expenses	13,087	33.6%	53,209	42.2%	9,040	41.3%	3,866	48.3%
Other Expenses	282	0.7%	1,139	0.9%	199	0.9%	(37)	-0.5%
Total Non-Markup/Interest Expenses	**13,369**	**34.3%**	**54,348**	**43.1%**	**9,239**	**42.2%**	**3,829**	**47.8%**
Profit Before Tax and Extra Ordinary Items	22,766	58.5%	61,785	49.0%	11,559	52.8%	(1,095)	-13.7%
Extra ordinary/unusual Items (to be specified)	-	0.0%	1,247	1.0%	-	0.0%	-	0.0%
PROFIT/ (LOSS) BEFORE TAXATION	**22,766**	**58.5%**	**60,537**	**48.0%**	**11,559**	**52.8%**	**(1,095)**	**-13.7%**
Taxation - Current	7,947	20.4%	16,155	12.8%	3,754	17.2%	186	2.3%
- Prior Years	(1,096)	-2.8%	(1,501)	-1.2%	(288)	-1.3%	25	0.3%
- Deferred	431	1.1%	4,793	3.8%	59	0.3%	(6)	-0.1%
PROFIT/ (LOSS) AFTER TAX	**15,484**	**39.8%**	**41,090**	**32.6%**	**8,035**	**36.7%**	**(1,300)**	**-16.2%**

Annex - C

Balance Sheets & Income Statements of CBs & AllBanks as of 31-12-2005

(Figures rounded off to nearest Million Rs)

	Comm. Banks		All Banks	
Financial Position	Amount	% age	Amount	% age
ASSETS				
Cash & Balances With Treasury Banks	322,937	9.1%	325,453	8.9%
Balances With Other Banks	130,566	3.7%	142,234	3.9%
Lending To Financial Institutions	211,856	6.0%	211,856	5.8%
Investments - Net	778,656	22.0%	800,036	21.9%
Advances - Net	1,926,519	54.3%	1,990,073	54.4%
Other Assets	100,825	2.8%	111,863	3.1%
Operating Fixed Assets	66,893	1.9%	69,151	1.9%
Deferred Tax Assets	7,982	0.2%	8,423	0.2%
TOTAL ASSETS	**3,546,235**	**100%**	**3,659,090**	**100%**
LIABILITIES	-		-	
Bills Payable	42,613	1.2%	42,997	1.2%
Borrowings From Financial Institution	260,952	7.4%	338,403	9.2%
Deposits And Other Accounts	2,817,933	79.5%	2,833,795	77.4%
Sub-ordinated Loans	18,059	0.5%	23,964	0.7%
Liabilities Against Assets Subject To Finance Lease	578	0.0%	600	0.0%
Other Liabilities	100,685	2.8%	123,022	3.4%
Deferred Tax Liabilities	8,348	0.2%	8,348	0.2%
TOTAL LIABILITIES	**3,249,168**	**91.6%**	**3,371,129**	**92.1%**
NET ASSETS	297,067	8.4%	287,961	7.9%
	-		-	
REPRESENTED BY:	-		-	
Share Capital	96,493	2.7%	110,439	3.0%
Reserves	64,546	1.8%	66,014	1.8%
Unappropriated Profit	62,837	1.8%	37,245	1.0%
	223,876	**6.3%**	**213,698**	**5.8%**
Surplus/Deficit On Revaluation Of Assets	73,191	2.1%	74,263	2.0%
TOTAL	**297,067**	**8.4%**	**287,961**	**7.9%**
OPERATING POSITION	-		-	
Mark-Up/ Return/Interest Earned	207,055	110.8%	215,601	110.6%
Mark-Up/ Return/Interest Expenses	73,758	39.5%	75,285	38.6%
Net Mark-Up / Interest Income	**133,297**	**71.3%**	**140,316**	**72.0%**
Provisions & Bad Debts Written Off Directly	13,802	7.4%	19,072	9.8%
Net Mark-Up / Interest Income After Provision	**119,495**	**63.9%**	**121,244**	**62.2%**
Fees, Commission & Brokerage Income	26,140	14.0%	26,157	13.4%
Dividend Income	5,463	2.9%	5,490	2.8%
Income From Dealing In Foreign Currencies	8,258	4.4%	8,258	4.2%
Other Income	13,710	7.3%	14,651	7.5%
Total Non - Markup / Interest Income	53,571	28.7%	54,556	28.0%
	173,066	**92.6%**	**175,801**	**90.2%**
Administrative Expenses	75,337	40.3%	79,203	40.6%
Other Expenses	1,619	0.9%	1,582	0.8%
Total Non-Markup/Interest Expenses	**76,956**	**41.2%**	**80,785**	**41.5%**
Profit Before Tax and Extra Ordinary Items	96,110	51.4%	95,015	48.8%
Extra ordinary/unusual Items (to be specified)	1,247	0.7%	1,247	0.6%
PROFIT/ (LOSS) BEFORE TAXATION	**94,863**	**50.8%**	**93,768**	**48.1%**
Taxation - Current	27,855	14.9%	28,042	14.4%
- Prior Years	(2,885)	-1.5%	(2,860)	-1.5%
- Deferred	5,283	2.8%	5,277	2.7%
PROFIT/ (LOSS) AFTER TAX	**64,608**	**34.6%**	**63,309**	**32.5%**

Annex-D

Bank-wise Major Statistics as of 31-12-2005

(Figures rounded to nearest Million Rs)

Sr. No.	Name of the Bank	Loans & Advances (Net)	Total Assets	Deposits	Capital	Profit/(Loss) before Tax	Profit/(Loss) After Tax
1	National Bank of Pakistan	268,839	577,719	463,427	74,341	19,056	12,709
2	First Women Bank Limited	2,462	10,503	8,716	727	221	134
3	Bank of Punjab	63,624	111,154	88,465	13,670	3,165	2,353
4	Bank of Khyber	10,612	25,034	17,452	2,520	324	287
5	Punjab Provincial Cooperative Bank	6,992	13,185	1,689	1,808	25	24
6	Industrial Development Bank of Pakistan	2,452	7,962	10,506	(26,138)	(1,398)	(1,401)
7	Zari Taraqiati Bank Limited	52,925	83,848	2,645	13,062	(91)	(129)
8	SME Bank Ltd	1,185	7,860	1,023	2,162	369	206
9	Allied Bank Limited	110,947	192,170	161,907	13,035	4,777	3,033
10	Bank Al-Falah Limited	118,864	248,314	222,345	7,464	2,563	1,702
11	Askari Commercial Bank Limited	85,977	145,100	118,795	8,587	2,859	2,022
12	Bank Al Habib Limited	55,304	91,502	75,796	5,246	2,022	1,464
13	Bolan Bank Limited	9,294	17,219	12,857	2,550	211	274
14	Crescent Commercial Bank Limited	3,724	9,618	5,985	1,632	(740)	(744)
15	Dawood Bank Limited	799	7,947	2,186	1,525	8	3
16	Faysal Bank Limited	62,324	110,281	74,737	14,260	3,969	3,069
17	Habib Bank Limited	307,603	506,068	416,603	39,041	13,163	8,916
18	KASB Bank Limited	10,739	19,103	14,828	1,736	(511)	(273)
19	Muslim Commercial Bank Limited	180,323	298,777	229,345	23,308	13,018	8,922
20	United Bank Limited	204,810	347,049	289,226	21,668	9,482	5,949
21	Prime Commercial Bank Limited	25,524	53,757	38,876	3,434	765	495
22	Metropolitan Bank Limited	43,463	79,666	56,713	5,659	2,032	1,465
23	Union Bank Limited	68,969	117,101	91,187	5,135	2,778	1,745
24	PICIC Commercial Bank Limited	33,162	65,129	53,468	4,058	1,906	1,504
25	Soneri Bank Limited	32,053	63,345	47,606	4,224	1,400	920
26	Saudi Pak Commercial Bank Limited	19,514	47,749	37,136	3,807	140	65
27	NDLC-IFIC Bank Limited	19,623	32,019	22,554	4,213	27	104
28	Meezan Bank	19,741	30,676	22,769	3,025	633	419
29	ABN Amro Bank	32,927	59,593	47,005	4,117	2,190	1,308
30	Habib Bank A. G. Zurich	27,728	44,910	33,436	2,814	788	554
31	Al Baraka Islamic Bank	7,205	14,619	10,312	2,357	388	346
32	American Express Bank	695	8,242	5,726	1,422	(27)	57
33	Citibank, N.A.	39,163	76,474	53,116	5,706	2,594	1,508
34	Deutsche Bank A.G.	1,898	5,597	1,505	2,221	(126)	(59)
35	The Hongkong & Shanghai Banking Corporation	5,744	13,272	8,604	2,215	227	176
36	Oman International Bank S.A.O.G	519	1,814	493	1,030	(12)	(12)
37	Rupali Bank Ltd.	10	567	128	164	(22)	(13)
38	Standard Chartered Bank	50,215	109,933	83,646	8,406	5,427	4,057
39	The Bank of Tokyo – Mitsubishi	2,122	4,216	984	1,750	133	113
	Total	1,990,073	3,659,090	2,833,795	287,961	93,733	63,274

Annex-E

Bank-wise Key Performance Indicators as of 31-12-2005

Sr. No.	Name of the Bank	Capital Adequacy Ratio	NPLs to Loans	NPLs to Loans (net)	ROA (after Tax)
1	National Bank of Pakistan	15.0%	11.3%	1.2%	2.2%
2	First Women Bank Limited	15.2%	2.1%	0.3%	1.3%
3	Bank of Punjab	12.0%	2.1%	0.8%	2.7%
4	Bank of Khyber	18.3%	23.6%	12.5%	1.2%
5	Punjab Provincial Cooperative Bank	12.9%	23.8%	13.8%	0.2%
6	Industrial Development Bank of Pakistan	-975.6%	96.0%	83.7%	-14.6%
7	Zari Taraqiati Bank Limited	25.7%	36.2%	21.9%	-0.2%
8	SME Bank Ltd	81.2%	85.5%	2.6%	2.5%
9	Allied Bank Limited	10.9%	10.5%	3.6%	1.7%
10	Bank Al-Falah Limited	8.7%	0.9%	-0.4%	0.8%
11	Askari Commercial Bank Limited	11.0%	2.7%	-0.1%	1.6%
12	Bank Al Habib Limited	8.6%	0.7%	0.3%	1.7%
13	Mybank	18.9%	13.5%	9.6%	1.8%
14	Crescent Commercial Bank Limited	21.9%	38.9%	12.5%	-7.4%
15	Dawood Bank Limited	47.2%	1.7%	0.0%	0.0%
16	Faysal Bank Limited	13.6%	3.9%	2.1%	3.3%
17	Habib Bank Limited	9.4%	10.6%	2.5%	1.8%
18	KASB Bank Limited	7.8%	9.4%	3.8%	-1.6%
19	Muslim Commercial Bank Limited	12.5%	4.5%	0.3%	3.2%
20	United Bank Limited	9.3%	7.7%	1.2%	1.9%
21	Prime Commercial Bank Limited	12.4%	3.0%	1.4%	1.1%
22	Metropolitan Bank Limited	10.6%	0.2%	-1.0%	2.0%
23	Union Bank Limited	8.9%	5.7%	3.0%	1.8%
24	PICIC Commercial Bank Limited	9.4%	1.8%	0.9%	2.6%
25	Soneri Bank Limited	11.7%	1.1%	-0.1%	1.6%
26	Saudi Pak Commercial Bank Limited	15.9%	20.9%	12.7%	0.1%
27	NDLC-IFIC Bank Limited	17.4%	3.5%	0.7%	0.4%
28	Meezan Bank	10.7%	0.9%	0.3%	1.7%
29	ABN Amro Bank	12.3%	0.5%	-1.0%	2.2%
30	Habib Bank A. G. Zurich	8.5%	0.9%	0.1%	1.3%
31	Al Baraka Islamic Bank	23.2%	3.8%	1.2%	2.6%
32	American Express Bank	88.6%	13.5%	0.0%	0.7%
33	Citibank, N.A.	12.8%	1.5%	-1.3%	2.1%
34	Deutsche Bank A.G.	59.0%	0.0%	-0.3%	-1.1%
35	The Hongkong & Shanghai Banking Corporation	22.8%	1.2%	-0.2%	1.4%
36	Oman International Bank S.A.O.G	149.3%	2.8%	-0.7%	-0.6%
37	Rupali Bank Ltd.	76.0%	93.2%	0.0%	-2.3%
38	Standard Chartered Bank	15.6%	0.8%	-0.4%	4.0%
39	The Bank of Tokyo – Mitsubishi	55.1%	0.0%	0.0%	2.6%

* KASB Bank Ltd subsequently injected fresh equity of Rs 78 million to meet the Capital Adequacy Ratio of 8 percent

Annex-F

Selected Indicators for Different Categories of Banks in terms of Size

Indicators	Top 5 Banks	Top 10 Banks	Top 20 Banks	Industry
Share of Total Assets	54.1%	72.5%	92.5%	100%
Share of Total Deposits	57.2%	76.1%	93.6%	100%
Share of Gross Income	57.0%	73.8%	94.9%	100%
Share of Risk Weighted Assets	53.2%	72.4%	92.2%	100%
Capital Adequacy				
Capital/RWA	11.4%	11.3%	11.9%	11.3%
Tier 1 Capital / RWA	7.8%	7.9%	8.7%	8.3%
Net Worth / Total Assets	8.4%	8.3%	8.2%	7.9%
Asset Composition				
Sectoral Distribution of Loans (Domestic)				
- Corporate Sector:	49.0%	71.8%	91.9%	100.0%
- SMEs:	55.9%	73.9%	89.0%	100.0%
- Agriculture	31.8%	38.2%	94.3%	100.0%
- Consumer Finance:	59.9%	78.1%	96.5%	100.0%
- Commodity Financing	69.8%	89.0%	97.6%	100.0%
- Staff Loans	67.4%	82.4%	94.5%	100.0%
- Others	46.8%	67.9%	85.7%	100.0%
- Total	52.2%	72.0%	92.5%	100.0%
NPLs / Gross Loans	8.2%	7.6%	7.6%	8.3%
Net NPLs / Capital	8.2%	9.7%	12.5%	14.3%
Earning & Profitability				
ROA	2.1%	2.1%	2.0%	1.9%
ROE	27.2%	27.0%	26.3%	25.7%
Net Interest Margin / Gross Income	73.6%	73.1%	72.6%	72.0%
Income from Trading & Foreign Exchange / Gross Income	6.7%	6.2%	6.5%	6.8%
Non-Interest Expense / Gross Income	39.9%	39.8%	39.7%	41.5%
Liquidity				
Liquid Assets / Total Assets	33.7%	32.5%	33.3%	33.7%
Liquid Assets held in Govt. Securities / Total Liquid Assets	48.4%	47.8%	49.3%	47.9%
Liquid Assets / Total Deposits	41.1%	40.1%	42.6%	43.6%

Chronology of Policy Announcements **Annex-G**

Date of Announcement	Circular #	Policy Decision
2005 07-January	(BSD-02) Circular Letter	**Risk Management Framework –Disclosure in Annual Accounts** In order to enhance disclosure and to meet information needs of the stakeholders, it has been decided that effective from the Accounting Year ended 31st December, 2004, all banks and DFIs will include a comprehensive paragraph under the heading "Risk Management Framework" in the Directors' Report in their Annual Accounts. This paragraph will cover the overall / broad plan to meet SBP's guidelines on risk management; the status and details of action / steps taken under the bank's individual plan to implement SBP's guidelines on Risk Management; and the indicative timeframe to achieve completion of their plan i.e. full compliance of SBP's guidelines.
2005 07-January	(BPD-02) Circular Letter	**Clarification-Service Charges on PLS Deposit Account** SBP has directed all banks that accounts maintained by (i) Students; (ii) Mustahiqueen of Zakat; and (iii) employees of Government/Semi-Government institutions for salary and pension purposes including widows/ children of deceased employees eligible for family pension/ benevolent fund grant etc. shall be exempted from levy of service charges in any manner whatsoever."
2005 19-January	(BSD-01) Circular	**Reporting Requirements on Frauds/Forgeries/Dacoities** Operational Risk is gaining importance in the banking industry in the wake of increasing complexity of operations and the risks involved therein. The incidents of internal and external frauds and forgeries are included in list of the operational risk events that have the potential to result in substantial losses. In view of the importance of frauds prevention/mitigation strategy in overall operational risk framework and to improve the mechanism for active supervisory response, SBP has formulated the revised reporting requirement for banks/DFIs on frauds/forgeries/dacoities cases. Submission of complete and timely information on revised formats will enable SBP to remain apprised of developments at banks/DFIs and monitor follow-up action taken by them for all medium and high severity frauds/forgeries including the emergency reported cases. The information so collected will also be used to develop a database of frauds, forgeries, and dacoities events, which will be used for measuring operational risk and determining capital requirements there against. Furthermore, banks/DFIs will separately report all material incidents of frauds/forgeries/dacoities etc. of Rs1 million and above on urgent basis as under:- a) Preliminary report within 2 working days of the occurrence of such incident by mentioning the date of the incident and other information about the case as available at the time of such reporting; and b) Detailed report within 15 days of the occurrence of such incident
2005 26-January	(BSD-03) Circular Letter	Guidelines on Internal Controls SBP has decided that banks/DFIs will include a Statement on Internal

		Controls, as envisaged in "Guidelines on Internal Controls" in their Annual Audited Financial Reports.
2005 28-January	(BPD-01) Circular	**Establishment of Subsidiaries /Brokerage Companies by Banks / DFIs** SBP has issued a consolidated circular containing its earlier instructions with some modification for Banks/DFIs intending to undertake brokerage business and diversification of their activities through subsidiaries The following instructions in consolidated form will supersede the earlier instructions 1. The Banks/DFIs are required to establish separate subsidiaries if they wish to undertake asset management or conduct brokerage business. However they may at their own discretion, establish other subsidiaries as admissible under the law. 2. The Banks/DFIs desiring to establish any subsidiary shall obtain prior approval of SBP. 3. The subsidiary can either be a public limited company or a private limited company. It should be ensured that the subsidiaries are established only for activities as are admissible under Section 23 of the Banking Companies Ordinance, 1962. It is clarified that the instructions contained in this circular are not applicable on the exchange companies established by the Banks in terms of FE Circular No. 9 of 30th July, 2002.
2005 28-January	(BPD-01) Circular	Restriction on Financing of Premium under the Car Finance Schemes In order to discourage speculative activities on car purchases, which may be facilitated by the bank financing of premium, SBP decided that the banks/DFIs shall extend loans only for the ex-factory tax paid price fixed by the car manufacturers.
2005 15-February	(BPD-04) Circular	**Branch Opening Policy for DFIs** In order to streamline the policy of granting permission for opening/closing/shifting of branches of Development Financial Institutions (DFIs), SBP has revisited and modified the Branch Opening Policy. As per the new policy, each DFI shall submit to SBP for approval an Annual Branch Expansion Plan at least 30-days before the commencement of calendar year during which it plans to open branches. The plan would indicate the number of new branches proposed to be opened, location of each of the proposed branch, and the area which would it serve. Moreover, the DFIs desirous of opening branch(es) in the year 2005, are being allowed, as a special case, to submit their Annual Branch Expansion Plans within 30 days from the date of issue of this Circular.
2005 26-February	(BPD-05) Circular	**Replacement of COT with margin financing** Securities and Exchange Commission of Pakistan had announced a time based action plan for phasing out of Carry Over Transaction (COT), generally known as Badla, In order to safeguard the interest of all stakeholders and to ensure smooth transition from COT to Margin Financing, SBP decided that banks/DFIs shall cap their COT exposure, in each share, at the existing level as on February 25, 2005.
2005 19-March	(BPD-10) Circular	**Housing Finance: Relaxations in the Regulatory Framework**

		In order to facilitate origination of housing loans and securitization of mortgage/construction/developer finance, following relaxations in the present regulatory framework are allowed to Banks/DFIs: Keeping in view the active role of banks/DFIs for the provision of housing finance to a cross section of the society, the maximum per party limit of Rs10 million in respect of housing finance, as per Regulation R-15 of the Prudential Regulations for Consumer Financing, is being removed with immediate effect. Accordingly, banks/DFIs are allowed to determine the housing finance limit in accordance with their internal credit policy, credit worthiness and loan repayment capacity of the borrowers. In order to facilitate securitization of mortgage/construction/developer finance through Special Purpose Vehicle (SPV), banks/DFIs are allowed the following relaxations with respect to Listed and Unlisted Mortgage /Construction/Developer Finance Asset Backed Securities (ABS): **a. Listed ABS:** The minimum credit rating for banks/DFIs to make direct investment and for taking exposure (i.e. undertaking lending and reverse repo) against listed ABS for mortgage/construction/developer finance is reduced from "A" to "A- (or equivalent)". **b. Unlisted ABS:** Banks/DFIs are allowed to invest in non-listed mortgage/construction/developer finance ABS having a minimum credit rating of "A- (or equivalent)" as well as to take exposure (i.e. undertaking lending and reverse repo) against the security of such non-listed ABS.
2005 21-March	(BPD-11) Circular Letter	**Opening of Pakistani Banks' Branches Abroad** SBP has allowed opening of Pakistani Banks' branches abroad. The procedure for opening of branch(es) /office(s) abroad by locally incorporated banks has been notified to them.
2005 28-March	(BSD-02) Circular	**Fit & Proper Criteria for Board Members and President/Chief Executive of Microfinance Banks** SBP has formulated "Fit & Proper Criteria" for the Board Members and President/Chief Executive of Microfinance banks, which prescribe the minimum qualification, experience and integrity standards etc. for the MFBs' Board Members and President/Chief Executive. The criteria are being introduced as Prudential Regulations for Microfinance Banks, Fit & Proper Criteria for MFBs' Board Members and President/Chief Executive Officer.
2005 31-March	(BSD-03) Circular	**Implementation of Basel II in Pakistan** SBP has decided to adopt the Basel II in Pakistan. For the smooth, realistic and undisrupted transition from present capital adequacy framework towards more risk sensitive new capital adequacy framework – the Basel II, all banks/DFIs are required to designate one senior officer from their institution who will supervise all activities relating to Basel II within the bank and will serve as a point of contact between SBP and that particular bank. For this purpose, banks may also put in place a support functionary to assist the person in charge as considered appropriate. SBP has provided a broad roadmap and outline which is required to start work for the adoption of Basel II. The new framework consists of three mutually reinforcing pillars; the first pillar relates to Minimum Capital Requirement, second pillar describes Supervisory Review Process under the new framework and the third pillar describes the Market Discipline required to be adopted by the banks. Under pillar one, the framework offers three distinct options for assessment of capital requirements for credit risk and three options for operational risk.

		The approaches available for assessment of capital for credit risk are Standardized Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach. The approaches available for computing capital charge for operational risk are Basic Indicator Approach, Standardized Approach and Advance Measurement Approach. Whereas the capital requirement as to the Market Risks remains unchanged and banks will continue to assess the capital charge against the market risk based on the existing instructions under the Basel-I. The timeframe for adoption of different approaches under Basel II is as under: - i) Standardized Approach for credit risk and Basic indicator / Standardized Approach for operational risk from 1st January 2008. ii) IRB approach from 1st January 2010. Banks interested in adopting IRB Approach for capital requirement against credit risk before 1st January 2010 may approach SBP for the purpose. Their requests will be considered on case-to-case basis. Banks/DFIs will be required to adopt a parallel run of one and a half year for Standardized Approach and two years for IRB Approach starting from 1st July 2006 and 1st January 2008 respectively. The above timeframe has been finalized after consultation with and with the agreement of the Presidents / CEOs of all banks/DFIs. Each bank/DFI is required to formulate their internal plans specifying the approach they are willing to adopt and the plans for moving to the particular approach. The plans should envisage the risk management setup, various risk assessment methodologies being used for assessment of various risk categories and the policy and procedures for the capital allocation. It must highlight what are the gaps for moving to Basel II implementation and what steps are required to overcome those gaps. Banks/DFIs should give a time bound action plan narrating the activities to be done and the time when it will be accomplished within the overall implementation timeframe as mentioned above.
2005 11-April	(BPD-15) Circular	**Financing Facilities by SBP (Enhancement In Repo Rate)** SBP has enhanced the minimum rate of return to be paid by recipients of financing facilities for meeting temporary liquidity shortage i.e. SBP 3-day Repo facility, against Government of Pakistan MTBs and PIBs from 7.5 percent to 9.0 percent.
2005 25-April	(EPD-04) Circular	**Advance Payments Against Imports** In order to address the genuine needs of the manufacturing/industrial sector, SBP decided to allow advance payment up to the amount of US$ 10,000/- or equivalent thereof in other currencies per invoice, against intended imports of spare parts/consumables by manufacturing and industrial users for their own use without the requirement of a Letter of Credit or bank guarantee.
2005 14-June	(EPD-05) Circular	**Export of Surplus Cash US Dollars by the Authorized Dealers** SBP has allowed the ADs to sell their surplus cash US Dollars to the respective Field Offices of SBP – Banking Services Corporation. SBP will provide credit of the counter value in the Nostro Account of the AD in the same value date, on confirmation of balances from SBP – Banking Services Corporation Field Offices.
2005 13-July	(BPD-27) Circular Letter	**Utilization of Unsecured/Clean Loans for Subscription in Initial Public Offering (IPO)**

		SBP has advised all banks/DFIs to institute necessary checks so that clean loans are not used for subscription in IPO. The banks/DFIs are required to obtain an undertaking from the client at the time of sanctioning a clean consumer loan/credit line that the drawings from the loan account will not be used for subscription in an IPO. Further, banks/DFIs should introduce an internal system, whereby, no cheques, drafts and/or payment instructions will be made for an IPO subscription account from a clean personal loan/ credit line account.
2005 16-July	(BSD-04) Circular	**Weekly Statement of Position** In order to remove redundancies and reduce the burden of reporting of banks and DFIs, SBP decided to revise the format of the Weekly Statement of Position. Banks and DFIs were advised to ensure the submission of the Weekly Statement of Position within 2 working days following each weekend. Further, all the banks and DFIs shall also submit Quarterly Position, in addition to the Weekly Statement of Position on the same format, if the date of quarter-end differs from the date of weekend. However, the Quarterly Position will be submitted within five working days following the quarter-end.
2005 20-July	(BPD-28) Circular Letter	**SBP Instructions on Compliance Function-Reporting Line of The Head of Compliance** SBP has observed that the banks/DFIs are following varying practices with regards to the reporting lines of the Head of Compliance. It is clarified that the Head of Compliance should report directly to the President /CEO of the bank/DFI.
2005 23-July	(BPD-23) Circular	**Guidelines For Infrastructure Project Financing (IPF)** Infrastructure projects, by their very nature and design, require relatively large investment, besides requiring longer gestation period for development, construction, start up and operation. Keeping in view the distinctive features of infrastructure projects, the guidelines have been tailored to the specific needs of the related parties. Banks/DFIs are encouraged to prepare their own structured lending schemes for the development of IPF, for which they may conduct/arrange their own studies to determine the potential in specific infrastructure projects. The banks/DFIs will also devise proper checks and controls to ensure necessary oversight on Infrastructure Project Financing products.
2005 01-August	(EPD-08) Circular	**Travel Health Insurance Coverage for the Schengen Countries** Since the European Union has directed to all Schengen Countries to ensure that all visitors intending to visit their country must show adequate proof of health/ medical insurance policy to cover them in the country of visit. Accordingly, in order to facilitate Pakistani travelers to meet the guidelines for issuance of travel visa to Schengen Countries, it has been decided to allow insurance companies to issue health/medical policy in foreign currency subject to following conditions: i. These policies will be issued only in favor of travelers to Schengen Countries for a period covering the stay of the

		visitors. ii. Though the policy will be denominated in foreign currency, the premium will be payable in PKR. iii. In case of settlement of claim, insurance companies will be allowed to remit the funds abroad through interbank.
2005 09-August	(EPD-09) Circular	**Repatriation of Surplus Sales Funds by Foreign Airlines Operating in Pakistan** As a further step towards the liberalization of foreign exchange regime and in order to facilitate Airlines operating in Pakistan, the following amendments have been made in existing procedure for remittances of surplus sales funds: a) Airlines are allowed to repatriate their sale funds (surplus) twice a month on receipt of payments from the travel agents. b) The Airlines are no more required to submit photocopies of Tickets/ Coupons/ Airway Bills to Authorized Dealers at the time of making request for repatriation of surplus funds.
2005 12-August	(EPD-11) Circular	**Investment Abroad by Locally Established Mutual Funds** In continuation of SBP's policy towards liberalization of Foreign Exchange regime, it has been decided to allow locally established mutual funds to invest abroad for the purposes of diversification of their asset classes / portfolio, to the extent of 30% of the aggregate funds mobilized (including foreign currency funds), in permissible categories subject to a cap of US$ 15 million at any given time.
2005 27-August	(EDMD-11) Circular	**Rules Governing Primary Dealer System** In order to make Primary Dealer system more broad based and meaningful the following new Rules are were being issued. The salient features of the Criteria, Obligations and Privileges of the Primary Dealers and other details under the new Rules are as under: Selection Criteria: 1. The applicant for the status of Primary Dealer (PD) must be a Bank / DFI / Investment Bank / Listed Brokerage House. 2. As a measure of financial stability, the institution applying for Primary Dealership must have a minimum equity (net of provisions and capitalized losses if any) of PKR 500 million. 3. As an indication of strong managerial /trading capabilities, PD's treasury operations have to be fully computerized. To ensure competent and knowledgeable staff, a minimum of five years of relevant professional experience would be required for main treasury / front office and back office personnel. To win the status of PD, the applicant has to be a "PRICE MAKER", quoting two-way price reflective of market sentiment and keeping trading window open through out the day with active trading in all marketable Government securities. Primary Dealer's Privileges: 1. Only PDs would be eligible to participate in the auctions of Govt. Securities. 2. In case a PD is unable to square its short position, SBP, at its discretion, would help using various options depending upon the situation.

		Appointment or termination of a Primary Dealer would be the sole discretion of SBP
2005 27-August	(PSD) Master Circular	**Master Circular of Payment Systems' Statements** In order to improve accuracy, avoid repeated errors, ensure timely submission and add new variables, State Bank of Pakistan issued Master Circular by consolidating all the previous instructions/circulars and incorporating new instructions where the same have been considered expedient. Accordingly, the banks and switch operators are required to submit quarterly statements positively by 15th of the month following the quarter to which it pertains.
2005 11- October	(BPD-26) Circular	**Classification Of Dormant / Inoperative Accounts** SBP has observed that banks are classifying the deposit accounts as dormant / inoperative without intimating the same to their customers, which in turn results in considerable inconvenience to account holders. It has, therefore, been decided that banks should immediately develop a well defined and transparent policy, if not existing presently, duly approved by the President of the bank for the purpose. Accordingly, on the basis of the approved policy, a clause in the Account Opening Form (AOF) may be added informing the prospective account holder about the bank's policies with regard to the classification of accounts as dormant / inoperative and its subsequent reactivation. For the existing account holders, the bank should advise in writing the same while sending the half yearly statement of account or through a separate letter, as they deem fit. Moreover, the account holders whose accounts have already been classified as dormant / inoperative may also be advised.
2005 22- October	(BPD-27) Circular	**Prudential Regulations For Agriculture Financing** SBP has issued Prudential Regulations for Agriculture Financing. The captioned regulations are intended to provide a broader regulatory framework to the banks/DFIs. The banks/DFIs should put in place appropriate management information system to monitor the quality of agricultural portfolio on a continuous basis and take appropriate decisions at the right time. They are encouraged to diversify their agricultural portfolio in terms of geographical areas, types of financing, etc. to avoid the risks of concentration of credit. They are also encouraged to extend agricultural financing on the basis of future cash flows, instead of relying solely on the collateral. Standard cash flows can be estimated for different crops and these cash flows can then be adjusted for specific borrowers, keeping in view the quality of land and efficiency of the individual farmers, etc. SBPhas allowed the banks/DFIs to determine suitable margin requirements in their agriculture financing policies, keeping in view the quality and other characteristics of the collateral. For better understanding of customers, banks/DFIs are encouraged to translate their application forms, checklists of all required documents and brochures in Urdu and other regional languages.
2005 22-October	(BPD-29) Circular	**Amendments in Regulation M-1 of Prudential Regulation for Corporate and Commercial Banking**

		SBP has reviewed the instructions given in BCD Circular No.29 of 1968 and 5 of 1989 with regard to opening of government account. SBP has substituted and added para 5(a) in the regulation M-1 of PR for corporate and commercial banking. The Banks/DFIs shall ensure that government accounts are not opened in the personal names of the government official(s). Any such account, which is to be operated by an officer of the Federal/Provincial/Local Government in his/her official capacity, shall be opened only on production of a special resolution/authority from the concerned administrative department duly endorsed by the Ministry of Finance or Finance Department of the concerned Provincial or Local Government.”
2005 27- October	(BSD-05) Circular	**Guidelines on Stress Testing** SBP, in pursuance of its goal to further strengthen the country’s banking system, has designed stress-testing guidelines for banks and DFIs to proactively manage their risks. Keeping in view the divergence of skill level and available resources among banks and DFIs, the model, initially, focuses on “Simple Sensitivity Analysis”. However, with the increasing know-how and availability of more data the model will over time undergo further refinement.
2005 28- October	(BSD-06) Circular	**Minimum Capital Requirements For Banks/DFIs** In order to further strengthen the solvency of individual banks/DFIs, it has been decided to raise the minimum paid up capital as well as Capital Adequacy Ratio based on Risk Weighted Assets (CAR) as under: i) The existing minimum paid up capital requirement for locally incorporated banks/DFIs has been raised to Rs 6 billion (net of losses) to be achieved in a phased manner as follows:

Minimum Paid-up Capital	**Deadline by which to be increased**
(Net of losses) to be increased to:	
a) Rs 3 billion	By 31-12-2006
b) Rs 4 billion	By 31-12-2007
c) Rs 5 billion	By 31-12-2008
d) Rs 6 billion	By 31-12-2009

The branches of foreign banks operating in Pakistan will also be required to increase their assigned capital to Rs6 billion within the above timelines prescribed for the locally incorporated banks/DFIs. However, those branches of foreign banks whose Head Offices hold a minimum paid up capital of US $ 100 million (net of losses) and have a CAR of 9% (determined as per Basel-I or Basel-II Accord) can be allowed to continue to maintain the minimum assigned capital of Rs2 billion (net of losses). All such branches of foreign banks shall, however, be required to seek specific permission from SBP to maintain the minimum assigned capital (net of losses) of Rs2 billion effective from 31st December 2005.
(ii) The required minimum CAR, on consolidated as well as on stand-alone basis, would continue to be 8%. However, the existing uniform requirement for CAR has been replaced with the variable CAR, which will be based on the Institutional Risk Assessment Framework (IRAF) Rating assigned by SBP to each bank and DFI. Under IRAF, each bank and DFI is rated on a scale of 1 to 5 based on its (a) compliance with standards, codes and

<table>
<tr>
<td></td>
<td></td>
<td>guidelines; (b) supervisory and regulatory information; (c) financial performance and condition; and (d) market information and intelligence. The required variable CAR to be maintained by each bank/DFI will be determined as follows:
<table>
<tr><th>IRAF Rating</th><th colspan="2">Required CAR effective from</th></tr>
<tr><td></td><td>31st Dec. 2005</td><td>31st Dec., 2006 and onwards</td></tr>
<tr><td>1 & 2</td><td>8%</td><td>8%</td></tr>
<tr><td>3</td><td>9%</td><td>10%</td></tr>
<tr><td>4</td><td>10%</td><td>12%</td></tr>
<tr><td>5</td><td>12%</td><td>14%</td></tr>
</table>
However, the banks/DFIs at the margin of the IRAF rating category which, in the opinion of the regulator, have high risk propensity may be asked to further increase the required CAR by One (1) percentage point.
The required minimum paid up capital as well as CAR can be achieved by the banks/DFIs either by fresh capital injection or retention of profits. The stock dividend declared after meeting all the legal and regulatory requirements, and duly reflected as such in the Annual Audited Accounts will be counted towards the required paid up capital of the bank/DFI pending completion of the formalities for issuance of bonus shares. “Any bank/DFI that fails to meet the minimum paid up capital requirement or CAR within the stipulated period shall render itself liable to the following actions:
i) Imposition of such restrictions on its business including restrictions on acceptance of deposits and lending as may be deemed fit by the SBP.
ii) Descheduling of the bank, thereby converting it into a non-scheduled bank.
iii) Cancellation of the banking license if SBP believes that the bank is not in a position to meet the minimum paid up capital requirement or CAR.”</td>
</tr>
<tr>
<td>2005
01- November</td>
<td>(BSD-07)
Circular</td>
<td>Amendments In Prudential Regulations - Classification And Provisioning For Loans And Advances

SBP has decided to make following amendments in the existing classification and provisioning criteria prescribed under the Prudential Regulations:

a) Elimination of OAEM category.
b) Revision of aging criteria whereby now the loans /advances overdue by 90 days will be classified as Substandard, 180 days as Doubtful and one year or more as Loss.
c) Increase in provisioning requirement for substandard category to 25 percent.
d) The revised criteria will be applicable to all types of financing facilities i.e. short, medium and long-term and to corporate, SME and consumer financing except Trade Bills (Import/Export or Inland Bills) and credit cards which will continue to be classified as loss if not paid/adjusted within 180 days from due date.
The benefit of forced sale value (FSV) of collateral allowed shall be available against the financing facilities of Rs5 million and above only Furthermore, the benefit of FSV of collateral under the aforesaid provisions of Prudential Regulations shall be further restricted to</td>
</tr>
</table>

		financing facilities of Rs10 million and above only with effect from December 31, 2006. SBP shall review the position to withdraw the benefit of FSV altogether after December 31, 2006.
2005 29- November	(BPD-30) Circular	**Introduction of Basic Banking Account** In order to facilitate and provide basic banking facilities to the low income people in Pakistan, SBP has decided that all commercial banks operating in Pakistan will introduce Basic Banking Accounts (BBA) facility with the following features:- a. The minimum initial deposit will be Rs1000. b. It will be non-remunerative account. c. No limit on minimum balance. In cases, where balance in BBA remains 'nil' for a continuous six-month period, such accounts will be closed. d. No fee for maintaining BBA. e. Maximum two deposit transactions and two chequing withdrawals are allowed, free of charge, through cash/clearing per month. f. Unlimited, free of charge, ATM withdrawals from the banks' own ATMs. In case of withdrawal from BBA through the ATM machines of other banks, the respective/other bank may recover charges for such transactions. g. For the existing banking accounts, banks may get the consent of all their customers whether they wish to maintain a BBA with them or a regular full service banking account with its accompanying terms and conditions. In case an account holder does not give his/her consent for a BBA, his/her account will be treated as a regular full service banking account. h. Statement of account will be issued once in a year.
2005 29- November	(BPD-31) Circular	**Guidelines For Higher Education Financing Scheme (HEFS)** Education plays a vital role for the development of human resources which, in turn, helps in sustained economic development of a country. SBP, in this context, has devised guidelines for promotion of higher education. The banks/DFI, are encouraged to develop their own products/scheme based on the aforesaid guidelines, and get these approved from their Board of Directors/competent authority This Higher Education Financing Scheme (HEFS) is in addition to and separate from the existing Students Loan Scheme (formerly Qarz-e-Hasna Scheme) for students administered by the National Bank of Pakistan.
2005 12- December	(BSD-08) Circular	**Information Systems: Guidelines On Audits And System Switchover Planning** Banks/DFIs should get their I.T. services audited by internal / third party auditors to ensure that adequate security and controls are in place. The internal/ third party auditors so engaged should review the IT related internal controls and evaluate/ validate the effectiveness of control systems. The

		board and the management should ensure that the independence, authority and accountability of the Information System Audit function are maintained and established by appropriate organizational setup in line with the international best practices. Therefore, the banks/DFIs are encouraged to upgrade their systems and related software. Banks /DFIs should also ensure that before introduction of new I.T. driven processes and systems for launching new products, the inherent operational risk is fully assessed and mitigated.
2005 27-December	(EPD-16) Circular	**Scheme for Warehousing in Kenya – Facilitation to the Exporters** In order to encourage exports to Kenya through a Warehousing Scheme. Exporters have been allowed enhancement in period for repartition of export proceeds from existing 180 days to 270 days. It is permissible for the exporters to reduce prices on the unsold stock. General permission have been granted up to a discount of 15%, if the goods are not sold. Beyond this limit, SBP's approval will be required on a case-to-case basis. Present retention percentage of 10% of FOB value of goods realized would be enhanced to 25% in case of export through the Warehousing Scheme.
2006 03-February	(PSD) Policy Guidelines	**Guidelines for Cardholders** State Bank of Pakistan issued a set of guidelines to cardholders (Debit & Credit cards) in Urdu and English and asked commercial banks to create awareness among the cardholders through various modes. Such guidelines suggest various precautionary measures for cardholders while executing transactions using delivery channel of e-banking. These guidelines would greatly help in reducing customer complaints and incidences of frauds and identity thefts in e-banking arena.
2006 15- February	(BSD-03) Circular	**Statutory Liquidity and Cash Reserve Requirements** WAPDA Sukuk has been declared as approved security for the purposes of meeting Statutory Liquidity Requirement (SLR) under Section 29 of the Banking Companies Ordinance, 1962 for banks having Islamic banking licenses either as full-fledged Islamic bank or Islamic banking branch. Further, SBP has also decided to revise the Cash Reserve Requirement (CRR) and Statutory Liquidity Requirement (SLR) for IBs/IBBs as under :- • As in the case of conventional banks, IBs / IBBs will maintain CRR of 5% of their time and demand liabilities on weekly average basis subject to daily minimum of 4%. • In addition to the CRR, IBs/IBBs will maintain SLR of 8% of their TDL on overall basis, in the form of investment in WAPDA Sukuk not exceeding 5% of their TDL and remaining in the shape of cash balance with SBP in Special Deposit Account.
2006	(BSD-04)	**Revised Forms Of Annual Financial Statements**

17- February	Circular	SBP amended the existing forms of Accounts and Balance Sheet of banks. All banks were directed to prepare their Annual Financial Statements on the revised forms, effective from the accounting year ending 31st December, 2006. Further, SBP also decided that in order to ensure certain minimum disclosure to stakeholders, the DFIs will also be required to adopt the forms with suitable modification(s) in line with their nature of business, to prepare their Annual Financial Statements effective from the accounting year ending 31st December, 2006.
2006 06-April	(PSD-1) Circular	**Guidelines for Standardization of ATM Operations** ATM is one of the most important delivery channels of e-banking. In order to enhance service level to international standards, SBP has issued guidelines for commercial banks using this channel. The main features of these guidelines are as follows: ❖ Pro-active resolution of suspect transactions by the ATM branches of the banks. ❖ Automatic refund of un-disbursed cash by ATM. ❖ Time-lines for refund of un-disbursed cash. ❖ Automatic settlement by the SWITCHES/Banks. ❖ Confirmation to customer for refund.
2006 13- April	(SMED-07) Circular	**Amendments In Prudential Regulation for Microfinance Banks (MFBs)** In order to bring the existing classification/provisioning/write-off criteria for Micro Loans in line with international best practices, certain amendments have been made in the existing PR. Nos. 12 and 14 for MFBs to ensure soundness and stability of the Microfinance banking industry. This will result in the following changes in the existing criteria for classification, provisioning and write-off:- i) Elimination of OAEM category. ii) Revision of aging criteria whereby now the loans /advances overdue by 30 days or more (but less than 90 days) will be classified as Substandard, 90 days or more (but less than 180 days) as Doubtful and 180 days or more as Loss. iii) Provisioning requirement for substandard category has been increased to 25 percent. iv) MFBs shall maintain a Watch List of all accounts delinquent by 5 – 29 days. v) The MFB/MFI shall maintain a General Provision equivalent to 1.50% of the net outstanding advances (advances net of specific provisions). vi) All Non-Performing Loans (NPLs) shall be written off, one month after the loan is classified as “Loss”, this shall, however, not extinguish the MFBs’ right of recovery of such written-off loans. vii) Classification and provisioning shall be made at the end of every

		month.
2006 20-April	(BSD-05) Circular	**Minutes of The Board of Directors'/General Meetings** The banks/DFIs, incorporated in Pakistan, shall submit certified copies of the approved minutes of meeting of their Board of Directors (BoD) and the general meetings (AGMs/EOGMs), within fifteen days of the date of the meeting in which these minutes were approved, alongwith the particulars of the directors present in the said meeting. It must be ensured that the minutes also contain the details of matters decided/resolved through circulation.

Glossary Annex-H

Available for sale securities are the securities which do not fall within 'held for trading' and 'held to maturity' categories.

Capital adequacy ratio is the amount of risk-based capital as a percent of risk-weighted assets.

Consumer Financing means any financing allowed to individuals for meeting their personal, family or household needs. The facilities categorized as Consumer Financing include credit cards, auto loans, housing finance and personal loans.

Corporate means and includes public limited companies and such entities, which do not come under the definition of SME.

Corporate Governance is a system of checks and balances designed to protect the interest of an entity's owners and other stakeholders. The three essential ingredients of Corporate Governance are (1) Checks and balances, (2) Clear division of responsibilities, and (3) Disclosure and transparency.

Credit risk arises from the potential that a borrower or counter-party will fail to perform an obligation or repay a loan.

Debt-Equity ratio is the long-term debt divided by shareholders equity plus long-term debt; the amount of long-term debt per rupee of equity.

Derivatives are the instruments that are based on or derived from the value of an underlying asset, reference rate or index. For example, interest rate futures are based on various types of securities trading in the cash market.

Discount rate is the rate at which SBP provides three-day repo facility to the banks, acting as the lender of last resort.

Duration (Macauley Duration) is a time weighted present value measure of the cash flow of a loan or security that takes into account the amount and timing of all promised interest and principal payments associated with that loan or security. It shows how the price of a bond is likely to react to different interest rate environments. A bond's price is a function of its coupon, maturity and yield.

Economic Value of Equity (EVE) is the present value of the expected cash flow of assets minus the present value of the expected cash flows on liabilities, plus or minus the present value of the expected cash flows on off-balance sheet instruments, discounted to reflect market rates.

Foreign exchange risk is the risk associated with exposure to fluctuation in spot exchange rates.

Funding liquidity risk is defined as an institution's inability to obtain funds to meet cash flow obligations or the risk that the counterparties who provide the bank with short-term funding will withdraw or not roll over that funding, e.g. there will be a 'run on the banks' as depositors withdraw their funds.

GAP is the term commonly used to describe the rupee volume of the interest-rate sensitive assets versus interest-rate sensitive liabilities mismatch for a specific time frame; often expressed as a percentage of total assets.

Gross income is the net interest income (before provisions) plus non-interest income; the income available to cover the operating expenses.

Held to maturity securities are the securities acquired by the banks/DFIs with the intention and ability to hold them upto maturity.

Held for trading securities are **t**he securities acquired by the banks/DFIs with the intention to trade by taking advantage of short-term market/interest rate movements. Such securities are to be sold within 90 days from the date of their classification as 'Held for Trading' under normal circumstances.

Incidence of NPLs is the impact of non-performing loans on the earnings of a bank; spread between effective return (interest income on loans minus provision & direct write off expenses divided by gross loans) and actual return (interest income divided by performing loans) on loans.

Incremental NPLs or Advances is the net increase or decrease in NPLs or advances between two periods.

Inter-bank rates are the two way quotes, namely bid and offer rates, quoted in the inter bank market are called as inter bank rates.

Interest rate risk is the exposure of an institution's financial condition to adverse movement in interest rates, whether domestic or worldwide. The primary source of interest rate risk is difference in timing of the re-pricing of bank's assets, liabilities and off-balance sheet instruments.

Interest rate spread is the ratio obtained by subtracting the cost of factor for interest bearing liabilities from the percentage yields on earning assets. Because interest-bearing liabilities are not normally equal to total earning assets, the spread is usually different from the net interest margin.

Intermediation cost is the administrative expenses divided by the average deposits and borrowings.

Liquid assets are the assets that are easily and cheaply turned into cash – notably cash and short term securities. It includes cash and balances with banks, call money lending, lending under repo and investment in government securities.

Liquidity risk is the risk that the bank will be unable to accommodate decreases in liabilities or to fund increases in assets. The liquidity represents the bank's ability to efficiently and economically accommodate decreases in deposits and to fund increases in loan demand without negatively affecting its earnings.

M2 includes currency in circulation (CIC), other deposits with SBP, demand deposits, time deposits and resident foreign currency deposits with the scheduled banks.

Market liquidity risk is the risk of a generalized disruption in asset markets that make normally-liquid assets illiquid or the risk that market transactions will become impossible due to market disruptions or inadequate market depth.

Market risk is the risk that changes in the market rates and prices will impair an obligor's ability to perform under the contract negotiated between the parties. Market risk reflects the degree to which changes in interest rates, foreign exchange rates, and equity prices can adversely affect the earnings of a bank.

Net interest income is the total interest income less total interest expense. This residual amount represents most of the income available to cover expenses other than interest expense.

Net interest margin (NIM) is the net interest income as a percent of average earning assets.

Net loans are loans net of provision held for non-performing loans.

Net non-performing loans (NPLs) is the value of non-performing loans minus provision for loan losses.

Net NPLs to net loans means net NPLs as a percent of net loans. It shows the degree of loans infection after making adjustment for provision held.

Non-Performing loans (NPLs) are loans and advances whose mark-up/interest or principal is overdue by 90 days or more from the due date are classified as non-performing.

NPLs to loans ratio stands for non-performing loans as a percent of gross loans.

Off-the-run securities are less liquid securities signifying low trading activity in the secondary market.

Open Market Operations is the buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system. Purchases inject money into the banking system and stimulate growth while sales of securities do the opposite

On-the-run securities are the relatively high liquid securities with active trading in the secondary market. These are the seasoned securities.

Over the counter (OTC) market is the market where securities transactions are made via telephone and computer rather than on the floor of an exchange.

Paid-up capital is equity amount actually paid by the shareholders to a company for acquiring its shares.

Rate sensitive assets (RSA) are assets susceptible to interest rate movements; that will be re-priced or will have a new interest rate associated with them over the forthcoming planning period.

Repricing risk arises from timing differences in the maturity of fixed rate and the repricing of floating rates as applied to banks' assets, liabilities and off-balance sheet positions.

Return on assets measures the operating performance of an institution. It is the widely used indicator of earning and is calculated as net profit as percentage of average assets.

Return on equity is a measure that indicates the earning power of equity and is calculated as net income available for common stockholders to average equity.

Risk weighted Assets: Total risk weighted assets of a bank would comprise two broad categories: credit risk-weighted assets and market risk-weighted assets. Credit risk weighted assets are calculated from the adjusted value of funded risk assets i.e. on balance sheet assets and non-funded risk exposures i.e. off-balance sheet item. On the other hand for market risk-weighted assets, first the capital charge for market risk is calculated and then on the basis of this charge amount the value of Market Risk Weighted Assets is derived.

Secondary market is a market in which securities are traded following the time of their original issue.

SME means an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing concern) and 50 persons (if it is trading / service concern) and also fulfills the following criteria of either 'a' and 'c' or 'b' and 'c' as relevant:
(a) A trading / service concern with total assets at cost excluding land and building upto Rs50 million.
(b) A manufacturing concern with total assets at cost excluding land and building upto Rs100 million.
(c) Any concern (trading, service or manufacturing) with net sales not exceeding Rs300 million as per latest financial statements.

Tier I capital: The risk based capital system divides capital into two tiers- core capital (Tier I) and supplementary capital (Tier II and Tier III). Tier 1 capital includes fully paid up capital, balance in share premium account, reserve for issue of bonus shares, general reserves as disclosed on the balance-sheet and un-appropriated /unremitted profit (net of accumulated losses, if any).

Tier II capital: Supplementary Capital (Tier II) is limited to 100 percent of core capital (Tier I). It includes; general provisions or general reserves for loan losses, revaluation reserves, exchange translation reserves, undisclosed reserves and subordinated debt.

Tier III capital: The tier III capital consisting of short-term subordinated debt would be solely for the purpose of meeting a proportion of the capital requirements for market risks.

Yield risk is the risk arising out of the changes in interest rates on a bond or security when calculated as that rate of interest which, if applied uniformly to future time periods sets the discounted value of future bond coupon and principal payments equal to the current market price of the bond.

Yield curve risk materializes when unanticipated shifts have an adverse effect on the bank's income or underlying economic value.

Yield spread is the difference in the rate of 10-year bond and overnight rate. Yield spread is positive when rate on longer tenor bond is higher.

Group-wise Composition of Banks Annex-I

1997-1998	2003	2004	2005
<u>A. Public Sector Comm. Banks</u> (6) - Habib Bank Ltd. - National Bank of Pakistan - United Bank Ltd. - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **<u>B. Local Private Banks</u> (16)** - Askari Commercial Bank Ltd. - Bank Al-Falah Ltd. - Bank Al Habib Ltd. - Bolan Bank Ltd. - Faysal Bank Ltd. - Metropolitan Bank Ltd. - Platinum Commercial Bank Ltd - Prime Commercial Bank Ltd. - Prudential Commercial Bank Ltd - Gulf Commercial Bank Ltd. - Soneri Bank Ltd. - Union Bank Ltd. - Muslim Commercial Bank Ltd - Allied Bank of Pakistan - Trust Bank Ltd. - Indus Bank Ltd. **<u>C. Foreign Banks</u> (20)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - ANZ Grindlays Bank - Bank of America - Bank of Ceylon - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - Credit Agricole Indosuez - Deutsche Bank A.G. - Doha Bank - Emirates Bank International - Habib Bank A. G. Zurich - The Hongkong & Shanghai Banking Corporation Ltd. - IFIC Bank Ltd. - Mashreq Bank PJSC - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Societe Generale - Standard Chartered Bank **<u>D. Specialized Banks</u> (4)** - Agriculture Development Bank of Pakistan - Industrial Development Bank of Pakistan - Federal Bank for Co-operatives - Punjab Provincial Co-operative Bank Ltd.	**<u>A. Public Sector Comm. Banks</u> (5)** - Habib Bank Ltd[1] - National Bank of Pakistan - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **<u>B. Local Private Banks</u> (18)** - Askari Commercial Bank Ltd. - Bank Al-Falah Ltd. - Bank Al Habib Ltd. - Bolan Bank Ltd. - Faysal Bank Ltd. - Metropolitan Bank Ltd. - KASB Bank Ltd. - Prime Commercial Bank Ltd. - Saudi Pak Commercial Bank Ltd - PICIC Commercial Bank Ltd. - Soneri Bank Ltd. - Union Bank Ltd. - Muslim Commercial Bank Ltd. - Allied Bank of Pakistan - United Bank Ltd. - Meezan Bank - NDLC-IFIC Bank Ltd - Crescent Bank Ltd. **<u>C. Foreign Banks</u> (14)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - Bank of Ceylon[2] - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - Credit Agricole Indosuez[3] - Deutsche Bank A.G. - Doha Bank[4] - Habib Bank A. G. Zurich - The Hongkong & Shanghai Banking Corporation Ltd. - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Standard Chartered Bank **<u>D. Specialized Banks</u> (3)** - Zari Taraqiati Bank Ltd. - Industrial Development Bank of Pakistan - Punjab Provincial Co-operative Bank Ltd. **<u>All Commercial Banks</u> (37)** Include A + B + C **<u>All Banks</u> (40)** Include A + B + C + D	**<u>A. Public Sector Comm. Banks</u> (4)** - National Bank of Pakistan - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **<u>B. Local Private Banks</u> (20)** - Askari Commercial Bank Ltd. - Bank Al-Falah Ltd. - Bank Al Habib Ltd. - Bolan Bank Ltd. - Faysal Bank Ltd. - Metropolitan Bank Ltd. - KASB Bank Ltd. - Prime Commercial Bank Ltd. - Saudi Pak Commercial Bank Ltd - PICIC Commercial Bank Ltd. - Soneri Bank Ltd. - Union Bank Ltd. - Muslim Commercial Bank Ltd. - Allied Bank of Pakistan - United Bank Ltd. - Meezan Bank - NDLC-IFIC Bank Ltd - Crescent Commercial Bank Ltd. - Habib Bank Ltd - Dawood Bank **<u>C. Foreign Banks</u> (11)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - Deutsche Bank A.G. - Habib Bank A. G. Zurich - The Hongkong & Shanghai Banking Corporation Ltd. - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Standard Chartered Bank **<u>D. Specialized Banks</u> (3)** - Zari Taraqiati Bank Ltd. - Industrial Development Bank of Pakistan - Punjab Provincial Co-operative Bank Ltd. **<u>All Commercial Banks</u> (35)** Include A + B + C **<u>All Banks</u> (38)** Include A + B + C + D	**<u>A. Public Sector Comm. Banks</u> (4)** - National Bank of Pakistan - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **<u>B. Local Private Banks</u> (20)** - Askari Commercial Bank Ltd. - Bank Al-Falah Ltd. - Bank Al Habib Ltd. - My Bank Ltd. - Faysal Bank Ltd. - Metropolitan Bank Ltd. - KASB Bank Ltd. - Prime Commercial Bank Ltd. - Saudi Pak Commercial Bank Ltd - PICIC Commercial Bank Ltd. - Soneri Bank Ltd. - Union Bank Ltd. - MCB Bank Ltd. - Allied Bank. - United Bank Ltd. - Meezan Bank - NIB Bank Ltd - Crescent Commercial Bank Ltd. - Habib Bank Ltd - Dawood Bank **<u>C. Foreign Banks</u> (11)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - Deutsche Bank A.G. - Habib Bank A. G. Zurich - The Hongkong & Shanghai Banking Corporation Ltd. - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Standard Chartered Bank **<u>D. Specialized Banks</u> (4)** - Zari Taraqiati Bank Ltd. - Industrial Development Bank of Pakistan - Punjab Provincial Co-operative Bank Ltd. - SME Bank Limited[5] **<u>All Commercial Banks</u> (35)** Include A + B + C **<u>All Banks</u> (39)** Include A + B + C + D

1. *SME Bank Ltd has been included in Specialized Banks category after it has been granted the banking license during Jun 2005 quarter.*
2. *On March 26, 2005 the name of Allied Bank of Pakistan Limited was changed to Allied Bank Limited.*
3. *On July 02, 2005, the name of Bolan Bank Limited was changed to My Bank Limited.*
4. *On July 30, 2005 the name of Muslim Commercial Bank Limited was changed to MCB Bank Limited.*
5. *On November 28, 2005 the name of NDLC-IFIC Bank Limited was changed to NIB Bank Limited.*
6. *On December 31, 2005, the name of The Bank of Tokyo Mitsubishi Limited was changed to The Bank of Tokyo Mitsubishi UFJ Limited.*
7. *The name of the bank was changed to Atlas Bank Limited on March 04, 2006.*