3 Performance of Scheduled Banks

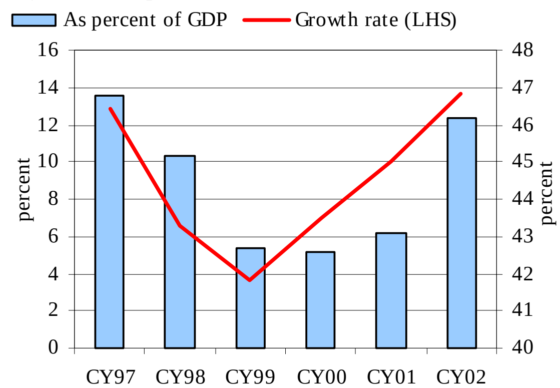
The banking sector was passing through the transition phase of reform process during 1990s and by the end-CY00 it was difficult to spot the solid signs of improvements, specifically in the wake of core set of banking reforms implemented since 1997. The reform process was itself very costly in its initial phase that included golden handshake schemes to right-size staff and closure of loss making branches.[1] Moreover, the overall macro-economic scenario was not very conducive for the banking sector, mainly due to the aftermath of freezing of foreign currency accounts. Despite these difficulties, some of the indicators started showing marginal improvements towards the end-CY00. However, to further strengthen the banking system, it was imperative to continue the reform process with more vigor. Privatization of nationalized banks, consolidation of smaller institutions, focused effort to arrest the increase in non-performing loans (especially of public sector banks), improvement in the corporate culture with efficient internal and external controls, ease in tax burden on the banking industry, technological up-gradation, and rationalization of yield on NSS instruments were some of the areas that required immediate attention of the policy makers.

During CY00-CY02, the thrust of policy framework for the financial sector in general and the banking sector in particular remained in line with above-mentioned areas. Discussion in this chapter is primarily based on the steps taken to improve the banking business in Pakistan, their rationale and the consequent impact on the financial health of the banking sector. It also points out some of the weak areas that need to be addressed.

3.1 Overview

During the last three years, deposits of the banking sector increased at an increasing rate (see **Figure 3.1**). It was the first time since 1997 that banks saw a double-digit deposit growth (13.7 percent) in CY02. Exceptional developments on external front, especially in the aftermath of September 11 events, played an important role in catalyzing the growth during CY01 and CY02.[2]

Figure 3.1: Deposits of Scheduled Banks



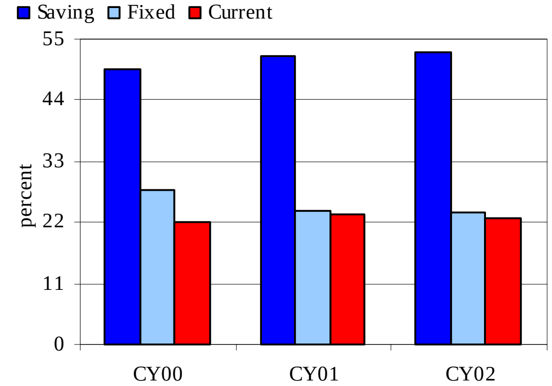
It is important to note that during CY00 and before CY98, FCAs were mainly contributing in fast rising deposits. Prior to the freeze in FCAs in May 1998, on placement with SBP (a mandatory condition) these deposits not only provided the counterpart Rupee for intermediation, but also earned very high returns by simply investing these funds in the government papers. However, after the freeze, the scheme was revised and banks were no more required to surrender their FCAs with the SBP. Although the growth in FCAs increased the deposit base of the banks during CY00, it was not really adding to Rupee liquidity, as was the case earlier. Further, as the SBP put a limit on the mobilization of FCAs,[3] growth in local currency deposits became imperative for banks. During CY01 (in last two months) and CY02, banks saw a remarkable surge in much needed local currency deposits, while the FCAs were falling in this period.[4] Both developments largely came about due to

[1] For details, see **Pakistan: Financial Sector Assessment 1990-2000**, SBP, 2002.
[2] For detailed analysis, see the **Chapter 6** of the **SBP Annual Report** for FY02.
[3] Vide BSD Circular No. 19 dated March 31, 2001, “foreign currency deposits mobilized under FE-25 scheme should not at any point exceed twenty percent of the local currency deposits of the banks / NBFIs at the close of business on the last working day of the preceding quarter”.
[4] Appreciation of Pak-Rupee against Dollar and expectations for further strengthening of Rupee eroded the effective return on FCAs.

the improvements in Pakistan's external account since October 2001. The phenomenal surge in the local currency deposits was on the back of Rupee injections by the SBP against foreign exchange purchases and higher remittance through the banking channel. The fall in FCAs reflected the decreasing attractiveness of foreign exchange holdings as the Rupee appreciated. The much higher growth in the former helped in replenishing the overall deposit base of banks.

During the last two years, another significant development was the changing composition of the deposit base. Relatively higher growth of deposits in current and saving categories compared to fixed accounts resulted in fall in the share of latter (see **Figure 3.2**).[5] This coupled with the falling interest rates played an important role in reducing interest cost during these years. Although in order to minimize the liquidity risk, it is important to have the higher share of fixed deposits, however, in the prevailing higher liquidity in inter-bank market, banks were very comfortable on this front. Persistent deposit growth, easy monetary policy stance, and proactive OMOs by the SBP were prime factors behind the liquid inter-bank market (for details see **Section 6.1.1**).

Figure 3.2: Composition of Deposits



As a result of significantly higher deposit growth, share of borrowing declined in CY02 compared to its level at the end of CY00. This fall was recorded for all the four banking groups (see **Table 3.1**). Since the borrowing is usually a relatively costlier source of funding than deposits, rising share of deposits in total funding means marginal interest cost of assets was declining during CY00-CY02. Further, with continuously declining interest rates (after November 2001), borrowing itself had been getting cheaper and cheaper overtime. This also helped banks in reducing the interest cost during CY01 and CY02 (for details see **Section 3.5**).

Table 3.1: Share in Total Liabilities
percent

	CY00	CY01	CY02
Public sector commercial banks			
Deposits	86.4	87.2	87.1
Borrowings	6.6	5.7	6.1
Others	7.1	7.1	6.7
Domestic private banks			
Deposits	79.5	83.4	82.3
Borrowings	14.8	11.1	11.5
Others	5.7	5.6	6.2
Foreign banks			
Deposits	73.2	70.2	73.3
Borrowings	22.8	25.6	21.2
Others	4.0	4.3	5.6
Specialized banks			
Deposits	13.8	15.4	13.5
Borrowings	70.8	69.2	56.6
Others	15.4	15.4	29.9
All banks			
Deposits	77.7	78.9	79.2
Borrowings	15.5	14.4	13.1
Others	6.8	6.7	7.7

In line with deposits, growth in assets started recovering from the May 1998 shock in CY00 (see **Figure 3.3**). However, the slowdown in demand for bank advances in CY01 (especially in the second-half of the year) decelerated the asset growth during the year.[6] Although the growth in advances also

[5] Within the current account, share of non-remunerative increased from around 75 percent at the end of CY00 to 83 percent on December 31, 2002.
[6] The subdued credit demand was mainly the outturn of September 11 shock (for details see **Chapter 5** and **6** of **SBP Annual Report** for **FY02**).

remained subdued during CY02, it was the remarkable surge in the deposits that the banking sector saw a double-digit growth in asset base. By the end of CY02, the aggregate assets of the banking sector reached to a record high level of 61.3 percent of GDP. This, however, primarily stemmed from a sharp increase in investment portfolio of banks, mainly in government securities. With the available excess liquidity and expectations for further fall in interest rates, banks were aggressively bidding to invest in government securities.

These developments significantly altered the asset composition of the banks during CY00-CY02. Specifically, the share of advances fell from 49.1 percent in CY00 to 41.5 percent by the end of CY02. While in the same period, share of investment approximately doubled from 16.8 percent to 31.5 percent (see **Table 3.2**).

Figure 3.3: Assets of Scheduled Banks

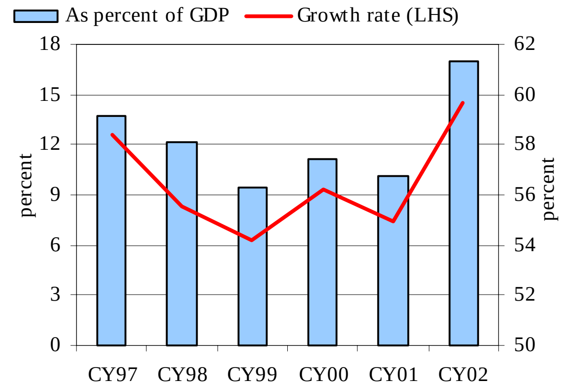


Table 3.2: Share in Total Assets

Percent

	CY00	CY01	CY02
PSCBs			
Advances	44.5	45.2	36.4
Investment	20.2	18.6	34.6
Others	35.2	36.2	29.0
DPBs			
Advances	51.9	46.4	41.1
Investment	18.4	22.6	34.6
Others	29.7	31.0	24.3
Foreign banks			
Advances	47.7	42.9	46.9
Investment	7.6	13.2	20.4
Others	44.7	43.9	32.8
Specialized banks			
Advances	77.3	76.5	75.3
Investment	5.4	4.4	5.6
Others	17.3	19.1	19.0
All banks			
Advances	49.1	46.9	41.5
Investment	16.8	18.1	31.5
Others	34.0	35.1	27.0

3.2 Capital Adequacy

During the last two years, the main thrust of the policy framework was to further strengthen the competitive abilities of banks, especially of smaller institutions. This had become imperative with the liberalization of the financial sector that could not fully instill the true spirit of competition in the banking industry during 1990s. This is because most of the new banks were very small and under capitalized. The fragmentation was not allowing the banking sector to achieve the economies of scales and technological upgradation that could help in reducing the intermediation cost, which was the prime objective of the financial sector reforms. Failure in achieving the reduction in intermediation cost till the end of 1990s brought to the forefront not only the need to spur meaningful competition in the banking industry, but also the strengthening of weak banks, whose survival had become more difficult with the integration of financial markets around the world.

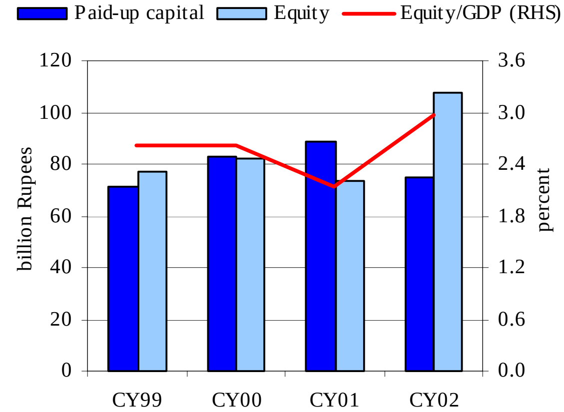
In order to prepare the domestic institutions for the emerging challenges of globalization, it was required to have fewer institutions, but with sizable capital base. Although a risk-based capital adequacy system was already in place since 1997, the existing system was not encouraging the small private sector banks to achieve the economies of scales.[7] To address this issue, the SBP doubled the

[7] It was essay to meet the required 8 percent capital to risk-weighted ratio by investing more in government securities (zero risk-weighted) without enhancing the capital base. Also, this easy-earning asset was discouraging banks to introduce new products.

minimum paid-up capital (net of losses) requirement for scheduled banks to Rs 1.0 billion.[8] Banks were required to meet this target in two phases, i.e., Rs 750 million to be achieved till end December 2001 and the final figure to be met by end-December 2002.[9]

The outcome of this policy showed mixed picture. At the end of second and final phase, i.e., as on December 31, 2002, 11 out of total 37 commercial banks did not achieve the target. Some of the failing banks were exempted, as these were under the process of either merger with other institutions or under liquidation. The rest have been granted extension. Surprisingly, despite the fact that most of the banks raised their paid-up capital during 2001 and 2002, the scheduled banks saw a fall of Rs 13.9 billion in the aggregate figures (see **Figure 3.4**). This was the outturn of restructuring of UBL before privatization. Specifically, accumulated losses of Rs 25.2 billion were offset against the bank's paid-up capital. On the contrary, the banking sector saw a sharp surge in equity buildup during CY02.[10] This was made possible by the continuously declining yield on government securities; as a result banks recorded capital gains on the sale and revaluation of assets booked earlier at relatively higher rates.

Figure 3.4: Captilization of Scheduled Banks



Increase in the capital base of the banking system helped in improving the capital adequacy indicators at the end of CY02. Capital to risk weighted assets ratio (CRWA), which was already above the required benchmark of 8 percent in CY00, improved further for all, except for the group of specialized banks (see **Table 3.3**). Although the growth in equity had a role to play, this improvement mainly stemmed from the changes in the asset mix of the banking sector. As mentioned earlier, the banking sector saw a significant increase in the share of investment (primarily in government securities), and a fall in that of advances by the end of CY02 when compared from the baseline of December 31, 2000. With the fact that investment in the government securities is assigned zero risk while the advances are weighted as hundred percent risky assets, the change in the asset mix played an important role in improving CRWA ratio, particularly for commercial banks. One out of the five banks falling short of 8 percent benchmark at end-December 2000 improved its CRWA ratio to meet the required level by the end of CY02 (see **Table 3.3**).

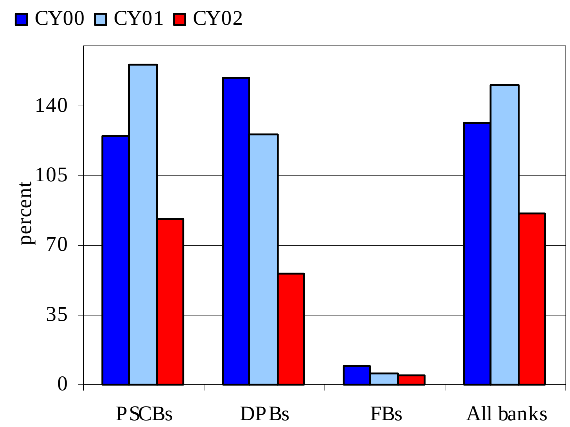
Table 3.3: Capital Adequacy
percent

	CY00	CY01	CY02
Capital to risk weighted assets			
PSCBs	10.4	9.6	12.3
DPBs	9.2	9.5	9.7
FBs	18.0	18.6	23.2
Specialized banks	-3.3	-13.9	-31.7
All banks	9.7	8.8	8.8
All banks (Excl. Sp. banks)	11.4	11.3	12.6
Bank below 8 percent CRWA (numbers)			
PSCBs	0	0	0
DPBs	3	3	2
FBs	0	0	0
Specialized banks	2	2	2
All banks	5	5	4
All banks (Excl. Sp. banks)	3	3	2

[8] Vide BSD Circular No. 31 dated December 6, 2000.
[9] It was decided that banks failing to meet this requirement would be de-scheduled with the corresponding restrictions on their business activities (see **Reform Matrix**, **Annexure 2.1**).
[10] Including surplus (deficit) on revaluation of assets.

It is important to note that the capital adequacy ratio of banks in PSCBs first deteriorated (though remained above the required level) in CY01 before improving in CY02. This fall in ratio mainly was largely explainable by the losses suffered by one of the bank in this group, mainly on account of substantial provisioning against the historic stock of un-provisioned non-performing assets.[11] While the other two groups observed continuous improvement since 2000, CAR for specialized banks continued to deteriorate over the same period.

Figure 3.5: Net NPLs to Capital



Although all groups (except specialized banks) were fulfilling the CRWA requirement at the end of CY00, the above hundred percent net NPLs to capital ratio was still a serious threat to the capital base of the banks. Besides the surge in equity, significant improvement in case of non-performing assets reduced the vulnerabilities, to an extent, faced by the capital base of the banks. This can be seen from the remarkable improvement in the net NPLs to capital ratio of the PSCBs and DPBs (see **Figure 3.5**). As a result, the ratio for overall banking system has gone down to 85.6 percent at the end of CY02 from above hundred percent for the last two years. This ratio decreases further to 54.5 percent, if specialized banks are excluded. It is expected that increase in the paid-up capital of banks (especially those, which are given extension to meet the Rs 1 billion requirement), and the measures taken during last couple of years to improve the asset quality of the banks, would further help in strengthening the soundness of the banking system of the country.

3.3 Asset Quality[12]

Improvement in the asset quality is the most basic ingredient to enhance the profitability and soundness of financial institutions. As the lending normally makes up the largest portion of banks' assets and is also an important source of earnings and losses, the credit quality has the direct bearing on the banks' net worth. One of the major problems of the banks in Pakistan at the end of 1990s was the huge stock of non-performing loans (NPLs), particularly of the public sector banks. Not only that banks were not earning any income on this bad portfolio, provisioning against such loans was further reducing their profits. Banks often used this as one of the excuses for keeping banking spread higher.[13] In addition, banks' pre-occupation in managing their existing portfolio instead of focusing on fresh lending was resulting in credit squeeze. Hence, there was an urgent need to address this issue with more vigor.[14]

A multidimensional approach had been adopted to tackle this core issue of NPLs since 2000. First, Corporate and Industrial Restructuring Corporation (CIRC) was established in September 2000 to deal with the historical stuck-up portfolio of the banking sector. The corporation had been empowered to takeover the non-performing assets of Nationalized Commercial Banks (NCBs) and

[11] This, however, needs to be interpreted carefully as on one level the appropriate provisioning is a positive sign for risk profile, while on the other level, being an expense, it simultaneously leads to deterioration in the profitability and ultimately the capital adequacy indicators.

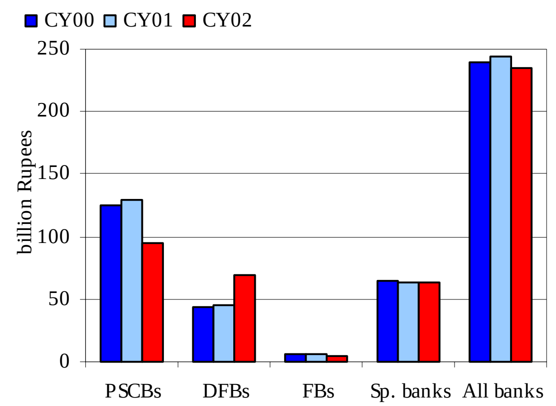
[12] Asset quality problems may arise from a variety of risks banks face in managing their assets, of which credit risk is the most important in nature. Here the main focus is on the credit risk, while the next section will discuss the liquidity risk.

[13] The difference between weighted average lending and deposit rates--also normally used as a proxy of banking efficiency.

[14] This has been discussed in detail in **Chapter 3** of **Pakistan: Financial Sector Assessment 1990-2000**, SBP, 2002.

Development Finance Institutions (DFIs).[15] Second, a Committee on Revival of Sick Industrial Units (CRSIU) had been formed to evaluate the possibilities of restructuring the industrial units that became non-operational due to unsustainable debt burden but were otherwise economically viable. Banks had significant amount of stuck-up loans with these units and it was expected that their revival would help banks in recovering a portion of their stuck-up loans. Third, in order to remove the legal difficulties and time delays faced by the banks in recoveries against defaulted loans, the Financial Institutions (Recovery of Finance) Ordinance, 2001 was promulgated. This would facilitate expeditious recovery of stuck-up loans by the right foreclosure and sale of mortgaged property with or without intervention of court. Fourth, banks had been followed more vigorously for adequate provisioning for their NPLs. Fifth, the cases of willful defaulters, after a due process of law, are being referred to National Accountability Bureau (NAB) for recovery. Sixth, to avoid the unnecessary political interventions and pressurized lending, privatization of the nationalized institution had been speeded-up. Furthermore, emphasis had also been made through issuing guidelines for improving the corporate governance, internal controls and quality of external audit. All these steps should not only help in managing outstanding stock of NPLs, but controlling the future growth of fresh NPLs as well.

Figure 3.6: NPLs of Scheduled Banks



These measures have already started paying dividends. As shown in **Figure 3.6**, the stock of NPLs decreased to Rs 234.2 billion by end-CY02, after increasing in the previous year (see **Figure 3.6**).[16] The increase of Rs 4.0 billion during CY01 needs to be adjusted on two accounts: (1) the merger of NDFC (an NBFI) with the National Bank of Pakistan; and (2) the transfer of operations of UK branches of some of the banks to their newly established subsidiaries. While the former led to significant rise of Rs. 13.6 billion in the NPLs of the banking sector, the latter resulted in a decline of Rs. 6.5 billion. In fact, if these two adjustments are taken into account the banking sector actually reduced its NPLs by Rs 3.1 billion during CY01.[17] In the group-wise position, the shifting of NDFC bad assets, left the PSCBs with an increase of Rs 4.4 billion in its NPLs during CY01, they otherwise could have improved their position. Some of the DPBs, however, saw further deterioration of their own loan portfolios, while the foreign and specialized banks as groups slightly improved their NPLs position (see **Figure 3.6**).

During CY02, while the outstanding stock of NPLs of the banking sector declined by Rs 9.9 billion as compared to CY01, the DPBs saw a sharp upsurge (see **Figure 3.6**). Most of this rise was due to regrouping of UBL and two foreign banks in this sector for this year.[18]

---

[15] According to the CIRC Ordinance, the corporation can deal with only those NPLs which are: (1) held as assets on the books of the financial institutions, (2) the principal or interest is overdue by 365 days, and (3) outstanding amount is equal to or over Rs 30 million. Furthermore, the CIRC is authorized to deal with NPLs of those financial institutions wherein the government's share in equity is in excess of 85 percent.

[16] Higher increase in fresh NPLs during Q1-CY02 against the corresponding figure of CY01was due to shifting of NDFC's NPLs to National bank of Pakistan during this quarter. **Figure 3.6** is based on data on domestic operations of banks and in this data NBP started declaring the NPLs received from NDFC since January 2002.

[17] This is because there should be an increase of Rs 7.1 billion (Rs 13.6 billion due to NDFC minus Rs 6.5 billion due to UK branches) in the bad portfolio of the banking system, while the actual was Rs 6.3 billion.

[18] UBL has been privatized in November 2002, Emirates and Societe Generale banks have been acquired by Union and Meezan (private sector) banks, respectively. Consequently, UBL which was earlier classified as a public sector bank, was grouped in domestic private banks.

Similarly, a portion of the fall in NPLs (stock) of the other two groups (PSCBs and FBs) also stemmed from this re-arrangement of banks in different groups. If adjusted for the re-grouping effect, a surprising result emerges that the PSCBs and FBs actually improved, while the DPBs group saw around Rs 1 billion increase in NPLs.

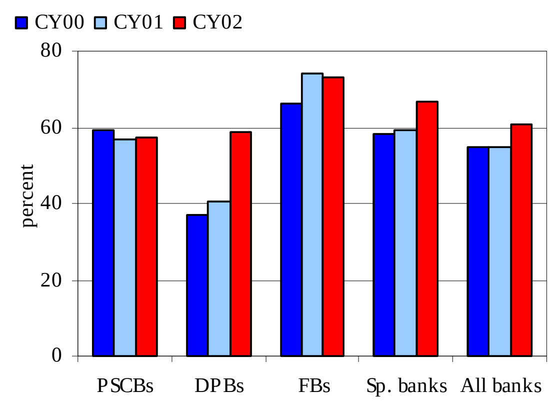
It is always important to see the NPLs in relation to advances. Banking industry as a whole saw improvement in both NPLs to gross advances and net NPLs to net advances ratios during CY00-CY02 (see **Table 3.4**). Like the stock of NPLs, the ratios slightly deteriorated first during CY01, prior to a significant improvement in CY02. However, it is interesting to note that the slight increase in the gross and net ratios during CY01 for the banks (excluding specialized banks) was not because poor showing of a particular banking group. Specifically, it was the DPBs that caused the increase in NPLs to gross advances ratio, while the PSCBs were responsible for higher net ratio at the end of CY01. This anomaly could be explained with the rise and fall in the provisioning to gross NPLs ratio for DPBs and PSCBs groups respectively (see **Figure 3.7**). This may further be explained with the fact that although the DPBs recorded a growth in NPLs, they had already taken into account its negative effects through higher provisioning, while the NPLs transferred to PSCBs were not sufficiently provisioned, hence their net NPLs to net advances ratio deteriorated. During CY02, all the sub-groups of banks recorded improvement in net NPLs to net advances ratios.[19]

Tables 3.4: Asset Quality

percent

	CY00	CY01	CY02
NPLs to gross advances			
PSCBs	26.3	25.9	25.5
DPBs	15.4	16.3	15.9
FBs	4.7	4.3	3.8
Specialized banks	52.4	53.0	54.7
All banks	23.5	23.4	22.0
All banks (Excl. Sp. banks)	19.5	19.6	18.0
Net NPLs to net advances			
PSCBs	12.7	13.1	12.8
DPBs	10.3	10.4	7.2
FBs	1.7	1.1	1.1
Specialized banks	31.6	31.5	28.5
All banks	12.2	12.1	10.0
All banks (Excl. Sp. banks)	10.1	10.3	8.4

Figure 3.7: NPLs to Provisioning Ratio



Despite this success in reducing the NPLs of the overall banking industry both in absolute term and in relation with advances, continuous efforts are still required for further improvement and to avoid reversal in this good performance in future. Especially there is an urgent need to carefully keep an eye on the growth in NPLs of private domestic banks. The deterioration--albeit only marginal--in the indicators of smaller banks is overshadowing the significant improvement in the asset quality of big banks.

Further, two important developments in the recent past required banks to be more careful and prudent in advancing loans. First, banks are flushed with liquidity and the yield on government securities are at historically low levels; as a result banks are becoming increasingly aggressive in credit extension. Due to this behavior there is a potential threat of adverse selection problem. Second, during last one year or so, there was a significant increase in the real estate prices. This would result in higher value

[19] For foreign banks net NPLs to net advance ratio improved from 1.14 to 1.06. This is not apparent from the data in **Table 3.4** due to rounding off to one decimal point.

of underlying collaterals and in this situation banks could lend more to borrowers than what is required on prudent grounds.[20] It is important to take into account the cash flows in addition to collateral values while extending loans.

3.4 Liquidity Risk

The term liquidity for the banks refers to their ability to quickly raise the cash at a reasonable cost. Adequate liquidity is important for the banks to pay creditors, meet unforeseen deposit runoffs, satisfy periodic changes in loan demand, and fund loan growth without making costly balance sheet adjustments. Absence of adequate liquidity may affect the profitability of an otherwise sound bank and in extreme case may lead to insolvency of a problem institution. Primarily, the liquidity risk arises due to mismatches in the maturity profile of assets and liabilities. Banks' ability to bridge this gap at relatively lower cost mainly depends on the efficiency and liquidity position of inter-bank market and the stance of monetary policy.[21]

Unlike the situation in CY00 (especially, towards the end of the year), banks were very comfortable with liquidity during most of CY01 and CY02. Although the banks were struggling to replenish their deposit base (especially in local currency),[22] the severe liquidity shortage during last three months of CY00 mainly stemmed from the central bank efforts to meet its end-December (IMF) NDA targets, and to mitigate the downward pressures on the value of Rupee against the US Dollar.[23] Scenario became altogether different toward the end of CY01 and throughout CY02. In the aftermath of 9/11, banks saw a remarkable growth in their local currency deposits and due to unparallel increase in the credit demand, inter-bank market remained flush with liquidity.[24] Still there were few occasions where banks used the SBP discount window, however, these resulted mainly due to speculative bidding in T-bill auctions with the expectation of further fall in interest rates (for more details, see **Section 6.1**). This behavior on the part of banks made it more difficult for the SBP to reduce volatility of over-night rates in the inter-bank market.

Table 3.5: Liquidity Indicators
percent

	CY00	CY01	CY02
Liquid assets to total assets			
PSCBs	37.1	36.5	48.6
DPBs	34.0	39.8	45.2
FBs	45.2	50.3	48.3
Specialized banks	12.7	13.6	16.4
All banks	36.0	38.5	45.7
All banks (Excl. Sp. banks)	37.5	39.9	47.0
Loan to deposit			
PSCBs	54.0	53.8	44.3
DPBs	67.5	57.9	52.8
FBs	71.5	66.8	71.5
Specialized banks	553.0	450.5	453.3
All banks	66.2	61.7	55.1
All banks (Excl. Sp. banks)	60.5	56.9	51.2

The improvement in the liquidity position of the banks is also visible from the indicators (see **Table 3.5**). Continuous fall in the loans to deposit ratio since CY00 was witnessed due to remarkable growth of deposits towards the end of CY01 and throughout CY02. On the other hand, the banks saw relative slowdown in growth of advances. Both impressive deposit growth and subdued increase in

[20] This issue, however, needs a detailed analysis. In the absence of data availability, it is difficult to strongly conclude in this matter.
[21] Monetary policy stance of central banks mainly reflects in the inter-bank liquidity position, however, in some cases it is quite possible that inter-bank market remains very volatile. This volatility in the inter-bank market usually increases the cost of raising liquidity.
[22] After May 1998, dollar deposits were not generating the much need Rupee liquidity for the banks, as prior to this date banks were required to surrender all the dollar deposits with SBP and get the Rupee counterpart. However, after the freeze of FCAs in May 1998, banks were no more required to keep these deposits only with SBP and even if they placed these with the central bank, no rupee counterpart was issued.
[23] For detail discussion see **Section 5.10** in **SBP Annual Report** for FY01.
[24] For details, see **Chapter 6** in SBP **Annual Report** for **FY02** and **Section 6** in **Quarterly Reports** for FY03.

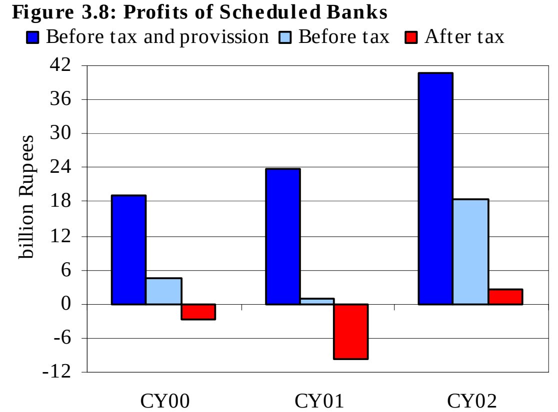
advances led to higher liquid assets to total assets ratio. Furthermore, the banks were striving to lock-in their funds in the government securities at that time. Although the statutory liquidity requirement (SLR) remained at 15 percent for the banks, in actual banks were maintaining 31.7 and 46.6 percent of their time and demand liabilities in government securities at the end of CY01 and CY02 respectively; while, the same was 29.2 percent at end of CY00.

3.5 Earnings and Profitability

Earnings quality for a bank generally refers to the composition, level and stability of bank's profits. A bank's ability to earn adequate return on its assets has direct bearing on its safety and soundness. The inability could lead to the failure to adequately: (1) serve the credit need of customers, (2) provide for the losses of the bank that may arise during its operations, and (3) build the capital to absorb any adverse shock due to macro or micro reasons. This ultimately means that depositors are at greater risk and shareholders return may become inadequate.

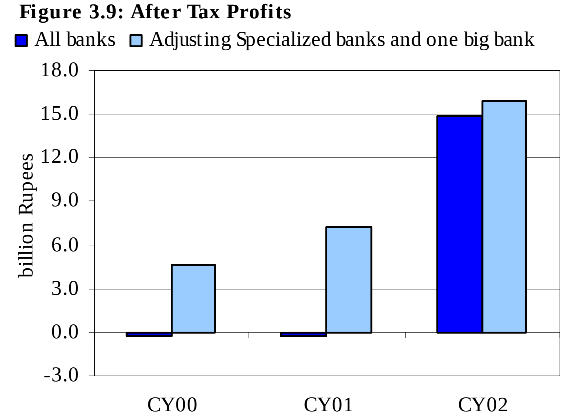
The banks in Pakistan have been finding difficulties in earning positive profits since 1997. Besides other reasons, a prime factor was the transition cost of ongoing reform process. The banks have been vigorously followed to declare the true nature of their financial accounts and to adequately provide for their non-performing assets.[25] With improvement in the quality of inspection and supervision and adoption of more transparent data reporting formats based on international standards, it is now difficult for banks to show a rosy picture of their accounts. All these efforts to improve soundness of the banking industry are not costless. The negative and approximately same magnitude of after-tax profits during first two years of 2000s was largely explainable by substantial provisioning made by the banks in these years. It means that the banks have to provide for the past poor asset quality, which emerged as a major drag on their profitability. Adjusting for tax and provisioning, the banking sector earned higher profits in CY01 compared to a year earlier (see **Figure 3.8**).

Figure 3.8: Profits of Scheduled Banks



Bank-wise analysis of the earnings and profitability reflects an important feature behind the overall negative profits of the banking sector in CY00 and CY01. It is observed that hefty losses suffered by specialized banks (as a group) and one big bank, again due to poor asset quality, rendered the whole banking sector in red during these years. As shown in **Figure 3.9**,[26] if the specialized banks and one (the most loss making) bank are excluded, the rest of the banking sector not only saw positive profits but also profits growing at an increasing rate during last three years. This indicates that the

Figure 3.9: After Tax Profits

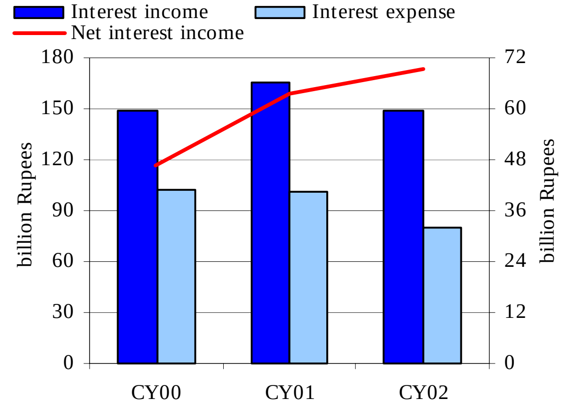


[25] For details, see pages 42-45 of **Pakistan: Financial Sector Assessment 1990-2000**, SBP, 2002.
[26] For each year the most loss-making bank was excluded that may be different for different years.

banking reforms have started paying dividends; the banking industry is on its way towards the path of sustained earnings and profitability.

Impressive rise in after tax profits of the banking sector was backed by considerable rise in its net interest income--interest income minus interest expense (**Figure 3.10**). In the CY01, this was made possible due to increase in interest income over previous year with almost the same level of interest expenses.[27] While for CY02, it was the outturn of a larger fall in interest expenses. It is interesting to note that despite a remarkable growth in deposits towards the end of CY01 and throughout CY02, banks managed to keep their interest expenses at previous year level in the former year and saw a sharp fall during CY02. These developments were basically caused by: (1) fall in deposit rates in line with overall declining interest rate structure;[28] (2) changing composition of deposit base, i.e., higher growth in current and saving deposits compared to the mobilization in fixed accounts;[29] and (3) low borrowing needs, also at relatively lower interest rates.[30] Besides these factors, the comparatively lower decline in interest income than interest expenses also stemmed from the fact that banks were carrying negative gaps between interest rate sensitive assets and liabilities. In the declining interest rate scenario, this implies that higher liability base got re-priced at falling rates compared with the asset portfolio.

Figure 3.10: Net Interest Income



It is important to note that during CY02 a sharp increase in profits of banks was recorded despite the fall in net interest margin (NIM) compared to CY01 (see **Table 3.6**). This, however, could be explained by a comparatively higher growth in earning assets of the banks relative to the percentage fall in margins. As mentioned earlier, banks saw a remarkable growth in deposits in the aftermath of September 11, 2001. The fact that this happened during falling interest rates, indicates that low interest rate environment is not only good for the economy but also for the banking industry.[31]

Table 3.6: Net Interest Margin (NIM)

percent

	CY00	CY01	CY02
PSCBs	3.5	4.3	3.7
DPBs	3.4	4.3	4.4
FBs	3.2	3.3	3.1
Specialized banks	4.1	6.7	7.4
All banks	3.5	4.3	4.1
All banks (Excl. Sp. banks)	3.4	4.1	3.9

[27] Increase in interest income, despite a fall in interest rates on interest earning assets, primarily stemmed from increase in asset base of banks. Moreover, significant fall in interest rates were observed towards the end of CY01 and at that time most of the loans were not on floating rates and re-pricing was not costless.
[28] This is applicable not only to the marginal deposits of banks but also to the old stocks of PLS deposits.
[29] During CY01, banks saw actual decline in term deposits against remarkable growth in current and saving deposits. Returns on time deposits are usually higher than those on the other types of deposits.
[30] All these development took palace in the declining interest rate scenario that started since the beginning of second half of CY01 and gained momentum after the 200 basis points cut in SBP discount rate in October 2001. As discussed earlier in **Section 3.4**, compared to previous year banks were relatively comfortable with liquidity in H2-CY01 and remained flush with liquidity almost through out CY02.
[31] It is well known that low and moderate level of interest rates minimize the problem of moral hazard and adverse selection in the financial sector. For details, see Mishkin, "The Economics of Money, Banking, and Financial Markets", Addison Wesley Publishers, 6th Edition 2002.

Non-interest income showed mixed trends during CY00-CY02. In CY01, when banks earned higher interest income over previous year, the non-interest income actually fell. Interestingly, exactly opposite was the case during CY02. Banks registered higher non-interest income, while the interest income was falling compared to CY01. Increase in non-interest income was primarily driven by capital gains on the assets sold during the year, and higher dividends received by the banks on their stock holdings.[32] On the expenditure side, the share of non-interest expenses in total increased from 31.7 percent for CY00 to 38.4 in CY02.

The other important factors that helped banks in earning higher after-tax profits during CY02 were the positive developments on the taxation front. First, the tax rate on the banking business that had been cut from 58 percent to 50 percent since July 2001 was further reduced to 47 percent in July 2002. Moreover, a clear path had been identified to bring the tax rates on the banking sector at par with corporate sector at 35 percent by July 2006. Second, the tax authorities accepted the long-standing demand of the banks in 2001 to exempt the interest income on NPLs that have been taken to suspense account. Third, in June 2002, the banks had been issued PIBs worth Rs 22 billion against their outstanding claims on CBR for deducting the advance taxes. Further, the rate of withholding tax on T-bills was reduced from 30 percent to 20 percent in the fiscal budget for FY02.

Table 3.7: Earnings and Profitability
percent

	CY00	CY01	CY02
ROAs(before tax)			
PSCBs	0.5	0.0	1.3
DPBs	-0.1	0.9	1.3
FBs	1.4	1.7	2.3
Specialized banks	-2.3	-8.4	-10.2
All banks	-0.3	0.1	0.9
All banks (Excl. Sp. banks)	0.4	0.6	1.5
ROAs (after tax)			
PSCBs	0.2	-0.5	0.6
DPBs	-0.7	0.4	0.7
FBs	0.6	0.8	1.5
Specialized banks	-2.3	-8.8	-12.1
All banks	-0.2	-0.5	0.1
All banks (Excl. Sp. banks)	-0.0	-0.0	0.8

As a result of all the above developments, banking sector ended with better profitability indicators by the end of CY02. Return on assets (ROA), which was negative for CY00 and CY01 improved to 0.8 percent in CY02. For the reasons explained earlier it is also important to see the ROA before taxes. During CY00-CY02, this ratio showed continuous improvement in the profitability of the banking sector (see **Table 3.7**). In the group-wise analysis, while all groups of banks saw an increase in ROA in CY02 over previous years, the specialized banks stayed in red.

3.6 Management Indicators

Although it is difficult to comment on the management performance of the banking sector without taking qualitative factors into account, expenses to income ratio and intermediation cost can be used to assess the overall management performance. Both indicators have recorded notable positive changes during the years under review (see **Table 3.8**). However, this improvement was not shared by

Table 3.8: Management Indicators
percent

	CY00	CY01	CY02
Expense to income ratio			
PSCBs	95.4	99.8	83.5
DPBs	101.3	91.0	85.2
FBs	87.7	85.9	72.9
Specialized banks	119.9	167.3	176.4
All banks	97.4	99.4	89.8
All banks (Excl. Sp. banks)	95.7	94.3	82.8
Intermediation cost with provisions			
PSCBs	4.0	4.0	3.3
DPBs	5.0	4.4	4.5
FBs	3.4	3.0	2.3
Specialized banks	7.8	17.1	20.8
All banks	4.4	4.7	4.5
All banks (Excl. Sp. banks)	4.2	4.0	3.6

[32] During CY02 banking sector as an aggregate realized a capital gain of Rs 6.0 billion on the sale of its assets. The data for the previous years is not available for comparison.

the specialized banks, as both their expense to income ratio and intermediation cost had further been deteriorated. Increasing intermediation cost of these banks is primarily explainable by heavy provisions made to provide for their outstanding stock of NPLs. Adjusting for this group, intermediation cost (including provisions) of all commercial banks fell to 3.6 percent by end-CY02 against 4.0 percent in CY01. This lower intermediation cost coupled with higher income (despite squeezing interest rate spread) and improvement in asset quality indicators reflects better management of the banking sector, particularly of the commercial banks.