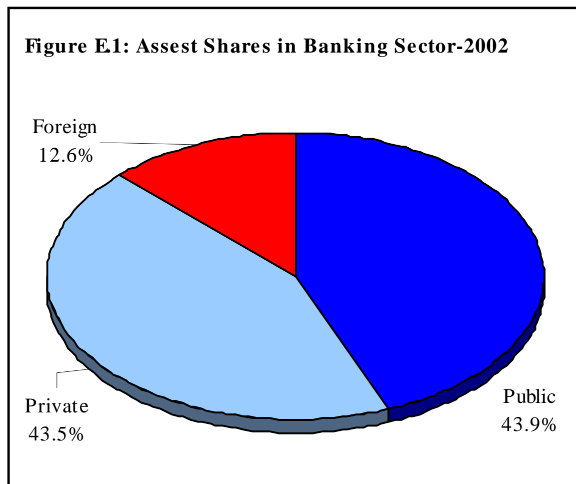
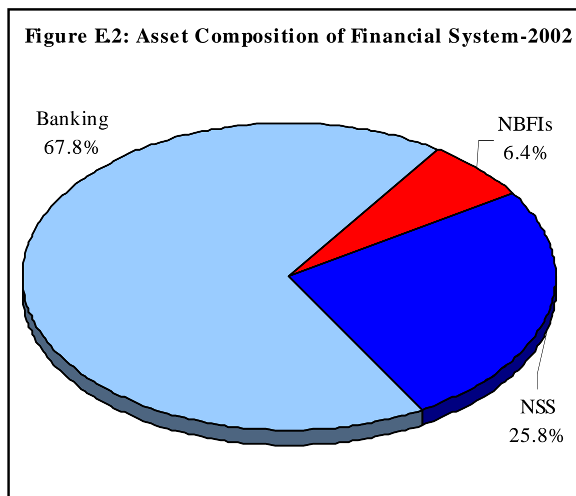
Executive Summary

Financial System Strengthening

Financial soundness indicators have shown a noticeable improvement for the overall financial sector during 2001-2002. Key financial ratios indicate improvement in capital adequacy, asset quality, management soundness, earnings and profitability and liquidity. However, prolonged excess liquidity in the system seems to have made the financial institutions more sensitive to various market risks. Performance of specialized bank is also an area of concern, as they are negatively affecting the profitability of overall financial sector.

Structure of financial system has changed considerably towards greater ownership of private sector during the last two years, particularly following the privatization of UBL and restructuring of DFIs. The share of private sector in assets of financial system has increased from 34.0 percent in 2000 to 42.4 percent in 2002. Within the banking sector, the share of private banks has gone up from 28.4 percent in 2000 to 43.5 percent in 2002 (see **Figure E.1**). Although the share of NBFIs has gone down from 8.6 percent in 2000 to 6.4 percent in 2002, the trend is not alarming as it was brought about by the mergers, acquisitions and liquidations that have taken place in the financial sector as a move towards consolidation.





The role of national savings schemes remained a source of concern for the financial system. Despite various reform measures to decrease the distortions created by these schemes, their importance in terms of GDP has gone up from 22.7 percent in 2000 to 23.3 percent in 2002. NSS still represents 25.8 percent of the assets of financial system (see **Figure E.2**). Another notable trend is the increasing utilization of financial system resources by the public sector. The share of public sector has gone up from 56.5 percent in total advances and investments of the financial system in 2000 to 62.9 percent in 2002. The rise in government use of financial resources is largely brought about by the increase in liquidity, whose greater part was sterilized through investment in government securities. Extent of sterilization is also an indication that the concomitant demand in the private sector does not seem to exist. This points towards the need for a revision in credit extension policies of financial institutions for various financing needs of private sector including project, housing, consumer and working capital financing. This also calls for the need to implement various demand inducement policies for investment as well as consumption, at the national level, to divert a greater part of available liquidity to productive sectors of the economy.

Fragmentation was considerably reduced during 2001-2002 as a result of the process of consolidation in the financial system. Process of mergers and acquisitions was triggered by the increase in minimum paid-up capital of both banks and NBFIs. Consolidation was also aided by various tax incentives and removal of legal hurdles. Over twenty deals of mergers/acquisitions were consummated during the last two years that involved about fifty financial institutions including banks and NBFIs. As a result, the number of financial institutions was reduced from 197 in 2000 to 178 in 2002. Process of consolidation had in fact, decreased the market concentration of top five institutions in banking system. This is an indication that the level of competition has increased in our financial system. This is in contrast with the experience of industrial countries, where the process of consolidation has reduced the competition and increased the monopoly power of a few big financial institutions. This experience should be kept in mind in managing the future pace of mergers/acquisitions in our financial system.

Several steps were taken during 2001-2002 to strengthen the supervisory system of financial institutions. Supervisory responsibilities between SBP and SECP have been demarcated legally. This demarcation has, in fact, called for a greater coordination between two supervisory authorities, which had already been formalized on a regular basis. SECP had issued a code to provide a framework for good corporate governance, which is aimed at enhancing investor confidence by increasing transparency in the business practices of listed companies. SBP had also enlarged and strengthened its prudential regulations by issuing separate guidelines for microfinance. Guidelines were also issued for corporate, consumer and SME financing.

Legal infrastructure was also strengthened for the regulation of monetary, credit, financial and corporate system in order to promote growth and development besides providing protection to depositors, creditor and investors. Several amendments were made in relevant Acts to strengthen SBP autonomy and its core central banking capabilities, implement strategic bifurcation of supervisory responsibilities between SBP and SECP, facilitate the process of consolidation in the financial sector and implement the process of Islamization of financial system on a parallel basis.

Effectiveness of monetary and exchange rate policies has also improved as a result of strengthening of financial system. Initial tightening of monetary policy during FY01 helped establish orderly markets for money and foreign exchange besides meeting performance criteria under agreement with IFIs. Successful management of interest rates and foreign exchange, even prior to the events of September 11, prepared the ground for implementing an accommodative monetary policy to spur economic growth without creating inflationary pressures. Post September 11 period saw an upsurge in foreign exchange inflows that not only helped in building up of reserves but also strengthened the needed monetary ease for the economy. The level of total liquid foreign exchange reserves rose from US$ 1.3 billion (on June 30, 2000) to US$ 10.7 billion (on June 30, 2003). Source of foreign exchange build-up was gradually shifted towards purchases from inter-bank market, eventually eliminating the need to purchase from kerb market.

Deepening of Financial System and Services

With gradual strengthening of the financial system, significant progress was also made during 2001-2002 in terms of expansion in financial services. In particular, microfinance activities started to expand, some new financial products were introduced, greater automation of retail banking took place, inroads were made for modernization of payment system and Islamic financial services took off with a new vigour.

Outreach of microfinance expanded with the implementation of Microfinance Sector Development Program and establishment of two microfinance banks; Khushhali Bank and the First Microfinance Bank. By the end of 2001, Khushhali Bank had already expanded its services to 30 districts and loans of Rs 476 million were disbursed by the end of 2002. First Microfinance Bank had also disbursed

loans totaling to Rs 18 million by that time. Outreach is expanding slowly, given the special nature of micro-credit.

During the last few years, banking sector also expanded its menu of services by introducing new products and aggressively marketing old but seldom used products. Credit cards were marketed very competitively that resulted in an increase in the value of transactions from Rs 8.5 billion in 2000 to Rs 14.2 billion in 2002. Auto loans, which were introduced by banks in1990s, saw a quantum jump during the last couple of years. Shariah compliant auto financing schemes also gained popularity during this period. Banks have introduced housing finance recently and also started to compete with housing finance companies

Credit rating services, already in vogue since mid-1990s, became more important after SBP made it mandatory for all financial institutions to get themselves rated and disclose these to public. Asset management services also expanded during the last couple of years with the establishment of two more companies in the private sector.

A rapid increase was witnessed in the use of automated teller machines (ATMs) from the year 2000 and onwards. Number of ATMs have jumped from 206 in 2000 to 445 in the first half of 2003. Till March 2003, five banks have introduced debit cards, six banks have enabled their customers to manage their accounts electronically and eleven banks have started phone banking services. E-banking services are very limited but are likely to expand with the ongoing IT related investment being undertaken by several banks. Various steps have been taken to modernize the payment system that include an ongoing project at SBP to implement the Real Time Gross Settlement System (RTGS) which will also eventually replace the existing book-based settlement of government securities.

Scope of Islamic financial services expanded greatly with the three-pronged strategy adopted by SBP to establish Islamic Banking firmly but in parallel with conventional banking. Strategy allows setting up of full-fledged Islamic commercial banks, establishment of subsidiaries by commercial banks to undertake Shariah compliant banking business, and establishment of branches dealing exclusively in Islamic financial products. Meezan Bank Limited was given the first Islamic commercial banking license.

Performance of Scheduled Banks

The banking sector experienced a surge in deposits that grew at 10.2 percent per annum during 2000-2002. It was the second time since 1997 that banks saw a double-digit deposit growth. The phenomenal surge in the local currency deposits was observed on the back of Rupee injections by SBP against foreign exchange purchases and higher remittance through banking channel. The composition of deposits, however, tilted towards demand deposits during this period. This development, in fact, helped the banks in reducing their mobilization costs in a declining interest rate scenario, although an opposite development would have been better from the point of view of asset-liability management by them.

Aggregate assets of the banks also reached a record high level of Rs 2,225.2 billion (61.3 percent of GDP) by the end of 2002. This, however, primarily stemmed from a sharp increase in the investment portfolio of banks, mainly in government securities. With the available excess liquidity and expectation of declining interest rates, banks were aggressively bidding to invest in government securities. This diversion of liquidity to government securities altered the asset composition of banking system. The share of advances fell from 49.1 percent in 2000 to 41.5 percent by the end of 2002. While in the same period, share of investment almost doubled from 16.8 percent to 31.5 percent.

Change in the asset composition helped the commercial banks to increase their capital to risk weighted asset ratio from 11.4 percent in 2000 to 12.6 percent in 2002. Although the banks in aggregate had an adequate capital base, four banks were still short of the minimum required CRWA of 8.0 percent by the end of 2002. Asset quality of the banks improved considerably during this period, with decline in NPLs to Rs 234.2 billion by the end of 2002, after increasing in the previous year. The increase of Rs 4.0 billion in 2001 occurred due to merger of NDFC with NBP and the transfer of UK branches of some of the banks to their newly established subsidiaries. Banking industry as a whole saw improvement in both gross and net NPLs to advances ratios during 2000-2002. Gross NPLs to advances went down from 23.5 percent in 2000 to 22.0 percent in 2002, whereas net NPLs to net advances decreased from 12.2 percent to 10.0 percent in the same period.

Liquidity position of banks improved considerably during most of 2001 and 2002. Liquid assets to total assets ratio of the banking system rose from 36.0 percent in 2000 to 45.7 percent in 2002. Phenomenal deposit build-up due to foreign exchange inflows was responsible for the rise in liquidity position. Although the statutory liquidity requirement (SLR) remained at 15 percent, banks were actually maintaining 46.6 percent of their time and demand liabilities in government securities at the end of 2002. This was in contrast with a lower percentage of 31.7 maintained at end 2000.

Banking sector also showed better profitability indicators by the end of 2002. Return on assets (ROA), which was negative for 2000 and 2001 improved to 0.1 percent in CY02. Aggregate negative profits were mainly due to hefty losses of one or two big banks that occurred due to massive provisioning. If one bank (the most loss making) is excluded, the rest of the banks (as an aggregate) not only saw positive profits but also profits growing at an increasing rate during the last three years.

Although the increasing profitability of banks looks surprising in the wake of declining interest rate scenario, it actually implies a comparatively lower decline in interest income than interest expenses. In other words, the banks were carrying negative gaps between their interest rate sensitive assets and liabilities. It is well known that low and moderate level of interest rates also minimize the problems of moral hazard and adverse selection in the financial sector. Low interest rate environment, therefore, proved to be beneficial for banks themselves, besides turning the economy towards the direction of increasing growth.

The financial health of specialized banks, however, remained considerably weak during the period of analysis. Indicators of capital adequacy deteriorated over this period. Capital to risk weighted asset ratio (CRWA) dipped down to negative 31.7 percent in FY02 from negative 3.3 percent in FY00. However, it is the one specialized bank (IDBP) which mainly accounted for the negative equity. While the asset quality indicators of ADBP showed marginal improvement, it is the bad assets of IDBP which greatly distorted the overall picture. Government has chalked out a restructuring plan to make this group sound. FBC is under liquidation, ADBP has been restructured and renamed as ZTBL and IDBP has also been restructured for sale as a commercial bank to the private sector.

Performance of Non-bank Financial Institutions

Non-bank financial institutions (NBFIs) have undergone a significant structural change during 2001-2002. Overall assets declined sharply by Rs 32.6 billion to Rs 206.6 billion by end FY02. The decline was mainly on account of merger of NDFC with NBP, liquidation of BEL and merger of Al-Faysal Investment Bank with Al-Faysal Bank Limited. The decline in the size of overall sector is, in fact, a move towards consolidation of financial system due to mergers and acquisitions of small and fragmented institutions.

Despite the decline in asset size, distribution of assets remained skewed towards DFIs, which held over 30 percent of total assets by the end of FY02 (see **Figure E.3**). Out of eight groups of NBFIs,

four groups (DFIs, IBs, DHs, VCCs) registered declines in their assets during FY00-FY02. Assets of HFCs remained almost at the same level, while the assets of leasing companies, modarabas and mutual funds increased. As a result, the share of the latter three groups increased from 33.8 percent in FY00 to 43.8 percent in FY02.

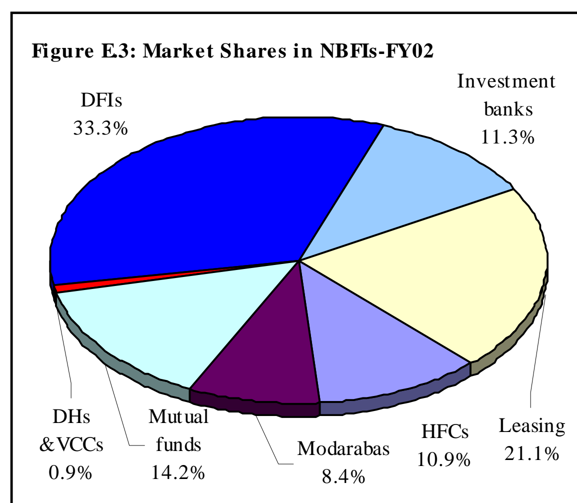


Figure E.3: Market Shares in NBFIs-FY02

Financial health of existing DFIs slightly improved during FY00-FY02. Assets of exiting DFIs increased at a compound annual average growth rate of 6.1 percent during FY00-FY02 to Rs 68.7 billion. Business activities grew mainly due to lease operations and investments (particularly in stocks). Capital adequacy in terms of capital to liability ratio increased from 19.0 percent in FY00 to 34.9 percent in FY02 mainly due to establishment of Pak Oman Investment Company. Although earning assets of DFIs have increased in relation to total assets, the composition has changed away from advances which does not augur well for financing of investment projects.

Investment banks have seen a steep slide of Rs 18.2 billion in their assets during FY00-FY02. These were largely due to mergers/acquisitions of IBs with commercial banks. However, the overall assets of existing IBs saw a rise of Rs 3.0 billion during this period. Performance indicators of IBs deteriorated in FY01 but improved considerably during FY02. However, the overall performance of aggregate IBs is far from normalcy. Since IBs are in a state of flux and the process of restructuring, mergers, acquisitions and liquidation, it is difficult to comment on the performance of overall IBs with a greater degree of confidence.

Overall assets of leasing companies increased during FY01 due to growing leasing business. Although leasing business continued to grow during FY02 as well, overall assets declined largely due to merger of two leasing companies with investment banks. Nevertheless, assets of existing leasing companies jumped from Rs 32.1 billion in FY01 to Rs 43.3 billion in FY02. The financial health of these companies remained satisfactory over the last few years except for the week capital position of a few leasing companies. While most of the financial ratios remained stable, earnings and profitability of leasing sector has declined over the years. This is due to increasing competition from banks, declining interest rate scenario, increase in administrative expenditure and higher provisioning against bad assets.

Total assets of modaraba companies rose moderately from Rs 15.6 billion in FY00 to Rs 17.4 billion in FY02. Modaraba sector remained extremely fragmented even after six merger/acquisition deals that had taken place during last two years. Top 10 modarabas (out of 40) held over 70 percent of assets and 65 percent of total equity at the end of FY02. This indicates a strong likelihood of continuation of further consolidation in future.

Housing finance companies were unable to expand their business during the last two years as reflected in only a marginal rise in their assets from Rs 22.2 billion in FY00 to Rs 22.4 billion in FY02. Two HFCs are facing severe financial problems, with one under the process of liquidation. Performance of this sector mainly reflects that of HBFC, which is the dominant institution with a share of 97.8 percent in total assets. Although key financial ratios indicate some improvement during the last two years,

HFCs are likely to face tremendous competition from commercial banks who have started marketing housing loans by tailoring their products according to targeted groups of prospective buyers.

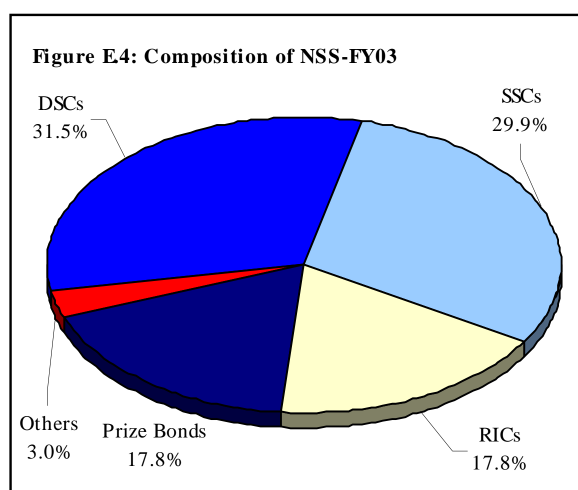
The net assets of mutual funds industry increased to Rs 25.1 billion in FY02 after declining to Rs 20.8 billion in FY01 from Rs 23.1 billion in FY00. Declining interest rate scenario and improvement in capital market performance largely contributed to increase in net-worth in FY02. Earlier decline was due to the poor performance of capital market in FY01. Although the share of open-end mutual funds in overall industry declined during the last two years, they still dominate the industry due to NIT and establishment of new open-end mutual funds in private sector.

Business activities of discount houses and venture capital companies deteriorated during the last couple of years. Total assets declined for both of these groups. Surprisingly, despite the process of liquidation of two discount houses, overall profitability of discount sector remained intact mainly due to the satisfactory performance of remaining two discount houses. One relatively big venture capital company was also liquidated that decreased the assets of venture capital industry during the last two years.

National Savings Schemes

Slowdown in NSS net inflows witnessed during FY00 proved to be short lived as the outstanding amount surged to Rs 982.5 billion by the end of FY03 as compared to Rs 715.0 billion in FY00. Within NSS, the composition has significantly changed as net inflows in SSCs guided the rise in outstanding amount, taking its share to 29.9 percent by end FY03 from 22.8 percent in FY00 (see **Figure E.4**).

Figure E.4: Composition of NSS-FY03



Several measures were taken by the government to reduce the distortions caused by the presence of national savings schemes. Despite the noteworthy implementation of linkage of profit rates on major schemes with PIB yields, this source remained very expensive for the government for budgetary financing. Had the government borrowed Rs 231.2 billion from the market-based instruments instead from NSS, it would have saved about Rs 10.7 billion per annum. Dramatic fall in interest rates for the banking sector together with relatively lesser decline in profit rates of NSS created interest arbitrage opportunities in the market during FY03, which enabled both the investors and banks to benefit from this distortion at the expense of the government. As a result, the sale of DSCs and SSCs was suspended from bank outlets by the government in June 2003.

Although the linkage of NSS rates of return with yields on PIBs is a step in the right direction, the six-monthly pre-announced adjustment mechanism in the scenario of falling PIB yields made the investors to adjust their behaviour in a way that considerably weakened the linkage. In fact, gross inflows during FY03 were much higher compared with the previous years because of investors' ability to lock in their funds before downward rate adjustments. The higher investment in NSS shifts medium term investment away from the banking sector thereby shrinking their potential base of fixed deposits. One must keep in mind that the proportion of fixed deposits in total deposits of banks is considerably lower in Pakistan as compared to the average of eight select peer countries, i.e., 56.6 percent versus 89.4 percent. Since the real rates of return for NSS are considerably higher as compared to banks' fixed deposits, banks are forced to either keep their fixed deposit rates high or switch towards mobilization of demand deposits.

Distorted term structure of interest rates, due to the presence of national saving schemes, has far reaching negative consequences not only for the financial system but also for the economy as a whole. Higher rates of return on NSS reduce the opportunities for the real productive investment to only those projects which can yield even higher risk adjusted real rates of return. The development of bond market is also negatively affected by the high rates of return on NSS, which act as a kind of de-facto benchmark for interest rates on long-term private paper.

While the recent policy initiatives to streamline the NSS, the alignment of NSS rates to PIB yields, introduction of a new scheme for pensioners and the exclusion of institutional investors from the scope of these schemes are welcome developments, there are still many distortions which need to be addressed. Possibility should be explored for replacing some NSS with new market-based papers that are either sold through subscriptions or auctions rather than on tap basis. Furthermore, establishment of private pension funds can also help remove the distortions created by NSS.

Performance of Financial Markets

Considerable transformation was witnessed during the last two years in the money, capital and forex markets together with increase in their activities. Money market experienced a phenomenal increase in liquidity that not only eased the liquidity shortages observed prior to FY01 but also caused the interest rates to decrease to historic low levels. The extent of liquidity can be gauged from the enormous surge in the amount of bids received in auctions of T-bills which rose to Rs 1,551 billion in FY03 from Rs 615 billion in FY02. A significant portion of liquidity was sterilized by accepting bids totaling to Rs 317 billion in FY02 and Rs 643 billion in FY03.

Secondary market of T-bills also witnessed a surge in trading volumes from Rs 4,304 billion in FY02 to Rs 5,198 billion in FY03. However, trading activity in 3-month T-bills went down in FY03. The main surge was witnessed in 12-month T-bill trading. Despite the increase in trading volumes, the volatility in overnight rates remained very high. The SBP is trying to reduce this volatility by strengthening the process of day-to-day liquidity estimation and fine-tuning the size of interventions. A fundamental reason for continued volatility is that the SBP is targeting monetary aggregates. Unless this is supplemented with an operational target range of overnight rates, reduction in volatility would remain difficult. To overcome this difficulty, SBP had already started experimenting with interventions that would decrease the likelihood for money market rates to dwindle near zero.

Although the newly introduced marketable long-term government bonds, i.e., PIBs proved to be a success since their launch in December 2000, the role of primary dealers in the development of secondary market remained a source of concern. PDs not only failed to quote firm two-way rates but also allegedly indulged in excessive use of pass-through bids, implying a reluctance to take PIBs on their books. PD rules were subsequently revised recently to make them more effective. The number of PDs have now increased to eleven from original seven appointed in 2000. Another source of concern is that banks' holding of PIBs have increased from 25.8 percent (of outstanding stock) in July 2001 to 59.0 percent in June 2003. Since PIBs were primarily meant for the non-banking sector, the increased appetite from the banking sector is not a healthy development either from the banks' risk management perspective or from the government's limits on borrowing from the banking system.

Capital market had been strengthened considerably after the establishment of SECP in 1999. In order to improve the regulatory framework of capital market, SECP enacted various laws and guidelines with a view to consolidate enforcement and monitoring, rationalize trading practices, improve risk management and enhance corporate governance. Capital market infrastructure was also improved considerably during the last couple of years. By the end of CY02, 406 securities were already active in the Central Depository Company (CDC). By that time 308 securities were also being cleared and settled through the National Clearing Company of Pakistan Limited (NCCPL) that was established in July 2001.

A spate of de-listing was witnessed during the last couple of years as a result of SECP enforcement of its rules and procedures for the betterment of stock exchanges. The number of listed companies on KSE went down to 705 in FY03 from 762 in FY00. This reduction is, in fact, a move towards a greater instillation of corporate governance, as the companies which are being de-listed were either inactive, or the relatively inactive firms got merged with the better ones. Despite this reduction, listed capital increased at KSE from Rs 229 billion in FY00 to Rs 301 billion in FY03.

Value of shares traded in KSE increased to Rs 2,271 billion in FY03 from Rs 1,878 billion in FY00 after declining considerably in FY01 and FY02. Market capitalization jumped during FY03 to Rs 756 billion from Rs 394 billion in FY00. Stock exchanges at Lahore and Islamabad closely followed the trends witnessed in KSE. Corporate debt market witnessed a surge in activity after institutional investors were stopped from investing in NSS. Not only 27 new issues were launched during FY01 and FY02 but a gradual evolution also occurred in the pricing structure of TFCs. Starting from the plain vanilla structure with fixed coupon rates, market has witnessed an increasing number of bonds with floating structures.

A market-based unified exchange rate regime was established in July 2000 with the abolishment of the dual exchange rate system established after the nuclear detonations of May 1998. The development process of the market, however, remained slow due to the weak macroeconomic fundamentals in the early period and the skeptical expectations of market players. The process, nevertheless, took momentum after the post-September 11 extraordinary developments, which flushed the market with forex liquidity and altered the self-fulfilling expectations of a uni-directional movement of the exchange rate. The market, which witnessed extended episodes of volatile exchange rate and a sharp depreciation of the Rupee before September 11, turned into a vibrant stable market after September 11. The market segmentation into the kerb and the inter-bank market, which had been a great hurdle in its development, came to an end after the international drive against Hundi network. The massive inflows in the inter-bank market, which were earlier coming through the kerb market, resulted in a sharp appreciation of Rupee and helped accumulation of foreign exchange reserves with the SBP. The reserve buildup of SBP also helped change the market expectations and allowed further liberalization of the market.

Financial System Stability

Although there was a slowdown in economic growth during FY00 and FY01 due to drought and geopolitical situation and the current growth rate is still lower than the average observed in 1980s, the turnaround that started in FY02 and accentuated in FY03 is likely to support the financial system in its move towards soundness. Macroeconomic environment in terms of inflation, budget deficit, debt servicing, forex reserves, BOP situation and the exchange rate trends is also supportive for the financial sector. Exchange rate behaviour with its allied indicators suggests that there is neither any negative pressure on the rupee in the forex market nor there is a threat of any financial crisis. NPLs of the financial institutions, which surged upto Rs 286.9 billion by end CY00, witnessed a sharp reversal during CY02. As a result, NPLs in terms of GDP have declined from 9.1 percent to 7.1 percent in the same period.

The most noteworthy development related to Pakistan's financial stability during FY01-FY03 was the containment of debt vulnerability and improvement in debt servicing ratios. In Rupee terms, total debt has shown a reduction of Rs 62.9 billion during the last two years. Total debt in terms of GDP declined from 106 percent in FY00 to 95.1 percent in FY03. Public debt servicing burden also declined from 71.5 percent to 42.3 percent of total revenue during the same period. The stock of total external debt and liabilities declined by US$ 2.4 billion during this period to US$ 35.5 billion. The annual average compound rate of growth of external debt during last three years was only 1.1 percent compared with 4.6 percent witnessed during the last decade. These changes reflect a prudent external

debt management on the part of the government that has put Pakistan on the path of a sustainable debt.

Various indicators of financial deepening and intermediation also registered improvements but the financial system of Pakistan still lags behind countries of a select peer group in many respects. Financial sector has still a long way to go to catch up with other countries in the region with similar economic characteristics. However, recent structural changes, economic revival and stronger rupee if sustained will make it possible for Pakistan to substantially improve its position at least in relation to most of the countries with the same per capita income.