The Team

Leader
Riaz Riazuddin

Researchers
Abid Qamar
Fida Hussain
Mahmood-ul-Hasan Khan
Moinuddin
Muhammad Amin Khan Lodhi
Muhammad Ayub
Muhammad Mazhar Khan
Muhammad Waheed
Sardar Shah
Tasneem Alam
Zulfiqar Hyder

Data/Information Support
Anwar Saeed
Bashir Ahmed
Faisal Maqsood
Inayat Hussain
Muhammad Javaid Ismail
Saleemullah

Research Assistance
Adil Mahboob
Asma Khalid
Sadia Bader
Preface

Financial sector witnessed a continuity of reforms during the last three years. These reforms started in early 1990s and had significant impacts on the financial as well as the real sector. A detailed assessment was provided by the Research Department of the State Bank of Pakistan in its earlier publication released in September 2002. The assessment also identified the future direction of reforms in the beginning of twenty-first century. Just like the need for continuity in reform process, continuity in assessment is also necessary to identify strengths and weakness with a view to alter and adjust the implementation process.

Outline of present assessment of financial sector follows the spirit of continuity of reforms and their impacts on the financial system and macro-financial stability. First two chapters provide a natural link to the earlier report and discuss main developments and reforms undertaken during 2001 and 2002. Chapter 1 analyzes the developments encompassing financial system soundness, strengthening of supervision and effectiveness of monetary policy. Chapter 2 focuses on progress related to the deepening of financial system and services. Chapter 3 evaluates the performance of commercial banks during these years. Chapter 4 achieves an identical objective for the non-bank financial institutions. Chapter 5 discusses the role of national saving schemes and their impact for the financial sector. Chapter 6 evaluates the performance of financial markets and the last Chapter discusses some aspects of financial system stability during 2001-2002. Last chapter also concludes with a sketch of reforms needed for sustained growth of financial sector in the country.

It is hoped that the present report, just like the earlier one, would add to strengthening the process of using stakeholder inputs not only in charting the nature and content of future reforms, but also in formulation of implementation strategy.
Acknowledgements

The team of this Report thanks the members of Advisory Group on Financial System especially, Mr. Ali Raza, Mr. Zakir Mahmood, Mr. Aftab Manzoor, Mr. Tariq Iqbal Khan and Mr. Jehangir Siddiqui who provided valuable comments and suggestions. We also thank Mr. Najam Ali, Mr. Abid Sattar, Mr. A. Saeed Siddiqui, Mr. Haseeb Babar and officers of Economic Policy Department for providing comments for improvement. Team also thanks Mr. Khalid Siraj who gave useful suggestions on the initial outline of this report. The team is greatly indebted to Dr. Ishrat Husain for his continuous guidance and support.

The team bears the responsibility of all errors and omissions. The observations made in this report are entirely those of the working team and do not necessarily represent the views of the members of Advisory Group or those of the SBP management.
# Contents

**Executive Summary**  
1

**Chapters**

1 Financial System Strengthening  
1.1 Financial System Soundness  
1.1.1 Structure of Financial System  
1.1.2 Performance of Overall Financial System  
1.1.3 Privatization of Financial Institutions  
1.1.4 Financial System Consolidation  
1.2 Supervisory System Strengthening  
1.2.1 Corporate Governance  
1.2.2 Legal Infrastructure  
1.2.3 The SBP Prudential Regulations for Commercial Banks  
1.3 Effectiveness of Monetary and Exchange Rate Policies  
1.3.1 Monetary Policy Developments  
1.3.2 Exchange Policy Developments  

2 Deepening of Financial System and Services  
2.1 Role of Microfinance Institutions  
2.1.1 Microfinance Sector Development Program (MSDP)  
2.1.2 Outreach of Microfinance Institutions (MFIs)  
2.2 Emergence of New Financial Products and Services  
2.2.1 Consumer, Auto and Housing Finance  
2.2.2 Credit Rating and Other Financial Services  
2.2.3 Automation of Retail Banking Transactions  
2.2.4 Modernization of Payment System  
2.3 Islamization of Financial Services  
2.3.1 Full-fledged Islamic Banks  
2.3.2 Islamic Banking Through Subsidiaries and Stand-alone Branches  
2.3.3 Islamic Financial Products for Capital Market  
2.3.4 Regulation of Islamic Banking  
2.4 Financial Services Commitment under GATS  

3 Performance of Scheduled Banks  
3.1 Overview  
3.2 Capital Adequacy  
3.3 Asset Quality  
3.4 Liquidity Risk  
3.5 Earnings and Profitability  
3.6 Management Indicators  

4 Performance of Non-bank Financial Institutions  
4.1 Structure of NBFIs  
4.2 Development Finance Institutions  
4.2.1 Mergers/Acquisitions of DFIs  
4.2.2 Financial Position of DFIs  
4.3 Investment Banks  
4.3.1 Mergers/Acquisitions of Investment Banks  
4.3.2 Financial Position of Investment Banks  
4.4 Leasing Companies  


4.4.1 Policy Initiatives 63
4.4.2 Performance of Leasing Companies 65
4.5 Modaraba Companies 66
  4.5.1 Policy Initiatives 67
  4.5.2 Performance of Modarabas 67
4.6 Housing Finance Companies 68
4.7 Mutual Funds 70
  4.7.1 Performance of Open-end Mutual Funds 71
  4.7.2 Performance of Close-end Mutual funds 71
4.8 Discount Houses 73
4.9 Venture Capital Companies 73

5 National Savings Schemes 75
  5.1 Characteristics of NSS and Mobilization Trends 75
  5.2 NSS, Deficit Financing and National Savings 78
  5.3 Profit Rates on NSS 78
  5.4 Distortionary Impacts of NSS 79
    5.4.1 Impact of NSS on Banking Sector 79
    5.4.2 Impact of NSS on Domestic Debt Management 80
    5.4.3 Interest Rate Distortions and Money Market Considerations 82
  5.5 Recent Policy Initiatives for Removal of Distortions 82
  5.6 Conclusion 83

6 Performance of Financial Markets 85
  6.1 Performance of Money Market 85
    6.1.1 Financial System Liquidity and SBP Interventions 85
    6.1.2 Secondary Market of Treasury Bills 89
    6.1.3 Government Bond Market 91
    6.1.4 Developments in Yield Curve 94
  6.2 Capital Market 95
    6.2.1 Supervisory Role of Securities and Exchange Commission of Pakistan (SECP) 95
    6.2.2 Improvement and Modernization of Securities Market Infrastructure 97
    6.2.3 Performance of Stock Exchanges 98
    6.2.4 Corporate Debt Market 100
  6.3 Foreign Exchange Market 103
    6.3.1 Pre-September 11 Developments 104
    6.3.2 Post-September 11 Developments 106

7 Financial System Stability 111
  7.1 Indicators of Macro-financial Vulnerability 111
  7.2 Impact of NPLs on Financial System Performance 117
  7.3 Financial Deepening and Intermediation 118
  7.4 Financial Savings 121
  7.5 Public Debt Vulnerability Issues 123
  7.6 Conclusion 130

Annexes 135
Acronyms 158
## List of Tables

### 1. Financial System Strengthening

1.1 Dynamics of Financial System Assets 11  
1.2 Dynamics of Financial System Deposits 12  
1.3 Key Indicators of Financial Sector 13  
1.4 Financial System Resource Utilization 15  
1.5 Group-wise Composition of Banks’ Assets 16  
1.6 Consolidation of Financial Institutions during 2000-2002 19  
1.7 Number of Financial Institutions 19  
1.8 Market Concentration of Financial Institutions 20

### 2. Deepening of Financial System and Services

2.1 Khushhali Bank Outreach 30  
2.2 Microfinance Institutions 31  
2.3 Some Prudential Requirements for Consumer Financing 32  
2.4 Amount of Credit Card Transactions 32  
2.5 Interest Rates on Credit Cards 33  
2.6 Asset Management Companies in Pakistan 34  
2.7 Some Facts about ATMs 35  
2.8 Distribution of ATMs 35  
2.9 Growth in ATMs Transactions 36  
2.10 Indicators of Turnover in Clearing House 37  
2.11 Face Value of T-bills and Bonds Moved from one SGLA to Other 38

### 3. Performance of Scheduled Banks

3.1 Share in Total Liabilities 46  
3.2 Share in Total Assets 47  
3.3 Capital Adequacy 48  
3.4 Asset Quality 51  
3.5 Liquidity Indicators 52  
3.6 Net Interest Margin (NIM) 54  
3.7 Earnings and Profitability 55  
3.8 Management Indicators 55

### 4. Performance of Non-bank Financial Institutions

4.1 Assets of NBFIs 57  
4.2 Key Financial Ratios of NBFIs 58  
4.3 Performance Indicators of DFIs 60  
4.4 Performance Indicators of Investment Banks 62  
4.5 Consolidation in the Leasing Sector 64  
4.6 Performance Indicators of Leasing Companies 66  
4.7 Consolidation in the Modaraba Sector 67  
4.8 Key Indicators of Modarabas 68  
4.9 Indicators of Housing Finance Companies 69  
4.10 Key Statistics of Closed-end Public Sector Mutual Funds 70  
4.11 Open-end Mutual Funds 71  
4.12 Performance of Private Sector Closed-end Mutual Funds 71
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.13 Performance of Public Sector Closed-end Mutual Funds</td>
<td>72</td>
</tr>
<tr>
<td>4.14 Asset Shares of Discount Houses</td>
<td>73</td>
</tr>
<tr>
<td>4.15 Major Indicators of Discount Houses</td>
<td>73</td>
</tr>
<tr>
<td>4.16 Major Indicators of VCCs</td>
<td>73</td>
</tr>
</tbody>
</table>

5. National Savings Schemes

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 Major Characteristics of Selected NSS</td>
<td>76</td>
</tr>
<tr>
<td>5.2 Profit Rates on Major NSS and Bank Deposits</td>
<td>79</td>
</tr>
<tr>
<td>5.3 Nominal and Real Rate of Returns on Selected NSS</td>
<td>79</td>
</tr>
<tr>
<td>5.4 Target vs Actual Net NSS inflows for FY03</td>
<td>81</td>
</tr>
<tr>
<td>5.5 Cost Differential of Borrowing from Selected NSS and PIBs during FY03</td>
<td>81</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1 SBP 3-day Repo Rates</td>
<td>85</td>
</tr>
<tr>
<td>6.2 Discount Window</td>
<td>86</td>
</tr>
<tr>
<td>6.3 Treasury Bill Auctions Summary</td>
<td>87</td>
</tr>
<tr>
<td>6.4 Secondary Market Trading Volume</td>
<td>89</td>
</tr>
<tr>
<td>6.5 Volatility in Overnight Rates</td>
<td>90</td>
</tr>
<tr>
<td>6.6 Pakistan Investment Bonds Auction Summary</td>
<td>92</td>
</tr>
<tr>
<td>6.7 PIB Auction Performance</td>
<td>92</td>
</tr>
<tr>
<td>6.8 PIB Coupon Rates</td>
<td>92</td>
</tr>
<tr>
<td>6.9 Profile of Karachi Stock Exchange</td>
<td>98</td>
</tr>
<tr>
<td>6.10 New Floatation at KSE</td>
<td>100</td>
</tr>
<tr>
<td>6.11 Performance of LSE and ISE</td>
<td>100</td>
</tr>
<tr>
<td>6.12 Overall Composition of Listed TFCs</td>
<td>101</td>
</tr>
<tr>
<td>6.13 Corporate Debt Market</td>
<td>102</td>
</tr>
<tr>
<td>6.14 Major Market Flows</td>
<td>105</td>
</tr>
<tr>
<td>6.15 Market Intervention /Support by SBP</td>
<td>105</td>
</tr>
<tr>
<td>6.16 SBP Spot Transactions with Banks</td>
<td>106</td>
</tr>
</tbody>
</table>

7. Financial System Stability

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1 Major Macroeconomic Indicators of Financial Vulnerability</td>
<td>112</td>
</tr>
<tr>
<td>7.2 Current Account, Capital Account and Forex Reserves Accumulation</td>
<td>114</td>
</tr>
<tr>
<td>7.3 Major External Indicators of Financial Vulnerability</td>
<td>115</td>
</tr>
<tr>
<td>7.4 Non-Performing Loans</td>
<td>117</td>
</tr>
<tr>
<td>7.5 Effect of NPLs on Interest Rate Spread</td>
<td>118</td>
</tr>
<tr>
<td>7.6 Indicators of Financial Deepening</td>
<td>118</td>
</tr>
<tr>
<td>7.7 Indicators of Financial Depth &amp; Efficiency -2001</td>
<td>120</td>
</tr>
<tr>
<td>7.8 Financial Savings</td>
<td>122</td>
</tr>
<tr>
<td>7.9 Profile of Domestic and External Debt</td>
<td>124</td>
</tr>
<tr>
<td>7.10 Maturity Profile of Domestic Debt</td>
<td>125</td>
</tr>
<tr>
<td>7.11 Servicing Burden of Domestic Debt</td>
<td>127</td>
</tr>
<tr>
<td>7.12 Pakistan's External Debt &amp; Liabilities</td>
<td>128</td>
</tr>
<tr>
<td>7.13 Debt Stock Indicators</td>
<td>130</td>
</tr>
</tbody>
</table>
List of Figures

Executive Summary

E-1 Shares in Banking Sector’s Assets-2002 1
E-2 Asset Composition of Financial System-2002 1
E-3 Market Share in NBFIs-FY02 5
E-4 Composition of NSS-FY03 6

1. Financial System Strengthening

1.1 Asset composition of Financial System 14
1.2 Monetary Policy Changes 25

2. Deepening of Financial System and Services

2.1 Outstanding Numbers of Credit Cards 32
2.2 Trends in Auto Finance 33

3. Performance of Scheduled Banks

3.1 Deposits of Scheduled Banks 45
3.2 Composition of Deposits 46
3.3 Assets of Scheduled Banks 47
3.4 Capitalization of Scheduled Banks 48
3.5 Net NPLs to Capital 49
3.6 NPLs of Scheduled Banks 50
3.7 NPLs to Provisioning Ratio 51
3.8 Profits of Scheduled Banks 53
3.9 After Tax Profits 53
3.10 Net Interest Income 54

4. Performance of Non-bank Financial Institutions

4.1 Asset Shares of NBFIs for FY02 58
4.2 Overall Assets of DFIs 59
4.3 Assets of Investment Banks 61
4.4 Break-up of Lease Finance during FY02 63
4.5 Overall Assets of Leasing Companies 65

5. National Savings Schemes

5.1 Outstanding Amount in NSS 75
5.2 Stock of NSS and Rate of Return on NSS 76
5.3 NSS as percent of GDP 76
5.4 Gross Mobilization from NSS 77
5.5 NSS as Percent of Budget Deficit 78
5.6 Trend in Savings vs NSS Flows 78
5.7 Net Inflows: Fixed Deposits vs NSS 80
5.8 Net Inflows: FCAs vs NSS 80

6.1 Key Interest Rates 85
6.2 Total Deposits of Scheduled Banks 85
6.3 Excess Cash Reserve 86
6.4 Open Market Operations 86
6.5 T-Bill Auctions Summary 88
6.6 Treasury Bills Trading 89
6.7 Repo Bid-Offer Spread (basis points) 90
6.8 Term Repo Rates 90
6.9 PIB Market Yields 93
6.10 PIB Trading Volume 93
6.11 Banks’ Holdings of PIB 93
6.12 Yield Curves (end-June) 94
6.13 Term Premium 94
6.14 KSE-100 Index and Turnover 99
6.15 Growth in TFC Market 101
6.16 Exchange Rate since July 2000 104
6.17 Volatility in the Exchange Rate 104
6.18 SBP intervention and ER 105

7. Financial System Stability

7.1 Growth & Inflation (percent) 112
7.2 Budget Deficit as percent of GDP 113
7.3 Debt Servicing of TDL to FEE Ratio 114
7.4 Reserves to Total External Debt and Liabilities Ratios (percent) 114
7.5 Evolution of Current Account Balance 115
7.6 Real Interest Rates on Deposits 116
7.7 Market Exchange Rates 116
7.8 NPLs of Financial Sectors 117
7.9 Ratio of M2 to GDP 119
7.10 Ratios of Deposits 119
7.11 Banking Spread 120
7.12 Structure of Financial Savings during FY02 121
7.13 Profit Rates on NSS vs Bank Deposits 122
7.14 National and Financial Savings 123
7.15 Outstanding Level of Domestic Debt 125
7.16 Structure of Domestic Debt 126
7.17 Growth of Pakistan’s External Debt Liabilities 128
7.18 Pakistan’s External Debt Liabilities Stock 129
7.19 Debt Burden Indicators 129
7.20 External Debt Vulnerability Indicators 130