State Bank of Pakistan

Banking Supervision Department

Quarterly Performance Review of the Banking System

June 2003

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PERFORMANCE REVIEW OF THE BANKING SYSTEM
For the Quarter Ended June 30, 2003

1. Overview

The quarter was significant in the sense that it saw a substantial rise of Rs 70.2 billion in loans portfolio. However, this was one off increase as majority of funds flowed to individuals under NSS related loans. Despite this massive diversion of funds, yield on government securities kept downward move shedding a few more basis points.

Balance sheet expansion by 7.6 percent came on the back of continuous and massive inflow of funds, which led to further increase in deposits by 6.3 percent during the quarter. This massive source of financing kept the market liquid and further reduced the cost of funds with historically low interbank and deposits rates that kept the interest margins intact even in the face of declining returns on earning assets.

The profitability of the banking system maintained the rising trend with an impressive return on assets (ROA) at 1.2 percent and results for the first two quarters of the year 2003 surpassed the whole year 2002. While strong net interest income underlined this improvement, non-interest income, like in previous two quarters, grew significantly. The net interest income was largely volume driven which also got support from NSS related loans whereas major increase in non-interest income came from gain on sale of securities which is of non-recurring nature. The improved profitability position helped improve capital adequacy ratio by 40 basis points to 9.2 percent – a development that becomes more conspicuous when seen in the perspective of massive asset growth.

The non-performing loans of the banking sector have been reducing for the last one-year or so. Strenuous efforts by banks' management, well supported by the policy environment, led to further reduction in NPLs by Rs 14.5 billion or 6 percent that translated into improvement in NPLs related indicators. Finally, the latest episode of arbitrage financing was just one of the moral hazards excess liquidity creates. Although banks were provided with additional avenues of consumer and housing finance, building up portfolio in these lines would take time and in the mean time banks, loaded with excess liquidity, were tempted into devising novel ways of making money. This puts the burden on SBP to restrain banks from undertaking such activities.

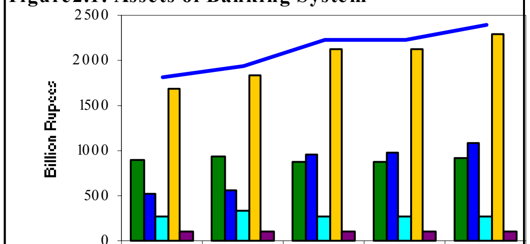
2. Sources and Uses of Funds

Persistent rise in deposits kept fueling the increase in the balance sheet of the banking system during this quarter as well. As compared with the slow growth in the last quarter of just 0.1 percent, the growth of Rs 168.9 billion or 7.6 percent in the total assets was noteworthy during the quarter under review (see **Figure 2.1**). In addition to massive increase in deposits by Rs 109.3 billion, borrowings, unlike the previous quarter, also played an important part in boosting the total assets of the banking system by contributing Rs 47.3 billion.

In sharp contrast to the last quarter, increase in deposits and borrowings mainly translated into an increase in loans. Growth in loans by Rs 70.2 billion substantially outpaced the relatively lower growth in investments, which increased by Rs 31.1 billion during the quarter under review. As a result, the composition of assets underwent a slight change (see **Figure-2.2**).

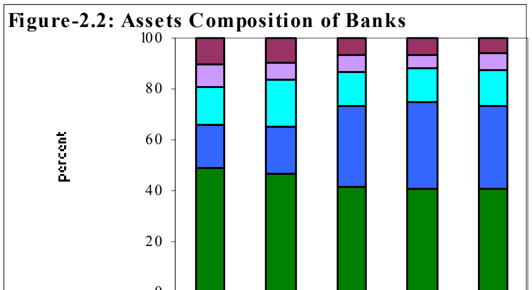
All the groups registered increase in their asset base with the local private banks in the vanguard by contributing Rs 103.8 billion or 61.5 percent followed by public sector commercial banks by Rs 42.8 billion or 25.3 percent and foreign banks by Rs 14.2 billion or 8.4 percent. Heavy growth helped the local private banks claim even

Figure2.1: Assets of Banking System



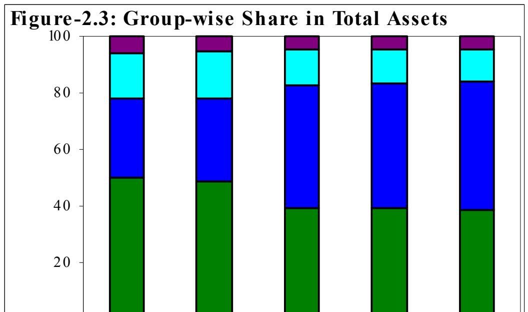
	CY00	CY01	CY02	Mar-03	Jun-03
PSCBs	902.0	946.5	877.6	878.0	920.8
LPBs	513.5	565.9	968.3	983.1	1,086.9
FBs	280.6	323.7	280.9	265.9	280.1
CBs	1,696.1	1,836.1	2,126.8	2,127.0	2,287.9
SBs	111.5	106.2	98.5	100.2	108.1
All	1,807.6	1,942.3	2,225.2	2,227.1	2,396.0

Figure-2.2: Assets Composition of Banks



	CY00	CY01	CY02	Mar-03	Jun-03
Other Assets	10.4	9.4	6.4	6.5	5.8
Lending to Fin. Insts.	8.9	7.0	6.6	5.7	6.7
Cash & Bank Blances	14.7	18.7	13.9	13.2	14.0
Investments	16.8	18.1	31.5	33.8	32.7
Advances	49.1	46.9	41.5	40.7	40.8

Figure-2.3: Group-wise Share in Total Assets



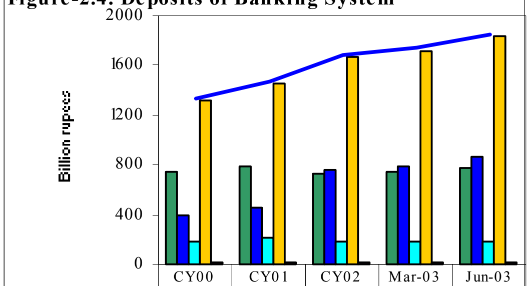
	CY00	CY01	CY02	Mar-03	Jun-03
SBs	6.2	5.5	4.4	4.5	4.5
FBs	15.5	16.7	12.6	11.9	11.7
LPBs	28.4	29.2	43.5	44.1	45.4
PSCBs	49.9	48.8	39.4	39.4	38.4

greater share in the total assets of the banking sector (see **Figure-2.3**).

2.1 Deposits

Deposits expansion accelerated substantially during the quarter with an increase of Rs 109.3 billion or 6.3 percent from Rs 1,736.3 billion in March 2003 to Rs 1,845.6 billion in June 2003 (see **Figure-2.4**). Domestic deposits accounted for around 98 percent of the total increase. As was the case in previous quarters, continuous inflow of funds from abroad appear to be fueling the deposits growth. Foreign remittances recorded a further increase of around US$ 1 billion during the quarter.

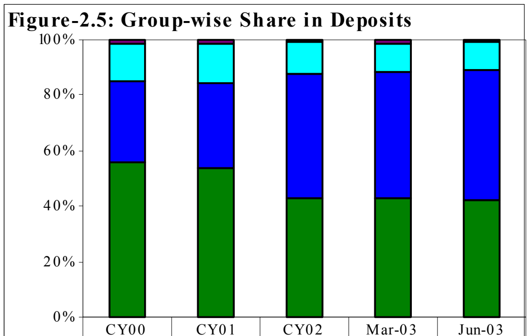
Figure-2.4: Deposits of Banking System



	CY00	CY01	CY02	Mar-03	Jun-03
PSCBs	743.7	795.2	721.9	742.2	777.9
LPBs	394.2	453.7	754.2	790.5	864.3
FBs	187.4	207.8	184.1	185.4	186.8
CBs	1,325.3	1,456.7	1,660.2	1,718.2	1,829.0
SBs	15.6	18.0	16.4	18.1	16.6
All	1,340.9	1,474.7	1,676.5	1,736.3	1,845.6
Domestic All	1,159.0	1,308.4	1,534.8	1,605.6	1,712.6

Local private banks, once again, were instrumental with a share of 67.5 percent in the total deposits growth of the banking system during this quarter. Though they are offering relatively higher rates, but rates are not deciding factor in the current scenario. It probably is expanded branch network vis-à-vis foreign banks and superior delivery vis-à-vis public sector banks, which seem to be the key drivers. This increased their share in total deposits of the system (**see Figure-2.5**). Public sector commercial banks accounted for 32.6 percent of the total increase in deposits. Foreign banks also witnessed a rise in their deposits during the current quarter. In fact, the increase in total deposits of the foreign banks was facilitated largely by the increase in their foreign currency deposits, which represented around 70 percent of the increase in their total deposits. However, it was LPBs, by recording an increase of rupee equivalent 3.3 billion of foreign currency deposits, who managed to check the attrition in overall foreign currency deposits because of a decline of around 3.5 billion

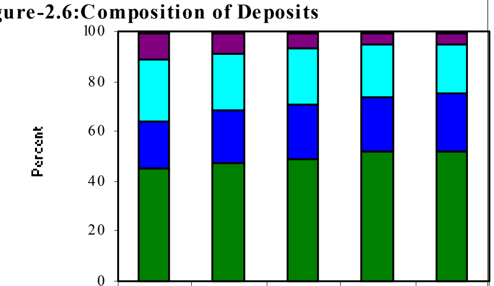
Figure-2.5: Group-wise Share in Deposits



	CY00	CY01	CY02	Mar-03	Jun-03
SBs	1.2	1.2	1.0	1.0	0.9
FBs	14.0	14.1	11.0	10.7	10.1
LPBs	29.4	30.8	45.0	45.5	46.8
PSCBs	55.5	53.9	43.1	42.7	42.1

of rupee equivalent foreign currency deposits of the public sector commercial banks. The five largest banks got around 60 percent of the growth in total deposits against their share of 66 percent in the total deposits of the banking system.

Figure-2.6:Composition of Deposits



	CY00	CY01	CY02	Mar-03	Jun-03
Others	0.6	0.5	0.5	0.6	0.6
From Fin. Instit.	10.4	8.8	6.5	4.7	4.3
Fixed Deposits	24.9	22.1	22.3	21.2	20.1
Current Accounts	19.2	21.4	21.4	21.3	23.3
Saving Deposits	44.9	47.3	49.2	52.3	51.7

Category-wise position shows that largest increase was observed in the customers' non-remunerative current account deposits which grew by around 19 percent or Rs 58 billion followed by saving deposits by around 5 percent or Rs 47 billion over the last quarter. Saving deposits, however, continued to form major chunk of the total deposits of the banking system (**see Figure-2.6**).

2.2 Borrowings

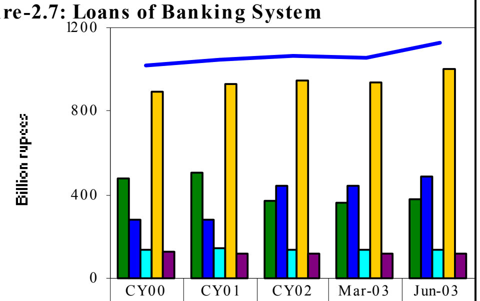
Borrowings by banks increased considerably. It recorded an increase of Rs 47.3 billion from Rs 246.5 billion in the last quarter to Rs 293.8 billion at June end 2003. This significant rise may be surprising with excess liquidity in the market. However, pre-auction market perception about upward yield movement on PIBs, improving export performance and rising loans portfolio might have spurred the increased activity. Heavy repo borrowings, mainly interbank, with an increase of Rs 21.4 billion mainly financed the increase in total borrowings of the banking system. Foreign banks were in forefront in repo borrowings followed by local private banks.

Ever-improving exports indicators may be responsible for considerably high borrowings against export refinance in this quarter. The same witnessed an increase of Rs 15.2 billion or 36.5 against a decline of Rs 4.1 billion in the previous quarter. A further fall in export refinance rate from 3.5 percent to 2 percent might also have induced greater resort to this form of borrowings. Local private banks mainly finance the trade related activities and hence their share in total export refinance borrowings at 66.4 percent is also dominant. Naturally they also contributed heavily in total growth of export refinance i.e. 89.1 percent of total increase during the current quarter.

2.3 Loans

Loans portfolio witnessed a phenomenal growth of Rs 70.2 billion[1] over the quarter stretching the loans level to Rs 11,26.3 billion as of end June 2003 (see **Figure-2.7)**. Almost all the increase was witnessed in the domestic loans portfolio. The increase in loans underscores some interesting developments. First, it marked the departure from the past trend whereby loans portfolio starts picking up in Oct-Dec quarter, and after reaching apex by end of December follows an overall declining trend in the succeeding March, June and September quarters. The increase in loans emanated mainly from the non-traditional users, individuals, and puts into question the sustainability of the increase due to special circumstances surrounding it (arbitrage lending against DSCs/NSCs). The increase came on the back of intense rate competition as a consequence of liquidity forcing the banks to under cut each other in the buyers' market (see **Table-2.1**).

Figure-2.7: Loans of Banking System



	CY00	CY01	CY02	Mar-03	Jun-03
PSCBs	475.7	501.0	374.2	362.1	382.1
LPBs	282.2	281.2	438.9	438.5	485.7
FBs	138.3	143.4	135.4	136.2	137.3
CBs	896.2	925.6	948.5	936.7	1,005.1
SBs	123.9	118.4	117.0	119.4	121.2
All	1,020.1	1,043.9	1,065.4	1,056.1	1,126.3
Domestic All	926.4	963.6	982.6	973.5	1,043.1

The increase of Rs 82.2 billion under the head of others was largely DSCs/NSCs driven and with curb on such lending in June 2003, chances of its recurrence are remote (see **Table-2.2**). However, not all the banks have benefited with this increase in loans as only four banks accounted for more than two third of the increase, with the rest showing marginal increase in their loan portfolio. As regard the overall credit pick up, a

Table-2.1: Interest Rate structure

(Percent)	CY00	CY01	CY02	Mar-03	Jun-03
Discount Rate	13.00	10.00	7.50	7.50	7.50
W.A.Lending Rates	13.88	13.40	10.31	8.26	7.58
W.A.Deposit Rates	5.23	4.96	3.60	2.81	1.90
Export Finance Rate	8.00	10.00	7.00	5.00	3.50
Export Refinance Rate	6.00	8.50	5.50	3.50	2.00
$ Export Rate	0.00	5.65	3.84	3.84	1.93
PIB rates					
3y	12.50	10.50	7.00	7.00	7.00
5y	13.00	11.00	8.00	8.00	8.00
10y	14.00	12.00	9.00	9.00	9.00
PIBs Yield					
3y	12.45	10.49	4.56	2.79	3.08
5y	12.95	11.00	4.86	3.12	4.16
10y	13.97	11.92	5.52	4.01	5.61
T. Bill Rate wt.avg					
3m	10.23	7.65	3.90	1.96	1.66
6m	10.96	7.93	4.32	2.09	1.67
12m	11.49	8.40	4.36	2.66	2.37
T. Bill Rate cut off					
3m	10.23	7.65	3.90	2.00	1.66
6m	10.96	7.93	4.32	2.16	1.65
12m	11.49	8.40	4.36	2.75	2.36

[1] Global position and only principal amount.

disbursement of Rs 37 billion under fixed investment to corporate sector could be interpreted as a growing optimism of the business community on economic fundamentals - prompting recourse to banking sector. Nearing of the peak borrowing period – September onwards – is also another factor that should give confidence about the sustainability of this trend into coming quarter(s).

Table-2.2: Sector-wise Break Up of Loans
Domestic Operations

(Billion rupee)	Mar-03	Jun-03	Change	% age
Corporate Sector	536.9	524.3	-12.6	-2.4
SMEs	162.2	145.3	-16.9	-10.4
Agriculture	121.0	119.4	-1.6	-1.4
Consumer Finance	26.5	45.0	18.5	69.8
Credit Cards	*6.0*	*6.7*	*0.7*	*11.2*
House Loans	*2.1*	*3.8*	*1.7*	*81.0*
Auto Loans	*10.5*	*15.8*	*5.3*	*50.3*
Others [2]	*7.9*	*18.7*	*10.8*	*136.7*
Others:[3]	127.0	209.2	82.2	64.7
Commodity Operations	-	*83.5*	-	-
Others[4]	-	*125.7*	-	-
Total	973.5	1,043.1	69.6	7.1

Sector-wise, the local private banks posted the highest increase of Rs 47.2 billion in loans, taking the loans portfolio to Rs 485.7 billion. The growth, however, remained skewed with just three banks taking away around 70 percent share of the increase. Public sector commercial banks had a share of Rs 20 billion or 28.5 percent in the overall increase of Rs 70.2 billion. Here once again, only one bank had the lion's share, i.e. Rs 12 billion. Foreign banks seem to be left out of the bonanza as they recorded a nominal increase.

Share of consumer finance, albeit minor as yet, is expanding with a robust pace. Since the start of the year consumer financing portfolio has grown to Rs 45 billion, an increase of Rs 18.5 billion or 70 percent. This increase notwithstanding, consumer finance still remains the domain of a select few as the majority is either simply not interested (impression conveyed by either token amount under this head or altogether absence of such lending) or still engaged in drawing up modalities for their entry into this area.

Housing finance scheme seems to be picking up as another five banks entered the housing finance market during the quarter taking the tally to fourteen. The total amount of housing finance increased to Rs 3.8 billion, registering an over the quarter increase of Rs 1.7 billion. Initial pattern suggests that banks are quite tentative in their approach and seemingly concentrating on upper group clientele. This perhaps is the reason for gradual migrating of average loan size to Rs 0.9 million in June 03 against Rs 0.8 million for preceding quarter. Moreover, at present, they seem to be more interested in financing for outright purchase than for any other mode- construction and improvements. In fact, their concentration in this particular mode accounts for

[2] Includes personal loans and financing for home appliances.
[3] Break-up for March-03 not available
[4] Includes loans to individuals (including NSS related loans), staff loans etc.

almost two-third of their total housing finance. This is quite opposite to HBFC's strategy that concentrates almost solely on construction financing (see **Table-2.3**). Although the housing finance market is still in its infancy stage, intense competition has already set in. The development will certainly serve the consumer interest besides leading to rapid expansion in market size.

Table-2.3: Type-wise Composition of Housing Finance

(As percent of Total Housing Finance)

	Construction		Outright Purchase		Renovation	
	Banks	HBFC	Banks	HBFC	Banks	HBFC
Mar-03	23.9	93.4	64.4	6.6	11.7	0.0
Jun-03	20.7	93.0	64.6	7.0	14.7	0.1

2.4 Investments

Investments, especially in government papers, have been occupying a sizeable portion of the banks' assets portfolio for quite some time now. This marked shift in assets mix came in the aftermath of change in the patterns of foreign remittances, improvement in the country's external account, and the resultant easy liquidity settings, as the major portion of the large inflow of funds found its way into the government papers. However, the pace of growth of investment in government securities has slowed down on account of SBP's strategy of sticking to the maturities and restrained targets in auctions.

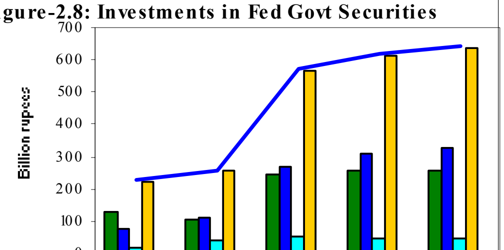
Table-2.4: Total Investment of banking sector

(Billion rupees)	CY00	CY01	CY02	Mar-03	Jun-03
Government papers:					
MTBs	95.8	126.6	373.9	417.8	420.6
FIBs	84.0	53.9	42.2	28.2	26.5
PIBs	2.0	42.0	116.7	122.3	150.9
Provincial Govt. Securities	1.7	1.6	1.4	1.5	1.2
Others	46.8	36.9	40.2	48.7	42.3
Equity investment *	16.0	25.4	29.0	33.9	35.1
TFCs, bonds, debentures and PTCs	40.7	49.0	55.5	59.5	66.1
Others	23.9	20.5	19.8	22.4	22.8
Total investment	311.0	356.0	678.6	734.4	765.5
Provision/surplus/deficit	-6.6	-5.0	22.9	18.8	18.9
Total after provision/surplus/deficit	**304.3**	**351.1**	**701.5**	**753.2**	**784.4**

*Including Investment in Subsidiaries and associate undertakings

During the quarter under review total investments increased by Rs 31.1 billion or 4.2 percent contributing 18.4 percent of the growth in total assets. Government papers, especially PIBs, were at the center of this increase as the level of these bonds rose by 28.6 billion or 23.4 percent. This high growth, however, mainly originated from the quarter end PIBs' auction which, having unprecedented targeted and

Figure-2.8: Investments in Fed Govt Securities



	CY00	CY01	CY02	Mar-03	Jun-03
PSCBs	129.8	106.2	242.7	256.5	259.3
LPBs	72.9	108.0	270.4	306.9	328.1
FBs	20.0	41.0	55.2	47.9	47.3
CBs	222.8	255.2	568.3	611.3	634.7
SBs	5.8	4.3	4.7	5.7	5.6
All	228.6	259.5	573.0	617.0	640.3

accepted amounts[5], was mainly influenced by authorities' one-off policy drive to contain the fall in rates on national saving scheme in line with conditionality of international donor agencies. On the other hand, MTB's growth remained subdued mainly because of lower targeted and accepted amounts during the quarter under review (see **Table-2.4**).

The group-wise position shows that local private banks made the highest increase in Federal Government securities. They accounted for around 91 percent of the total increase (see **Figure-2.8**).

The fall in the banks' exposure to public sector may be attributed to the lower growth of investment in government papers as credit exposure to public sector remained almost flat (see **Table-2.5**)

Table- 2.5: Banks' Exposure to Public Sector

(Percent)	CY00	CY01	CY02	Mar-03	Jun-03
Credit	19.3	20.7	16.9	15.3	15.3
Total (Credit+Govt. papers)	36.6	35.5	44.3	45.0	44.7

Source: Weekly Statement

[5] Accepted amount for the June 28, 2003, auction i.e. Rs 30.6 billion was higher than combined total of preceding four auctions' accepted amount.

3. Performance of the Banking System

3.1: Capital Adequacy

Healthier operating performance of the banks coupled with the fresh injections aimed at meeting the capital requirements have further strengthened the capital base of the banking system during the quarter under review.

Paid-up-capital of the banking system grew by around 9 percent to Rs 76.5 billion. This was helped by the fresh injection and issuance of bonus shares. The strengthening of capital position reduced the number of banks not meeting the enhanced minimum capital requirement to 12 from 14 as of last quarter. Of the 12 non-compliant banks, 5 banks are in the merger or acquisition process and are expected to meet the requirement by the end of this year. Significant equity growth by 9.3 percent to Rs 120.2 billion has widened the gap between the paid-up-capital and equity of the banking system signifying the build-up of reserves out of the profitable operations and the surplus on the revaluation of reserves (**see Figure- 3.1**). Of the total equity composition, more than one third constitutes the surplus on revaluation of assets. As liquidity has been finding its way into fixed income securities, falling rates proved a blessing in disguise and, in addition to impressive profit, appreciation in the value of assets helped further strengthen the equity base.

Figure-3.1: Capitalization of Banking System

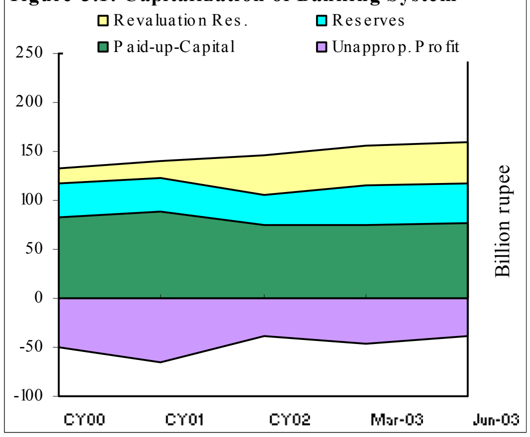
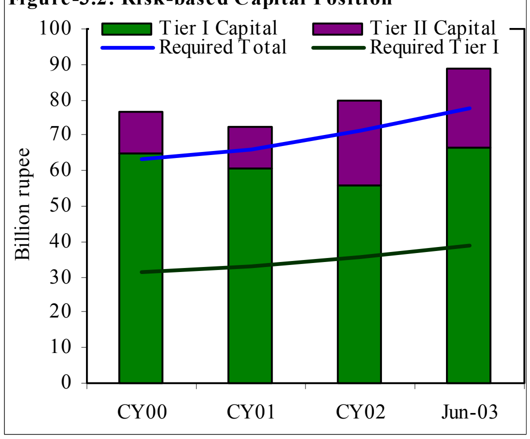


Figure-3.2: Risk-based Capital Position



The risk-based capital position[1] of the banking system shows that the core capital, which was on the declining course, took an upward turn on account of improved profitability coupled with fresh injections. The supplementary capital almost remained flat (see **Figure-3.2**). The risk-weighted assets also went up by 9 percent leading the risk-weighted assets to total assets ratio to 40.5 percent in June 2003 from 40.2 percent as of December 2002 (see **Figure-3.3**). However, the relatively greater growth of risk-based capital translated into improved capital adequacy indicators. Both the ratios, overall capital adequacy ratio (CAR) and core capital to risk-weighted assets ratio improved to 9.2 percent and 6.8 percent from 8.8 percent and 6.2 percent respectively as of December 2002. The capital to total assets ratio also inched up by 20 basis points to 5 percent (see **Table 3.1**).

Figure-3.3: RWA to Total Assets

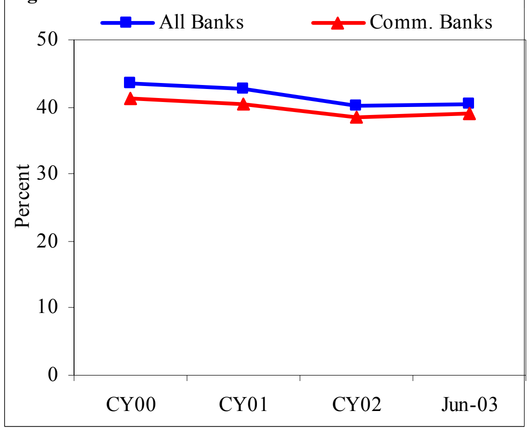


Table3.1: Capital Adequacy Indicators

(Percent)	CY00	CY01	CY02	Jun-03
Capital Adequacy Ratio (CAR)				
PSCBs	10.4	9.6	12.3	13.7
LPBs	9.2	9.5	9.7	9.8
FBs	18	18.6	23.2	21
Comm. Banks	11.4	11.3	12.6	12.7
SBs	-3.3	-13.9	-31.7	-31.7
All banks	9.7	8.8	8.8	9.2
Tier 1 Capital to Risk Weighted Assets				
PSCBs	7.7	7.1	8.6	10.4
LPBs	8.1	8.4	6.6	7.1
FBs	17.9	18.6	23	21
Comm. Banks	9.8	9.7	9.7	10.2
SBs	-3.4	-13.9	-31.7	-31.7
All banks	8.3	7.3	6.2	6.8
Capital to Total Assets				
PSCBs	4.6	3.7	5.6	5.9
LPBs	3.5	3.8	5.3	5.6
FBs	8.8	8.5	10.6	9.2
Comm. Banks	4.9	4.6	6.1	6.2
SBs	-1.1	-10.3	-23	-19.2
All banks	4.5	3.8	4.8	5.0

The group-wise, public sector commercial banks and local private banks ameliorated their capital adequacy ratios whereas foreign banks experienced a slight deterioration as some of them repatriated their surplus capital. The specialized banks, which experienced significant deterioration in their capital adequacy indicators mainly because of the balance sheet clean up exercise undertaken by one of them, reduced the equity deficit during the quarter. This is testified by the improved capital to total assets ratio.[2]

[1] The capital adequacy position of some of the banks is as of Dec-02 as they are yet to submit their position as of Jun-03.
[2] The capital adequacy ratio and tier I to total assets ratio of the specialized banks is as of December 2002.

The distribution of banks by CAR shows that the number of banks with capital adequacy ratio over 15 percent reduced to 20 from 23 as of end December 2002 (see **Table-3.2).** Of the three banks moving to lower band, one local private bank experienced a rise in its risk-weighted assets while two foreign banks repatriated their surplus capital. Accordingly, the market share of banks with CAR over 15 percent reduced to 28.7 percent from 46.2 percent. However, the market share of banks with CAR of 10 percent and above, the well-capitalized banks rose to 72.5 percent in June 2003 from 58.9 percent in December 2002 as one of the big banks improved its ratio. With the completion of undergoing mergers and acquisitions, the position is expected to improve further.

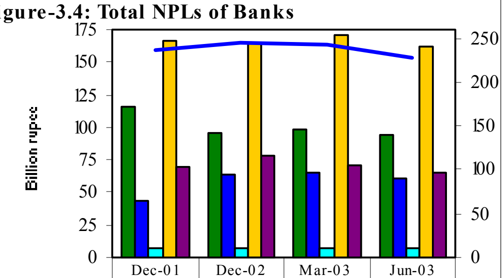
Table 3.2: Distribution of Banks by CAR with Market Share

CAR	Below 8%	8 to 10%	10 to 15%	Over 15%
CY00	5 (13.4 %)	6 (31.6 %)	16 (45.0 %)	17 (10.0 %)
CY01	5 (12.2 %)	5 (38.7 %)	11 (34.9 %)	22 (14.2 %)
CY02	4 (10.1 %)	4 (31.1 %)	9 (12.7 %)	23 (46.2 %)
Jun-03	4 (10.2 %)	5 (17.3%)	11 (43.8%)	20 (28.7 %)

3.2 Non-performing Loans[3]

Asset quality of the banking system improved in the current quarter as well. This is witnessed by a further decline in NPLs by Rs 14.5 billion[4] and in net NPLs by Rs 10.2 billion (see **Figure-3.4 & 3.5**). Specialized banks, again, were noticeable as they recorded a reduction of Rs 6.1 billion and Rs 2.7 billion in their gross and net NPLs respectively. Even more encouraging is the marked reduction in NPLs of commercial banks by Rs 8.5 billion which speaks volumes not only of the success of policy measures initiated in recent years but also prudent fresh lending on the part of banks.

Figure-3.4: Total NPLs of Banks



	Dec-01	Dec-02	Mar-03	Jun-03
PSCBs	115.4	95.3	98.6	94.1
LPBs	43.4	63.1	65.5	61.4
FBs	7.8	7.1	6.9	6.9
CBs	166.6	165.4	170.9	162.4
SBs	69.6	78.8	71.3	65.2
All (RHS)	236.1	244.2	242.2	227.7

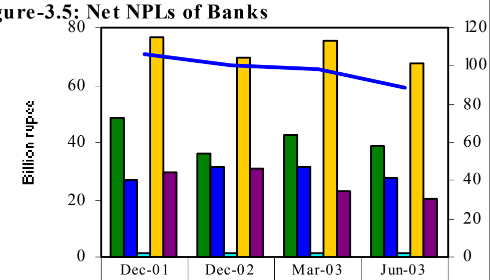
Public sector commercial banks and local private banks were almost equally successful in reducing their NPLs. The PSCBs registered a decrease of Rs 4.5 billion and Rs 3.5 billion in their gross NPLs and net NPLs respectively whereas LPBs

3 Domestic operations only

4 Includes mark-up.

managed a decline of Rs 4.1 billion in their NPLs. NPLs of foreign banks, on the other hand, stayed almost at the last quarter's level.

Figure-3.5: Net NPLs of Banks



	Dec-01	Dec-02	Mar-03	Jun-03
PSCBs	48.7	36.4	42.4	38.9
LPBs	26.7	31.5	31.4	27.3
FBs	1.4	1.6	1.5	1.4
CBs	76.8	69.5	75.3	67.7
SBs	29.8	31.0	23.1	20.4
All (RHS)	106.6	100.5	98.3	88.1

A look at the impact of write off (settlement) guidelines issued last year, would indicate the success of the policy measures and the likely impact on the NPLs level in the coming days. Uptil June 2003, an amount of Rs 18.8 billion was settled out of Rs 83.6 billion worth of cases received. A down payment/ recovery of Rs 1.3 billion was also effected. Given the response received so far, there seems to be a lot of potential for the settlement of perennial bad loan under this head.

Another gauge of asset quality is the behaviour of its key ratios. NPLs to total loans ratio of all banks improved from 23.6 percent in the last quarter to 20.7 percent in the current quarter (see **Table-3.3**). The ratio is even better for all commercial banks, which improved from 19 percent to 16.7 percent. Net NPLs to net loans ratio also declined from 11.5 percent to 9.5 percent for all banks and in case of commercial banks it improved from 9.6 percent to 7.9 percent in the same period. The improvement in this ratio came on the back of better coverage ratio, which increased to 74 percent from 63.2 percent for all banks. This growth in coverage ratio coming at a time of rapid increase in loans portfolio is a welcome development providing the needed buffer in case some of the rapid increase in loans portfolio turns out to be of poor quality.

Table-3.3 : NPLs Indicators

(Percent)	Dec-01	Dec-02	Mar-03	Jun-03
NPLs to total loans				
PSCB	23.3	28	29.1	26.9
LPBS	15.3	11.1	15.4	12.7
FBs	5.3	45.1	5	4.9
CBs	18	16.6	19	16.7
SBs	81	61.1	56.6	51.3
All Banks	23.3	23.7	23.6	20.7
Net NPLs to net loans				
PSCBs	11.9	13.5	15.6	13.9
LPBs	10.2	8.2	8.1	6.2
FBs	1	1.2	1.1	1.1
CBs	9.5	8.9	9.6	7.9
SBs	73.1	41.7	32.4	27.5
All Banks	12.6	11.7	11.5	9.5
Provisions to NPLs				
PSCBs	64.3	66.1	61.7	73.8
LPBs	45.9	55.8	55.6	64.6
FBs	84.1	80.8	81.1	93.3
CBs	60.5	62.8	60.2	71.1
SBs	60.2	63.7	70.4	81.2
All Banks	60.4	63.1	63.2	74

3.3 Profitability

Second quarter of the current year witnessed further consolidation in banks' earning position as the pre-tax profit for the sector climbed to Rs 26.2 billion,[5] more than the profit of Rs 18.4 billion recorded for the entire year 2002. After tax profit up till June 03 reached to Rs 14.3 billion as against Rs 2.4 billion for the whole last year (see **Table-3.4**). Accordingly, the return on assets[6] went up to 1.2 percent from 0.1 percent in last year (see **Table-3.5**).

Table 3.4: Profitability of Banking System

Billion rupees	CY00	CY01	CY02	Mar-03	Jun-03
Profit before tax					
PSCBs	3.9	0.2	10.9	2.9	7.3
LPBs	-0.6	5.0	11.3	5.4	12.8
FBs	3.7	5.0	6.6	2.2	4.0
Comm. Banks	7.0	10.3	28.9	10.6	24.2
SBs	-2.5	-9.2	-10.5	-3.1	2.0
All Bank	4.5	1.1	18.4	7.5	26.2
Profit after tax					
PSCBs	1.8	-4.6	4.8	1.7	4.4
LPBs	-3.5	2	5.9	3.4	7.5
FBs	1.4	2.4	4.2	1.5	2.3
Comm. Banks	-0.2	-0.2	14.8	6.6	14.1
SBs	-2.6	-9.5	-12.4	-3.1	0.1
All Banks	-2.8	-9.8	2.4	3.5	14.3

Figure-3.6: Interest Rate Spread

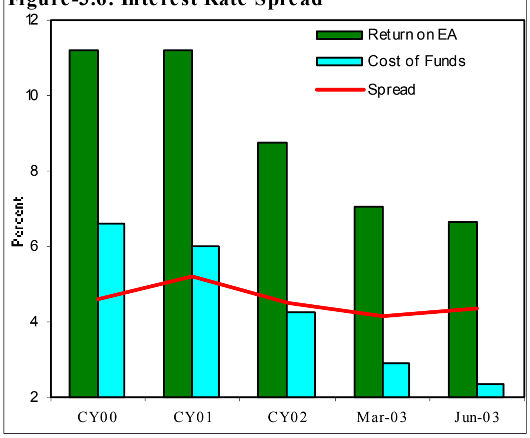
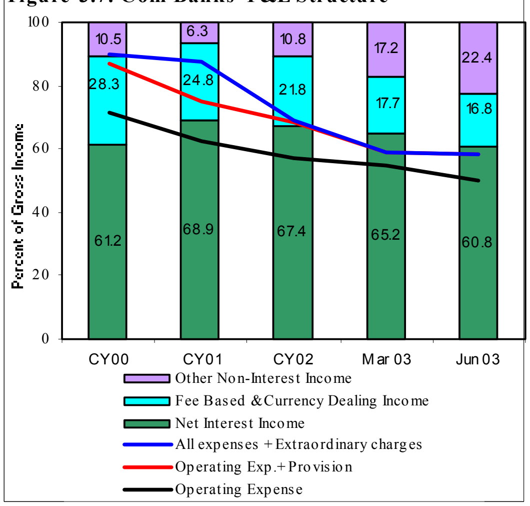


Figure-3.7: Com Banks' P&L Structure



The increase followed the pattern similar to that of previous quarters whereby net interest income continues to increase. Nonetheless an increase of Rs 5.2 billion or 29 percent in net-interest income over the previous quarter is itself quite commendable, which helped stretch the year-to-date net interest income to Rs 40.3 billion. The enabling factors for this feat were increased volume of earning assets including one off NSS related loans and spread improvement from 4.2 percent in March 2003 to 4.3 percent as of end June 2003 (see **Figure-3.6**).

The other major factor for the profit figure was continued asset price boom prompting large capital gains, which are of non-recurring nature, along with

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[5] Year-to-date profit.

[6] The profitability ratios for March and June quarters are annualized.

dividends income. Total year-to-date gains on sale of securities were Rs 7.5 billion, which is 28.6 percent of pre-tax profit as compared to Rs 4.5 billion or 24.4 percent of the pre-tax profit for the last year. Added to this is dividend income of Rs 3.7 billion, which surpassed Rs 2.9 billion for the whole last year.

Table-3.5: Earnings and profitability indicators

Percent	CY00	CY01	CY02	Mar-03	Jun-03
Before Tax ROA					
PSCBs	0.5	0.0	1.3	1.3	1.6
LPBs	-0.1	0.9	1.3	2.2	2.5
FBs	1.4	1.7	2.3	3.3	2.9
Comm. Banks	0.4	0.6	1.5	2.0	2.2
SBs	-2.3	-8.4	-10.2	-0.1	0.1
All Banks	0.3	0.1	0.9	1.4	2.3
Before Tax ROE					
PSCBs	10.9	0.5	26.3	23.4	28.8
LPBs	-3.2	25.4	30.5	41.1	46.7
FBs	15.6	19.3	24.2	31.1	28.5
Comm. Banks	8.8	12.2	26.9	32.2	35.8
SBs	-	-	-	-	-
All Banks	5.7	1.4	20.3	22.7	46.3
ROA (after tax)					
PSCBs	0.2	-0.5	0.6	0.8	0.9
LPBs	-0.7	0.4	0.7	1.4	1.5
FBs	0.6	0.8	1.5	2.2	1.7
Comm. Banks	0.0	0.0	0.8	1.2	1.3
SBs	-2.3	-8.8	-12.1	-8.5	0.0
All Banks	-0.2	-0.5	0.1	0.6	1.2
ROE (after tax)					
PSCBs	4.9	-12.2	11.5	13.3	16.8
LPBs	-17.4	10.3	15.9	26.0	27.4
FBs	6.1	9.1	15.2	20.7	16.7
Comm. Banks	-0.3	-0.3	13.8	20.0	20.9
SBs	-	-	-	-	-
All Banks	-3.5	-12.6	2.7	13.0	25.3
Net Interest Margin					
PSCBs	3.6	4.3	4.1	3.6	3.9
LPBs	3.4	4.3	4.0	4.0	3.8
FBs	3.2	3.3	3.3	3.7	3.6
Comm. Banks	3.5	4.1	3.9	3.8	3.8
SBs	3.2	3.3	3.3	5.3	11.3
All Banks	3.5	4.3	4.4	3.8	4.1
Operating Exp. to Gross Income (NII +Non-interest Income)					
PSCBs	70.1	62.3	57.7	61.7	52.2
LPBs	80.9	67.3	60.4	54.4	50.1
FBs	59.4	54.5	45.4	39.5	42.7
Comm. Banks	71.6	62.7	57.3	54.7	50.0
SBs	70.5	59.0	84.7	111.5	35.0
All Banks	71.6	62.4	59.6	56.7	48.8
Intermediation cost					
PSCBs	3.4	3.2	2.9	2.7	2.8
LPBs	3.9	3.6	3.3	3.3	3.2
FBs	2.9	2.5	2.3	2.6	2.6
Comm. Banks	3.4	3.2	3.0	3.0	3.0
SBs	3.2	3.9	7.3	2.9	2.8
All Banks	3.4	3.2	3.2	3.1	3.0

The performance of the banking sector during this period allays to great extent the fears regarding fall in banks' profitability in the wake of declining yield scenario and presence of excess liquidity. The very threat i.e. liquidity has been turned into opportunity by banking sector – thanks to depositors' insensitivity to the successive rate cuts. Besides availability of cheaper funds, one off income in the form of NSS related loans and gain on sale of securities provided considerable support to the profitability of the banking sector.

Another significant aspect of the strengthened net interest income of all commercial banks is that, now it not only covers all the expenses but also is well supported by non-interest income to fetch increasing profit margins (see **Figure 3.7**). Besides, the contained expenses also helped in the improved profitability as the operating expenses formed 50 percent of the gross income in June 2003 as compared to 57.3 percent in CY 2002 and 71.6 percent in CY 2000. The provision charges against non-performing loans as percentage of gross income also reduced to 8.6 percent from 11.3 percent in CY 2002 and 15.4 percent in CY 2000. This not only shows the strengthened gross income but also diminishing provision charges on account of improvement in asset quality.

Group-wise, the local private banks continued to be most impressive, accounting for more than 50 percent or Rs 7.6 billion of overall banking sector profit easily outweighing there respective share in total assets. In terms of gains on sale of securities, this was Rs 6.8 billion out of total Rs 7.5 billion.

Restoring specialized banks' profitability was the other note worthy development. A profit figure of Rs 0.1 billion, though miniscule, but is a significant achievement when viewed in the context of a series of losses sustained in previous years.

3.4 Liquidity & Sensitivity to Other Risks

An easy liquidity, gradually strengthening rupee, and falling interest rates regime that set in the wake of heavy foreign inflows and improved financials of govt. continued to prevail in the quarter under review as well. Liquid reserves well in excess of regulatory requirements and wide margin between SBP discount rate and interbank rates are indicative of the ample liquidity in the banking system (see **Figure-3.8**). While State Bank kept its discount rate intact at 7.5 percent, interbank rates, under the pressure of liquidity, sank to historically low levels: overnight rate 0.2-0.4 percent, six months rate 1.6-2.0 percent by the end of quarter under review.

Figure-3.8: Liquidity Held by Banks

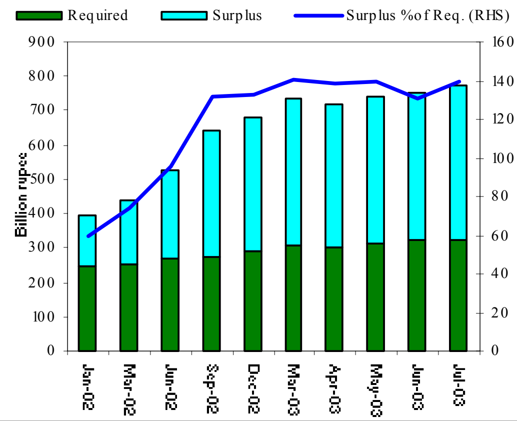
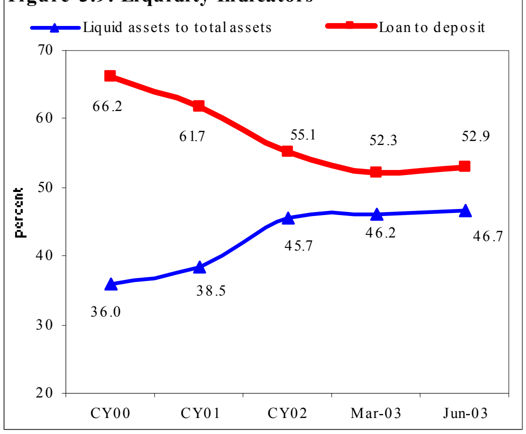


Figure-3.9: Liquidity Indicators



Liquid assets to total assets ratio witnessed further strengthening during the quarter as appreciable share of incremental funds rested in cash, bank balances and repo lending. While more than proportionate increase in loans during the quarter led to slight rise in loans to deposits ratio (see **Figure-3.9 & Table-3.6**).

Flush liquidity led to a sharp decline in returns on govt. papers as well as in lending rates in last quarter of the previous year. This declining returns phenomenon advanced into the quarter under review as well; cut-off yields on the issue of MTBs of all tenors witnessed further decline. Though cut-off yields on PIBs experienced some rise in the auction conducted at quarter end, this was mainly on account of authorities' stance to keep the return structure compatible with NSS rates and to contain any fall in the latter.

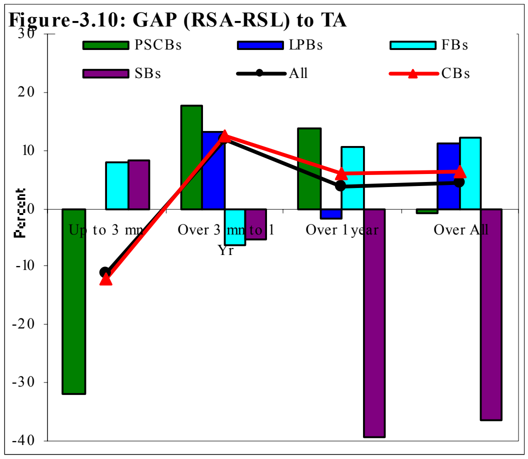
Table-3.6: Growth in Loans and Deposits

(Percent)	CY00	CY01	CY02	Mar-03	Jun-03
Loan Growth rate	14.7	2.3	2.1	-0.9	6.6
Deposits Growth Rate	6.9	10.0	13.7	3.6	6.3

* Growth rate for Mar and Jun-03 are for the quarters.

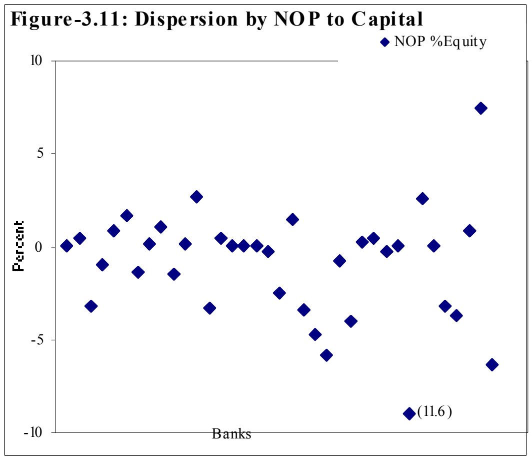
Banks were maintaining an overall cumulative asset sensitive position at 4.6 percent of total assets. The gaps between rate sensitive assets and liabilities maturing in different time buckets were also within the internationally accepted benchmark of ± 10 percent. The group-wise position shows that public sector commercial banks were holding a more aggressive stance in the shorter term, while large negative gaps for specialized banks were reflective of peculiar nature of their assets portfolio and sources of funds (see **Figure-3.10**).

Figure-3.10: GAP (RSA-RSL) to TA



During the quarter under review rupee's parity with US dollar remained more or less stable, and the former recorded slight appreciation over the quarter that was a natural consequence of healthy remittances by expatriate Pakistanis and improved export performance. Banks were holding aggregate over-sold Net Open Position (NOP) of US$38.7 million the rupee equivalent of which came to 1.6 percent of the system's total equity. **Figure 3.11** shows that almost all of the banks were holding NOP position well within acceptable limits of ±10 percent of the capital.

Figure-3.11: Dispersion by NOP to Capital



Glossary

Capital adequacy ratio The amount of risk-based capital (Tier I and II) as a percent of risk-weighted assets.

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

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

GAP 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.

Interbank rates The two way quotes namely bid and offer rates quoted in interbank market are called as interbank rates.

Intermediation cost The cost incurred by the depository institutions in the channelization of funds; administrative expenses divided by the average deposits and borrowings.

Liquid assets 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.

Net interest income 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) Net interest income as a percent of average earning assets. Reveals the difference between the yield on earning assets and the break-even yield (or the yield that is needed to cover all interest expenses).

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

Net non-performing loans (NPLs) The value of non-performing loans derived after the adjustment of provision for loan losses.

Net NPLs to net loans It describes the 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)** A term used to describe the classified loans and advances for which bank is receiving no income. In Pakistan the 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 The one of the measures of assets quality that quantifies the asset impairment by taking NPLs as a percent of gross loans.

Paid-up capital This is equity amount actually paid by the shareholders to a company for acquiring its shares. Paid-up capital may be having element of premium or discount value which is shown separately in the balance sheet.

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

Rate sensitive liabilities (RSL) Liabilities susceptible to interest rate movements; that will be repriced over the forthcoming planning period.

Return on assets It 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.

Risk weighted Assets Each asset and off-balance sheet item is assigned to one of the four broad risk categories based on the perceived credit risk of the obligor. These risk categories are assigned weights of 0 percent, 20 percent, 50 percent and 100 percent. The standard risk category is 100 percent. The rupee value of the amount in each category is multiplied by the risk weights associated with that category. The off-balance sheet items are first converted to credit equivalent values by using the conversion factors. The resulting values for each of the risk categories are added together. The resulting sum is the total risk weighted assets.

SME Sector Means an entity, not being a public limited company, which does not employ more than 250 persons (if it is manufacturing concern and50 persons (if it is trading /services concern) and also fulfils any of the following criteria:

- **i.** A trading/ services concern with total assets excluding land and building upto Rs 30 million.
- **ii.** A manufacturing concern with original value of total assets excluding land and building up to Rs 50 million.
- iii. Any concern (trading, services or manufacturing) with net sales not exceeding Rs 300 million as per latest financial statements.

Spread 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.

Tier I capital The risk based capital system divides capital into two tiers- core capital (Tier I) and supplementary capital (Tier II). Tier I capital is defined as common stockholders' equity (including common stock, surplus and undivided profits), non-cumulative perpetual preferred stock and minority interest in consolidated subsidiaries.

Tier II capital Supplementary Capital (Tier II) is limited to 100 percent of core capital (Tier I). It includes cumulative perpetual preferred stock, mandatory convertible debt, the general provision or reserves for loan losses, term subordinated debt, limited life preferred stock and other hybrid capital instruments.

Yield risk 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.

Abbreviations

CAR	Capital Adequacy Ratio
CBs	Commercial Banks
DSC	Defense Saving Certificates
FBs	Foreign Banks
HBFC	House Building Finance Corporation
MCR	Minimum Capital Requirement
MTBs	Market Treasury Bills
NII	Net Interest Income
NIM	Net Interest Margin
NOP	Net Open Position
NPLs	Non Performing Loans
NSC	National Saving Certificates
LPBs	Local Private Banks
PIBs	Pakistan Investment Bonds
PTCs	Participation Term Certificates
PSCB	Public Sector Commercial Banks
PSE	Public Sector Enterprise
P&L	Profit and Loss
ROA	Return on Assets
RSAs	Rate Sensitive Assets
RSLs	Rate Sensitive Liabilities
RWA	Risk Weighted Assets
SBs	Schedule Banks
TFC	Term Finance Certificate

Group-wise Composition of Banks

2001	2002	March 31, 2003	June 30, 2003
A. Public Sector Comm. Banks Habib Bank Limited National Bank of Pakistan United Bank Limited First Women Bank Limited The Bank of Khyber The Bank of Punjab B. Local Private Banks Askari Commercial Bank Limited Bank Al-Falah Limited Bank Al Habib Limited Bolan Bank Limited Faysal Bank Limited Metropolitan Bank Limited Platinum Commercial Bank Ltd Prime Commercial Bank Limited Saudi Pak Commercial Bank Ltd PICIC Commercial Bank Limited Soneri Bank Limited Union Bank Limited Muslim Commercial Bank Limited Allied Bank of Pakistan C. Foreign Banks ABN Amro Bank Al Baraka Islamic Bank American Express Bank Standard Chartered Grindlays Bank The Bank of Ceylon The Bank of Tokyo – Mitsubishi CITI Bank Credit Agricole Indo Suez Deutsche Bank Doha Bank Emirates Bank Habib Bank A. G. Zurich Hong Kong Shangai Banking Corporation IFIC Mashreq Bank PJSC Oman Bank Rupali Bank Society General Standard Chartered Bank D. Specialized Banks Agriculture Development Bank of Pak. Industrial Development Bank of Pakistan Federal Bank for Co-Operatives Punjab Provincial Co-operative Bank Limited **All Commercial Banks** Includes A + B + C **All Banks** Includes A + B + C + D	**A. Public Sector Comm. Banks** Habib Bank Limited National Bank of Pakistan First Women Bank Limited The Bank of Khyber The Bank of Punjab B. Local Private Banks Askari Commercial Bank Limited Bank Al-Falah Limited Bank Al Habib Limited Bolan Bank Limited Faysal Bank Limited Metropolitan Bank Limited KASB Bank Limited Prime Commercial Bank Limited Saudi Pak Commercial Bank Ltd PICIC Commercial Bank Limited Soneri Bank Limited Meezan Bank Union Bank Limited Muslim Commercial Bank Limited Allied Bank of Pakistan United Bank Limited C. Foreign Banks ABN Amro Bank Al Baraka Islamic Bank American Express Bank The Bank of Ceylon The Bank of Tokyo – Mitsubishi CITI Bank Credit Agricole Indo Suez Deutsche Bank Doha Bank Habib Bank A. G. Zurich Hong Kong Shangai Banking Corporation IFIC Mashreq Bank PJSC Oman Bank Rupali Bank Standard Chartered Bank D. Specialized Banks Zari Tarqiati Bank Ltd. Industrial Development Bank of Pakistan Punjab Provincial Co-operative Bank Limited **All Commercial Banks** Includes A + B + C **All Banks** Includes A + B + C + D	**A. Public Sector Comm. Banks** Habib Bank Limited National Bank of Pakistan First Women Bank Limited The Bank of Khyber The Bank of Punjab B. Local Private Banks Askari Commercial Bank Limited Bank Al-Falah Limited Bank Al Habib Limited Bolan Bank Limited Faysal Bank Limited Metropolitan Bank Limited KASB Bank Limited Prime Commercial Bank Limited Saudi Pak Commercial Bank Ltd PICIC Commercial Bank Limited Soneri Bank Limited Meezan Bank Union Bank Limited Muslim Commercial Bank Limited United Bank Limited Allied Bank of Pakistan C. Foreign Banks ABN Amro Bank Al Baraka Islamic Bank American Express Bank The Bank of Ceylon The Bank of Tokyo – Mitsubishi CITI Bank Credit Agricole Indo Suez Deutsche Bank Doha Bank Habib Bank A. G. Zurich Hong Kong Shangai Banking Corporation IFIC Mashreq Bank PJSC Oman Bank Rupali Bank Standard Chartered Bank D. Specialized Banks Zari Tarqiati Bank Ltd. Industrial Development Bank of Pakistan Punjab Provincial Co-operative Bank Limited **All Commercial Banks** Includes A + B + C **All Banks** Includes A + B + C + D	**A. Public Sector Comm. Banks** Habib Bank Limited National Bank of Pakistan First Women Bank Limited The Bank of Khyber The Bank of Punjab B. Local Private Banks Askari Commercial Bank Limited Bank Al-Falah Limited Bank Al Habib Limited Bolan Bank Limited Faysal Bank Limited Metropolitan Bank Limited KASB Bank Limited Prime Commercial Bank Limited Saudi Pak Commercial Bank Ltd PICIC Commercial Bank Limited Soneri Bank Limited Meezan Bank Union Bank Limited Muslim Commercial Bank Limited Allied Bank of Pakistan United Bank Limited Mashreq Bank C. Foreign Banks ABN Amro Bank Al Baraka Islamic Bank American Express Bank The Bank of Ceylon The Bank of Tokyo – Mitsubishi CITI Bank Credit Agricole Indo Suez Deutsche Bank Doha Bank Habib Bank A. G. Zurich Hong Kong Shangai Banking Corporation IFIC Oman Bank Rupali Bank Standard Chartered Bank D. Specialized Banks Zari Tarqiati Bank Ltd. Industrial Development Bank of Pakistan Punjab Provincial Co-operative Bank Limited **All Commercial Banks** Includes A + B + C **All Banks** Includes A + B + C + D

1. On its privatization, UBL shifted from PSCB to LPB in 2002.
2. Platinum Commercial Bank Limited was purchased by KASB and renamed as KASB Bank Limited – 08-05-2002.
3. Emirates Bank International – Pakistan Operations were purchased by Union Bank Limited – 02-09-2002.
4. Society Generale _Pakistan Operations – were acquired by Meezan bank Limited – 30-04-2002.
5. ANZ Grindlays Bank was merged into / acquired by Standard Chartered – 30-11-2002.
6. FBC is under liquidation, hence excluded from 2002.
7. Mashreq Bank after merger with Crescent Investment Bank converted into a local private bank just after the close of quarter Jun-03.