State Bank of Pakistan

Banking Supervision Department

Quarterly Performance Review of the Banking System

September 2005

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List of Abbreviations

CAR	Capital Adequacy Ratio
CB	Commercial Bank
CY	Calendar Year
FB	Foreign Bank
LPB	Local Private Bank
MCR	Minimum Capital Requirement
MTB	Market Treasury Bill
NII	Net Interest Income
NPL	Non Performing Loan
OMO	Open Market Operation
PIB	Pakistan Investment Bond
PSCB	Public Sector Commercial Bank
ROA	Return on Asset
ROE	Return on Equity
RSA	Rate Sensitive Asset
RSL	Rate Sensitive Liability
RWA	Risk Weighted Asset
SBP	State Bank of Pakistan
SB	Specialized Bank
SME	Small and Medium Enterprise

Glossary

Capital Adequacy Ratio is the amount of risk-based capital as a percent of risk-weighted assets.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Net loans are the loans net of provision held for NPLs.

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

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

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

NPLs to loans ratio/Infection ratio stands for NPLs as a percent of gross loans.

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

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

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

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

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

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

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

SME means an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing/ service concern) and 50 persons (if it is trading concern) and also fulfills the following criteria of either 'a' and 'c' or 'b' and 'c' as relevant:

(a) A trading / service concern with total assets at cost excluding land and building upto Rs50 million.

(b) A manufacturing concern with total assets at cost excluding land and building upto Rs100 million.

(c) Any concern (trading, service or manufacturing) with net sales not exceeding Rs300 million as per latest financial statements.

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

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

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

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

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

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The review is based on the data mainly taken from the Quarterly Reports of Conditions and Annual Audited Accounts submitted by banks. It covers their global[1] operations, unless otherwise indicated. The banks have been divided into four groups namely, Public Sector Commercial Banks (PSCBs), Local Private Banks (LPBs), Foreign Banks (FBs) and Specialized Banks (SBs). PSCBs include two nationalized commercial banks and two provincial banks, whereas LPBs consist of four privatized banks and sixteen domestic private banks. The composition of these four groups has been given in Annex-IV. The performance of the banking industry as a whole and these groups in particular has been evaluated by using the financial soundness indicators.

1. Overview

By capitalizing on the strong growth in high yield assets over the last many quarters, the banking system has started to produce impressive results. The quarter under review proved to be unprecedented in terms of profits. Year-to-date net profits reached Rs40.6 billion, surpassing the profit for the last full year. The sharp rise in profits had a very positive impact on return on assets (ROA) and return on equity (ROE) after tax of the banking system, which improved to 1.7 percent and 25.2 percent respectively. Yet another positive impact of growing profits is visible in the form of strengthening solvency profile. The increase in CAR to 11.4 percent from 10.9 percent in the preceding quarter strengthens the banking system to sustain adverse future shocks.

This notable performance in terms of profitability and solvency pivoted around the significant expansion in the volume of business of the banking system. It is also evident from the substantial increase in the loans portfolio over the last few quarters. However, during the quarter under review, credit growth lost pace as it coincided with the seasonal slackness in business activities. Resultantly, total loans of the banking system increased by Rs22.4 billion, considerably lower than the high growth patterns observed in previous quarters. In this respect, consumer financing provided the real impetus by growing at a rate of 13.2 percent over the previous quarter. A slower growth of 0.7 percent in corporate financing corresponded to its lower demand for credit in line with the seasonal sluggishness in business activities. Credit expansion to agriculture sector maintained a rising

[1] Domestic operations of all the banks operating in Pakistan plus operations of overseas branches of Pakistani Banks

trend. However, growth of SMEs remained almost static at its previous quarter's level.

Though the banking system so far has succeeded in managing its credit risk within reasonable limits, the gradual rise in interest rates, nevertheless, continues to expose them to high credit risk particularly in consumer lending. While the NPLs of the banking system continued their downward trend, those of commercial banks witnessed rise of Rs2.1 billion during the quarter. However, the whole rise in their NPLs was attributable to one weak bank. Further, Net NPLs maintained their downward course not only for all banks but also for commercial banks. Moreover, the key indicators of asset quality of the banking system have also shown further improvement. This is apparent by an improvement in NPLs to loans and net NPLs to net loans ratios to 10.5 percent and 2.7 percent respectively from 10.6 percent and 3.0 percent in the preceding quarter.

The concerns about higher credit risk, particularly with reference to consumer financing, also rested on the gradual hike in interest rates. The NPLs to loans ratio of consumer loans increased to 1.0 percent from 0.9 percent in the previous quarter. However, in spite of this deterioration, the incidence of NPLs against overall consumer loans remains the lowest among all sectors. Agriculture was the only sector to have reduced its NPLs to loans ratio during the quarter as one of the specialized banks recorded strong recovery. The position of corporate and SMEs sectors remained more or less static at the previous quarter's level.

Apart from the seasonal slow down, the relatively muted pace of growth in loans was also influenced by the reversal of the surging trend of deposits, which reduced the previously experienced liquidity overhang of banks. A fall of Rs39.5 billion in total deposits came as surprise given the fact that home remittances continued unabated. The major reason for this decline in deposits was pre-Ramazan withdrawals to avoid levy of Zakat. The decline in deposits not only scaled down appreciably the rapidly expanding balance sheet of the banking system, but also added to the developing liquidity pressures in the wake of SBP's efforts to mop up excess funds to restrain the inflationary tendencies.

The Islamic banking operations also grew during the quarter under review. With the licensing of one more bank, the number of full-fledged Islamic banks increased to four as of end September 2005. The simultaneous increase in branch network further helped in expanding the outreach of Islamic banking. This is evident by a growth of 5.7 percent in the asset base of Islamic banking operations. Like the conventional banks, Islamic banks witnessed decline in the deposits, though slightly, while financing on the other hand maintained an upward trend.

Despite a healthy growth pattern exhibited by the Islamic banking operations, their share in the overall banking system remained miniscule at 1.7 percent.

To conclude, the current quarter proved to be another profitable period for the banking system. With the impressive performance in the first three quarters, the banking system is poised firmly to end the year 2005 on a high note in terms of profits, solvency and growth of the key variables. The relative sluggishness in the pace of deposits and loans, as experienced in the current quarter, is expected to diminish with the onset of seasonal financing. The coming quarter is of special significance from the solvency point of view, as a number of banks will strive to meet the prescribed MCR of Rs2 billion, which is going to come into effect from December 31, 2005. Such banks, in addition to retention of healthy profits, will have to inject more capital. This will give a further boost to the solvency position of the banking system. The expected increase in funds inflow would provide a support to the banking system to meet the higher credit demand by the private sector and translate into higher business volume of the banking system with prospects of even stronger earnings.

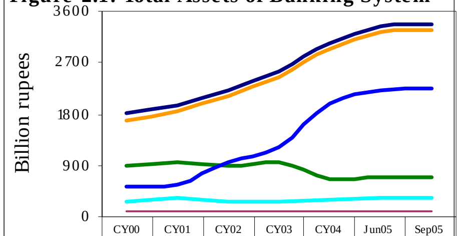
Another important development regarding the financial soundness and stability of the banking system is the recent amendment in Prudential Regulations pertaining to loans classification and provisioning. The amendments seek to make the loan classification and provisioning requirements relatively more stringent in line with the international best practices. While it may require banks to make additional provisioning, the overall benefit to the system is expected to outweigh the short-term pressures on earnings. This would force banks to observe more carefully the proper credit appraisal and monitoring standards and ensure better credit risk management to guide the banking system on a more sustainable and long-term growth trajectory.

2. Assets and Funding Structure

The rapidly expanding balance sheet of the banking system slowed down during the quarter under review. An increase of Rs20 billion (1 percent) in total assets is not only far below the increase of Rs228.5 billion (7 percent) in the preceding quarter but also is far-below the growth of Rs68.8 billion (2.4 percent) in the corresponding quarter of the previous year (see **Figure 2.1**). The decline in deposits happened to be the major factor responsible for this slowdown in growth of total assets. The asset mix tilted further in favour of loans as investment portfolio of the banking system declined appreciably during the quarter under review (see **Figure 2.2**).

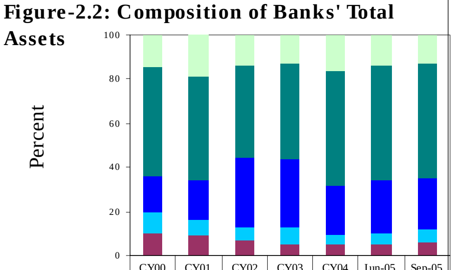
The sector-wise analysis reveals that it was primarily the local private banks (LPBs) which accounted for 95 percent of the growth in total assets of the banking system as the other major sector i.e. public sector commercial banks (PSCBs) witnessed a decline. With a growth of around one percent in their total assets, which is much subdued as compared with the preceding quarters, LPBs also managed to increase their share, though fractionally, in total assets of the industry (see **Figure 2.3**). The share of foreign banks (FBs) also increased slightly as they contributed 20 percent of the growth in total assets of the banking system. On the

Figure-2.1: Total Assets of Banking System



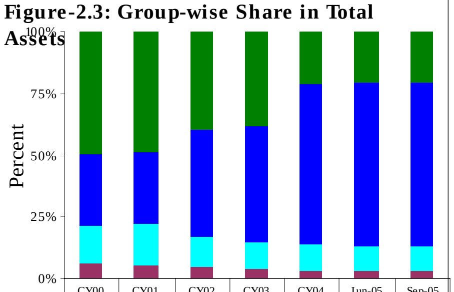
	CY00	CY01	CY02	CY03	CY04	Jun05	Sep05
PSCBs	902	947	878	959	650	685	684
LPBs	513	566	967	1212	1,980	2,227	2,246
FBs	281	324	280	267	304	325	329
CBs	1,696	1,836	2,125	2,438	2,933	3,236	3,259
SBs	112	106	98	100	104	113	110
All	1,808	1,942	2,223	2,538	3,036	3,349	3,369

Figure-2.2: Composition of Banks' Total Assets



	CY00	CY01	CY02	CY03	CY04	Jun-05	Sep-05
Cash &Bank Balances	14.7	18.7	14.0	12.5	16.1	13.7	12.4
Advances	49.1	46.9	41.4	43.6	51.9	52.4	52.6
Investments	16.8	18.1	31.5	31.0	22.2	24.1	23.0
Lending to FIs	8.9	7.0	6.6	7.7	4.7	4.5	5.8
Other Assets	10.4	9.4	6.4	5.2	5.1	5.4	6.2

Figure-2.3: Group-wise Share in Total Assets



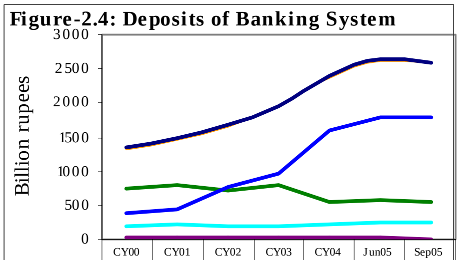
	CY00	CY01	CY02	CY03	CY04	Jun-05	Sep-05
PSCBs	49.9	48.8	39.5	37.8	21.4	20.4	20.3
LPBs	28.4	29.1	43.5	47.6	65.2	66.5	66.7
FBs	15.5	16.6	12.6	10.7	10.0	9.7	9.8
SBs	6.2	5.5	4.4	3.9	3.4	3.4	3.3

other hand, respective shares of public sector commercial banks and specialized banks declined on account of fall in their total assets.

The assets distribution is highly skewed in favour of top six banks, which hold 60.2 percent of the total assets of the banking system. This share, however, declined slightly from 60.9 percent in the preceding quarter as top two banks of the system witnessed a decline in their asset base. This indicates significant variation among banks in terms of their size. Interestingly, out of the total 39 banks, 18 banks hold merely 6 percent of the total assets. Another point to note is that this share has also witnessed a slight decline, which raises concern regarding their ability to compete with the aggressive growth of the top- and second-tier banks.

A fall of Rs39.5 billion in **deposits** of the banking system in this quarter proved to be an anticlimax of the high growth observed in the preceding quarters (see **Figure 2.4**). The decline is in sharp contrast to the impressive growth of Rs203.1 billion in the previous quarter. In the historical perspective, deposits of the banking system tend to exhibit sluggishness during this quarter of the year. However, this year pre-Ramazan withdrawals to avoid the Zakat levy as well as the withdrawal of privatization proceeds resulted in negative growth in the deposits for the quarter under review.

Figure-2.4: Deposits of Banking System

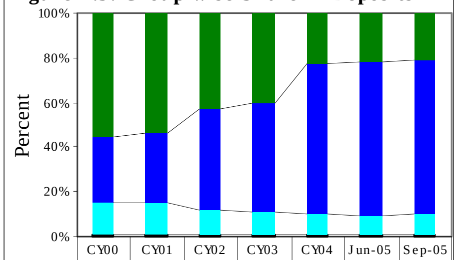


	CY00	CY01	CY02	CY03	CY04	Jun05	Sep05
PSCBs	744	795	722	799	545	583	542
LPBs	394	454	757	954	1603	1802	1802
FBs	187	208	183	192	227	236	239
CBs	1325	1457	1662	1945	2375	2621	2583
SBs	16	18	16	17	17	14	13
All	1341	1475	1678	1962	2392	2635	2596

Like assets, deposits of the banking system are also concentrated into top six banks. Rather their share in total deposits of the banking system, despite a slight fall in their deposits, is even greater at 64.5 percent. Similarly, the small 18 banks, in terms of asset size, hold only around 5 percent of the deposits of the banking system. These banks will have to explore better alternatives to increase their deposit base in terms of size, product innovation, outreach and technological know-how in an environment dominated by much stronger banks.

The group-wise analysis shows that all except foreign banks experienced a decline during the quarter. In fact, the growth of Rs3 billion (1 percent) in deposits of foreign banks was too insignificant to outweigh the fall caused by other groups. In this respect, the role of public sector commercial banks was conspicuous as they registered a decline of Rs40.2 billion (6.9 percent). The largest bank in the group was mainly responsible for this noticeable fall as the decline in its deposits accounted for 95.2 percent and 93.3 percent of the fall in deposits of the banking system and PSCBs respectively. Because of the significant decline in deposits of PSCBs, the share of LPBs increased further in total deposits of the banking system despite the fact that later also saw a slight decline in their deposits during the quarter (see **Figure 2.5**). The share of FBs also increased as a result of their growth during the quarter. On the other hand, the share of PSCBs displayed a visible decline while that of specialized banks (SBs) remained almost at the previous quarter's level.

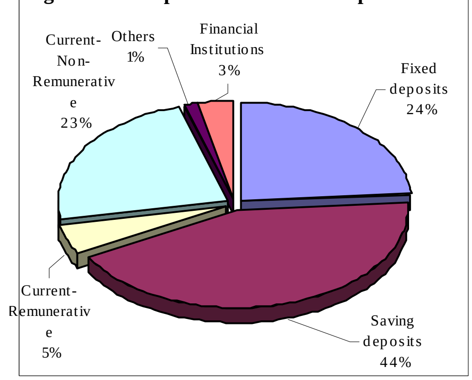
Figure-2.5: Group-wise Share in Deposits



	CY00	CY01	CY02	CY03	CY04	Jun-05	Sep-05
PSCBs	55.5	53.9	43.0	40.7	22.8	22.1	20.9
LPBs	29.4	30.8	45.1	48.5	67	68.4	69.4
FBs	14.0	14.1	10.9	9.9	9.5	9.0	9.2
SBs	1.2	1.2	1.0	0.9	0.7	0.5	0.5

A gradual but slow increase in return on deposits is also impacting the deposits structure of the banking system. This is evident by persistent increase in fixed deposits. With an increase of Rs59.4 billion during the quarter, their share in total deposits increased to 24 percent from 21.4 percent in the previous quarter (see **Figure 2.6**). Compared with their share of 18.5 percent in 2004, this growth is quite significant. With the increasing opportunity cost, saving deposits and non-remunerative current deposits have also started to show a downward movement. An outflow of Rs87.3 billion and Rs51.7 billion in saving deposits and non-remunerative current deposits respectively was too large for the increase in fixed deposits to prevent decline in total deposits of the system.

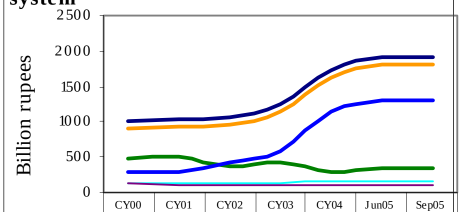
Figure-2.6: Deposits Structure- Sep-05



The low demand for credit in the current quarter also had its impact on the **borrowings** of the banking system, which reduced by Rs10.2 billion. All the groups, except PSCBs, reduced their demand for borrowing, apparently because of sluggish business activity. However, repo borrowings continued to increase by another Rs3.7 billion, but reduction of Rs9.2 billion in borrowing from SBP under export refinance scheme was more than enough to offset this increase. The reduction in borrowing under export refinance might be the necessary corollary of increase in export refinance rate in recent quarters.

Corresponding to the seasonal slackness in industrial activities, the growth in ***loan*** portfolio of the banking system displayed slow-down during this quarter. It grew by Rs22.4 billion or 1.2 percent, which is substantially below the strong growth patterns witnessed in the preceding quarters (see **Figure 2.7**). In addition to the seasonal factors, the gradual rise in interest rates as well as decline in funds inflow into the banking system, which reduces the liquidity, also explain the far lower growth in the current quarter.

Figure-2.7: Total Loans of the Banking system



	CY00	CY01	CY02	CY03	CY04	Jun05	Sep05
PSCBs	476	501	374	422	302	338	339
LPBs	282	281	435	597	1156	1296	1311
FBs	138	143	135	125	162	161	165
CBs	896	926	945	1143	1620	1795	1816
SBs	124	118	117	97	99	107	109
All	1020	1044	1062	1241	1719	1903	1925

Since corporate sector is the major user of bank loans, any variation in its demand invariably impacts the overall loan behaviour of the banking system. This is confirmed by the far lower credit intake of Rs6.9 billion by this sector in this quarter, eventually contributing to relatively sluggish growth of the total loans portfolio. This increase in loans is about four times lower than that experienced by this sector in the corresponding quarter of the previous year. This is apparent in the Figure 2.7, which shows loan demand taking a steep curve during CY04 while for the current year the curve gets flatter showing a marked slow-down in loan absorption.

The slow-down in loans might have been even more pronounced, had they not been propped up by the consumer finance sector (see **Table 2.1**). The consumer loans recorded an increase of Rs27.3 billion which, though slightly lower than the growth of Rs29 billion in the last quarter, is almost the same in the corresponding quarter of the previous year. It shows the growing attractiveness of this type of financing for banks as it is not only keeping afloat the demand for their loans but is also yielding rich dividends in the form of higher incomes.

Table 2.1 Sector-wise Break Up of Loans (Domestic Operations)*

(Billion Rupees)	Sep-04		Jun-05		Sep-05	
	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)
Corporate Sector	**768.0**	**54.4**	**944.0**	**52.3**	**950.9**	**52.1**
Fixed Investments	339.5	24.1	369.2	20.5	375.1	20.5
Working Capital	267.9	19.0	385.4	21.4	387.6	21.2
Trade Finance #	160.6	11.4	189.3	10.5	188.2	10.3
SMEs	**240.6**	**17.0**	**313.6**	**17.4**	**313.9**	**17.2**
Fixed Investments	21.2	1.5	31.7	1.8	33.1	1.8
Working Capital	161.8	11.5	224.0	12.4	221.5	12.1
Trade Finance #	57.5	4.1	57.8	3.2	59.3	3.2
Agriculture production	**117.8**	**8.3**	**131.5**	**7.3**	**140.6**	**7.7**
Consumer Finance	**130.6**	**9.3**	**206.1**	**11.4**	**233.3**	**12.8**
Credit Cards	12.7	0.9	19.3	1.1	23.6	1.3
Auto Loans	41.6	2.9	66.0	3.7	75.3	4.1
Consumer Durables	1.8	0.1	1.6	0.1	2.1	0.1
Housing Loans	12.4	0.9	27.1	1.5	31.4	1.7
Personal Loans	62.1	4.4	92.0	5.1	101.0	5.5
Commodity Operations	**85.0**	**6.0**	**140.3**	**7.8**	**114.0**	**6.2**
Staff Loans	**40.0**	**2.8**	**40.5**	**2.2**	**41.0**	**2.2**
of which Housing Loans	28.3	2.0	28.8	1.6	29.3	1.6
Other	**29.5**	**2.1**	**28.0**	**1.6**	**31.7**	**1.7**
Total	**1,411.4**	**100**	**1,803.9**	**100**	**1,825.4**	**100**

* Loans to both Public and Private sectors

Also include Export Finance

Due to its persistent growth, the share of consumer financing in the total loans portfolio of the banking system increased further to 12.8 percent as compared to 9.3 percent in the same period last year.

The break-up of consumer financing shows the highest growth in auto loans followed by personal loans during the quarter. However, in terms of their respective shares in the outstanding consumer finance, personal loans with 43.3 percent make up the highest proportion followed by auto loans at 32.3 percent, mortgage loans at 13.4 percent, credit cards at 10.1 percent and the rest by loans for consumer durables.

Owing to the growing credit outreach of banks, the agriculture sector, with an increase of Rs9.1 billion, also continued to display buoyancy. Consequently, its share in total loans also increased to 7.7 percent from 7.3 percent in the previous quarter. As against the healthy growth during the previous quarter, the SMEs sector, on the other hand, experienced only a fractional increase in this quarter. This also led to a marginal fall in its share to 17.2 percent from 17.4 percent in the preceding quarter. However, in terms of overall exposure of banks, the SMEs sector continues to hold the second position after the corporate sector, which claims the lion's share of 52.1 percent. The lending to SMEs is expected to pickup in the coming quarters with the expected upturn of the economic activities and the bank's increasing focus in this area of lending.

Figure-2.8: End-Use Distribution of Bank Loans - Sep-04

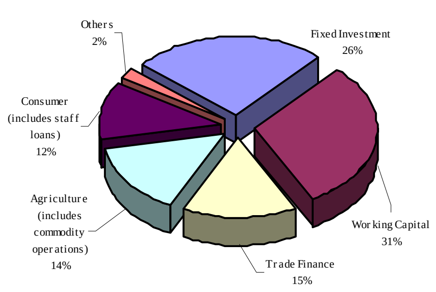
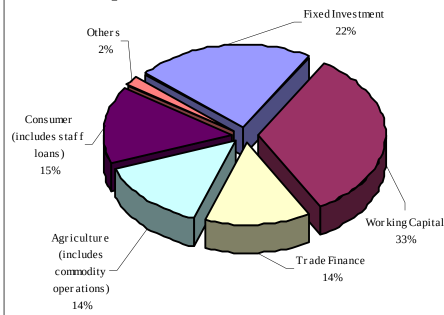


Figure-2.9: End-Use Distribution of Bank Loans - Sep-05



The effect of change in dynamics of overall loans growth over the last year is also visible on their end-use distribution (see **Figure 2.8 & 2.9**). Though the quarterly results show only a little change over the previous quarter, a comparison with the position in the same period last year reveals a decline in the share of loans for fixed investment. On the other hand, the share of consumer finance registered an impressive increase in its share over the same period.

Table-2.2 : Sector-wise number of Borrowers

	Dec-02	Dec-03	Dec-04	Jun-05	Sep-05
Corporate Sector	14,256	17,743	19,333	19,399	21,033
SME Sector	67,520	91,663	106,248	160,977	161,325
Agricultuer	1,339,961	1,411,508	1,503,827	1,572,202	1,708,762
Consumer Finance	252,156	721,201	1,619,207	1,992,912	2,210,081
Commodity Operation	1,458	2,069	3,207	5,945	5,834
Staff Loans	72,570	69,796	72,633	73,317	71,683
Others	56,683	63,696	73,735	58,200	47,524
Total	**1,804,604**	**2,377,676**	**3,398,190**	**3,882,952**	**4,226,242**

Domestic operations covering both public and private sector borrowers

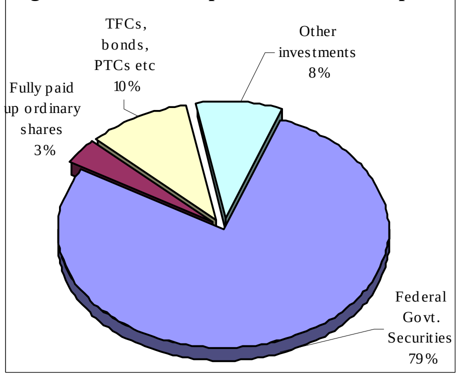
Despite the slow down in loans growth, the borrower-base of the banking system continues to depict healthy growth (see **Table 2.2**). The growth in this quarter exceeded that recorded in the previous quarter. Once again, the most significant contribution came from consumer finance sector, which accounted for around 65 percent of the increase in total number of borrowers. The rate of increase in the number of borrowers in agriculture sector was also quite substantial in this quarter depicting growing interest of banks towards this vital sector of the economy.

The decline in funds inflow into the banking system also had a visible impact on the **investment** portfolio of the banking system. Total investments dropped to Rs777.9 billion from Rs811 billion in the previous quarter. Since, federal government securities constitute an overwhelming share of total investments (see

Figure 2.10), any movement in their portfolio invariably wields a significant influence on total investments of the banking system. Exactly the same happened during this quarter as banks' holding of these securities decreased by Rs42.1 billion against an increase of Rs80.3 billion in the previous quarter.

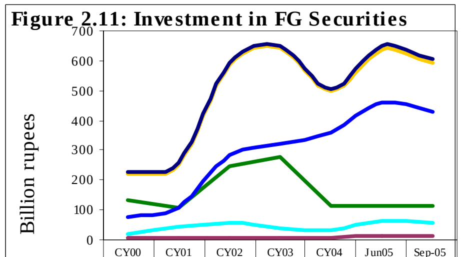
The break-up of government securities shows that it was the decline of Rs33.5 billion in MTBs, which mainly accounted for the reduction in government securities. Consequently, their share in government securities also decreased slightly. With no new auction of PIBs, investment in these securities decreased by another Rs6.4 billion during the quarter. The bullish trend of the stock markets also attracted banks' attention as investment in shares, TFCs/ bonds, etc increased by Rs7.3 billion.

Figure-2.10: Breakup of Investments Sep-05



The group-wise analysis identifies LPBs and FBs as mainly responsible for the fall in investments in government securities during the quarter (see **Figure 2.11**). LPBs accounted for 79.2 percent of the decrease in government securities while FBs and PSCBs brought about the rest. However, PSCBs saw only an inconsequential decline. SBs were the only group to register an increase of Rs1 billion in their investment in government securities.

Figure 2.11: Investment in FG Securities



	CY00	CY01	CY02	CY03	CY04	Jun05	Sep-05
PSCBs	130	106	246	280	111	114	114
LPBs	73	108	285	323	361	459	426
FBs	20	41	55	41	29	65	55
CBs	223	255	586	644	501	638	595
SBs	6	4	5	5	6	11	12
All	229	260	591	650	508	650	607

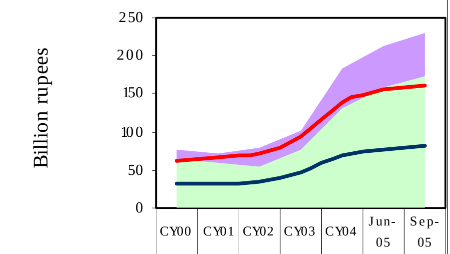
LPBs also hold the largest chunk i.e. 70.1 percent of the system's investment in government securities followed by PSCBs of 18.7 percent, FBs of 9.2 percent and SBs of the rest. The risk preference as to the composition of investment portfolio varies widely across the groups: FBs hold 96 percent of their total investment in government securities followed by SBs, 90 percent LPBs, 80 percent and PSCBs, 65 percent.

3. Financial Soundness of the Banking system

3.1 Solvency

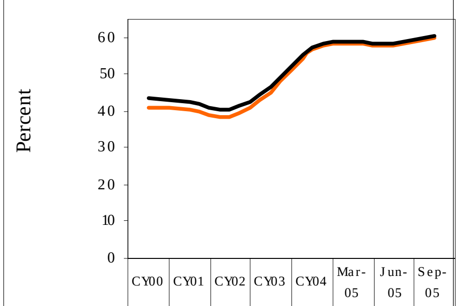
The solvency position of the banking system further improved during the period under review. Strong profitability provided the major support for the continued rising trend in the key solvency indicators. Besides, increase in sub-ordinated debt and revaluation surplus on shares strengthened the supplementary capital also. Banks, however, continued relying mainly on the core capital, which represents around 75 percent of the overall qualifying capital. Further, the core capital alone comfortably met the overall required capital (See **Figure-3.1.1**).

Figure-3.1.1: Risk based capital position



	CY00	CY01	CY02	CY03	CY04	Jun-05	Sep-05
Suppl. Capital	11.3	12.0	23.5	23.3	50.8	55.2	58.5
Core Capital	65.1	60.5	55.2	77.0	131.7	157.3	172.3
Required Tier I	31.5	33.1	35.9	47.3	69.6	77.8	81.0
Required Total	63.1	66.2	71.8	94.7	139.3	155.7	161.9

Fig-3.1.2: RWA to Total Assets



	CY00	CY01	CY02	CY03	CY04	Mar-05	Jun-05	Sep-05
CBs	41.2	40.5	38.6	45.1	56.7	58.3	57.8	60.0
All Banks	43.6	42.6	40.3	46.5	57.3	58.8	58.1	60.3

Despite slow down in asset growth during the quarter, risk weighted assets went up by Rs86 billion to Rs2,032 billion. This happened because of change in asset-mix towards assets attracting high risk weight under Basel Accord. Resultantly, the risk weighted assets as a percentage of total assets inched up to 60.3 percent from 58.1 percent during the quarter (see **Figure-3.1.2**).

Nonetheless, relatively stronger growth in the risk-based capital as compared to risk weighted assets led to further amelioration in the solvency indicators of the banking system (see **Table-3.1.1**). The overall capital adequacy ratio of the banking sector inched up to 11.4 percent from 10.9 percent in the previous quarter. The other two ratios i.e. tier 1 capital to RWAs and capital to total assets also improved appreciably, reflecting a well capitalized position of the banking system[2]. Moreover, the potential risk from the uncovered portion of NPLs to the solvency of the banking system is also reducing. This is manifested by continuous

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

improvement in the adjusted capital to total assets[3] ratio, which rose to 5.7 percent from 5.0 percent over the last quarter. The improvement in the ratio is on account of both reduction in the level of net NPLs and strengthening of capital base.

Table 3.1.1 Capital Adequacy Indicators

(Percent)	CY00	CY01	CY02	CY03	CY04	Mar-05	Jun-05	Sep-05
CAR								
PSCBs	10.4	9.6	12.3	11.0	13.4	14.4	14.1	16.0
LPBs	9.2	9.5	9.7	9.0	10.1	10.4	10.8	11.2
FBs	18.0	18.6	23.2	23.0	17.4	17.2	15.0	14.7
Comm. Banks	11.4	11.3	12.6	11.1	11.4	11.8	11.8	12.3
SBs	(3.3)	(13.9)	(31.7)	(28.2)	(9.0)	(14.4)	(10.2)	(13.2)
All banks	9.7	8.8	8.8	8.5	10.5	10.7	10.9	11.4
Tier 1 Capital to RWA								
PSCBs	7.7	7.1	8.6	8.2	8.6	9.2	9.3	11.0
LPBs	8.1	8.4	6.6	7.1	7.5	7.8	8.3	8.6
FBs	17.9	18.6	23.0	23.0	17.1	16.8	14.5	14.2
Comm. Banks	9.8	9.7	9.7	9.1	8.6	8.9	9.1	9.6
SBs	(3.4)	(13.9)	(31.7)	(28.7)	(15.0)	(20.2)	(16.3)	(19.3)
All banks	8.3	7.3	6.2	6.5	7.6	7.7	8.1	8.5
Capital to Total Assets								
PSCBs	4.6	3.7	5.6	6.1	8.2	9.3	8.8	9.7
LPBs	3.5	3.8	5.2	5.1	6.5	6.6	6.6	7.0
FBs	8.8	8.5	10.6	10.0	9.0	8.9	7.7	8.2
Comm. Banks	4.9	4.6	6.1	6.0	7.1	7.4	7.2	7.7
SBs	(1.1)	(10.3)	(23.0)	(9.5)	(11.3)	(13.5)	(9.2)	(11.7)
All banks	4.6	3.8	4.8	5.4	6.5	6.7	6.6	7.1
Capital (Free of net NPLs) to Total Assets								
PSCBs	(1.1)	(2.2)	0.9	3.1	6.8	7.7	7.6	8.7
LPBs	(1.9)	(1.0)	2.4	3.2	4.9	5.2	5.4	5.8
FBs	8.0	8.0	10.1	9.6	9.0	9.0	7.9	8.5
Comm. Banks	0.2	(0.0)	2.8	3.9	5.8	6.1	6.1	6.7
SBs	(25.5)	(34.4)	(44.5)	(30.9)	(27.6)	(24.3)	(26.4)	(24.9)
All banks	(1.4)	(1.9)	0.7	2.5	4.6	5.2	5.0	5.7

The group wise position reflects that all the groups barring SBs recorded improvement in their key solvency indicators. Foreign banks showed mixed picture. The deterioration in the solvency indicators of SBs is due to the loss suffered by one of them, while the capital adequacy and tier 1 capital to RWA ratio of foreign banks reduced due to relatively higher growth of their risk weighted assets as compared to risk based capital. PSCB, which recorded the highest improvement during the quarter, left behind the foreign banks in almost all the key solvency indicators.

Table 3.1.2 Capital Adequacy Indicators of Top Banks in terms of Size

(Percent)	Capital / RWA		Tier 1 Capital / RWA		Net worth / Total Assets	
	Jun-05	Sep-05	Jun-05	Sep-05	Jun-05	Sep-05
Top 5	10.9	12.0	7.4	8.5	6.6	7.4
Top 10	11.0	12.0	7.9	8.7	6.6	7.3
Top 20	11.6	12.1	8.6	9.1	6.9	7.4

The dispersion analysis of the top 5, 10 and 20 banks that are important for the stability of the system shows that top 5 banks showed the greatest improvement during the quarter. The performance of the next tiers i.e. top 6 to 10 and 11 to 20 banks was not that pronounced, however, all the tiers maintain a comfortable solvency indicators (see **Table 3.1.2**)

Table 3.1.3 Distribution of Banks by CAR

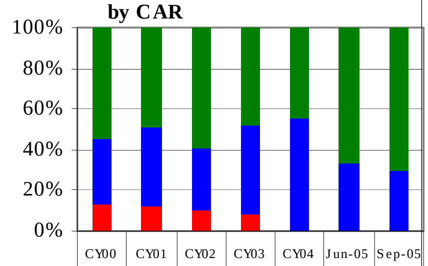
	Total	Below 8%	8 to 10 %	10 to 15 %	Over 15 %
CY00	44	5	6	16	17
CY01	43	5	5	11	22
CY02	40	4	4	9	23
CY03	40	4	10	5	21
CY04	38	1	13	9	15
Jun-05	39	1	8	15	15
Sep-05	39	1	8	14	16

On individual basis, further improvement has been observed in the solvency indicators of banks. Though there is no change in the number of well-capitalized banks (see **Table-3.1.3**), the

[3] Balance sheet capital less net non-performing loans to total assets

recent enhancement in regulatory requirements is expected to move more banks into the well-capitalized category. Moreover, improvement in the market share of banks having CAR 10 percent and above provides further strength to the stability of the banking system (see **Figure-3.1.3**).

Figure-3.1.3: Bank's Market Share by CAR



	CY00	CY01	CY02	CY03	CY04	Jun-05	Sep-05
10%&Above	55	49	59	48	45	67	70
8%- 10%	32	39	31	44	55	33	30
Below 8%	13	12	10	8	0	0	0

Though the banks are making strong profits and continuously improving their solvency position, the risks, which they are facing, are also on the rise. To further fortify the stability of the banking system, SBP has recently enhanced the minimum capital requirement from Rs2 billion to Rs6 billion to be achieved in a phased manner. By the year it also shifted from the uniform capital adequacy ratio to a variable one based on rating of banks under IRAF. These developments are likely to have a significant effect on the overall solvency of the banking system by strengthening its capital base and inculcating a sound culture of risk assessment and management among the banks.

3.2 Profitability

The banking system, on the back of higher economic activity, shift in the asset-mix towards high yielding assets and increasing spread because of gradual rise in interest rates, continued to record strong profits. The year-to-date profits reached Rs40.6 billion, surpassing the full year level of Rs32.9 billion for CY04 (see **Table 3.2.1)**. This also led to further improvement in return on assets and equity from 1.4 percent and 22.1 percent to 1.7 and 25.2 percent respectively (see **Table 3.2.2**)

Table-3.2.1: Profitability of Banking System

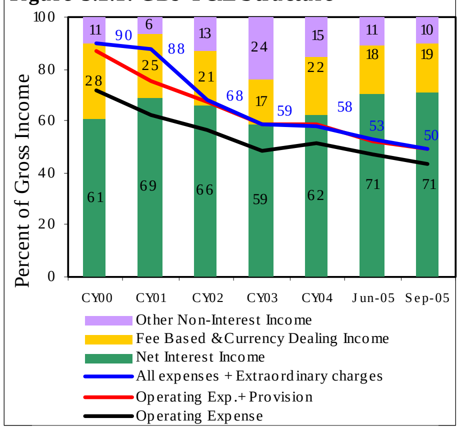
(Billion Rs)	CY00	CY01	CY02	CY03	CY04	Jun-05	Sep-05
Profit before tax							
PSCBs	3.9	0.2	10.9	16.1	14.3	8.7	16.2
LPBs	(0.6)	5.0	11.9	23.8	30.7	25.2	42.3
FBs	3.7	5.0	6.6	7.4	7.2	4.2	7.6
CBs	7.0	10.3	29.4	47.4	52.1	38.1	66.2
SBs	(2.5)	(9.2)	(10.4)	(3.3)	(2.6)	(2.0)	(3.5)
All Banks	4.5	1.1	19.0	44.1	49.6	36.1	62.8
Profit after tax							
PSCBs	1.8	(4.6)	4.8	9.4	8.0	5.2	11.1
LPBs	(3.5)	2.0	6.4	14.8	21.7	16.9	28.0
FBs	1.4	2.4	4.2	4.6	5.8	2.8	5.1
CBs	(0.2)	(0.2)	15.3	28.7	35.5	25.0	44.2
SBs	(2.6)	(9.5)	(12.4)	(3.7)	(2.6)	(2.1)	(3.6)
All Banks	(2.8)	(9.8)	2.9	25.1	32.9	22.8	40.6

The commercial banks that hold 97 percent of the banking system's market share have been showing a consistent improvement in their earning ability. They have come a long way since CY01 when they were in loss. Their consolidated income statement for Sep-05 quarter shows the overall strengthening that they have achieved over these years: all expenses and provision charges are contained to 50 percent of the gross income, which mainly comprise core and recurring incomes (**see Figure-3.2.1**).

Table-3.2.2: Profitability Indicators

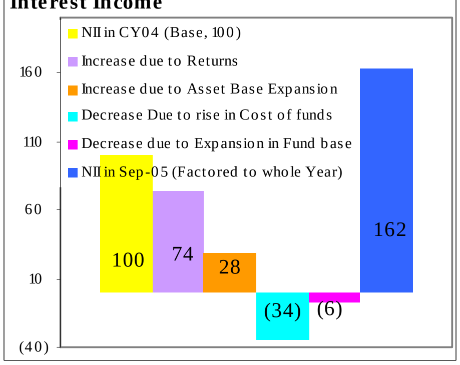
(Percent)	CY00	CY01	CY02	CY03	CY04	Jun-05	Sep-05
After Tax ROA							
PSCBs	0.2	(0.5)	0.6	1.0	1.3	1.6	2.2
LPBs	(0.7)	0.4	0.8	1.4	1.2	1.6	1.8
FBs	0.6	0.8	1.5	1.5	2.0	1.8	2.1
CBs	(0.0)	(0.0)	0.8	1.2	1.3	1.6	1.9
SBs	(2.3)	(8.8)	(12.1)	(3.2)	(2.6)	(3.7)	(4.9)
All Banks	(0.2)	(0.5)	0.1	1.1	1.2	1.4	1.7
After Tax ROE *(based on Equity plus Surplus on Revaluation)*							
PSCBs	4.9	(12.2)	11.5	17.3	18.0	19.1	25.7
LPBs	(17.4)	10.3	17.3	26.2	20.1	24.8	26.3
FBs	6.1	9.1	15.2	14.9	21.7	20.8	25.3
CBs	(0.3)	(0.3)	14.3	20.5	19.8	22.9	26.0
SBs	-	-	-	-	-	-	-
All Banks	(3.5)	(12.6)	3.2	20.5	19.5	22.1	25.2

Figure-3.2.1: CBs' P&L Structure



The strong credit growth over the last many quarters coupled with gradual rise in interest rates made the asset-mix of the banking system high yielding. The lending rates, in line with SBP's monetary drive to contain the inflationary pressures, are following a gradual rising pattern since the last quarter of CY04. Since then, weighted average lending and deposits rates have significantly inched up. As the growth in lending rates have been more pronounced than in deposit rates, the spread between the both has expanded to 7.2 percent from 6.6 percent in Jun-05 and 5.3 percent in Sep-04. This coupled with increasing return on government papers led to significant rise in the interest income of banks. The year-to-date interest income of commercial banks represents around 128 percent of the last full year's interest income. Though the rising interest rates pushed up the cost of funds also, it increased at a relatively slower pace. As a result, the year-to-date net interest income of Rs93.4

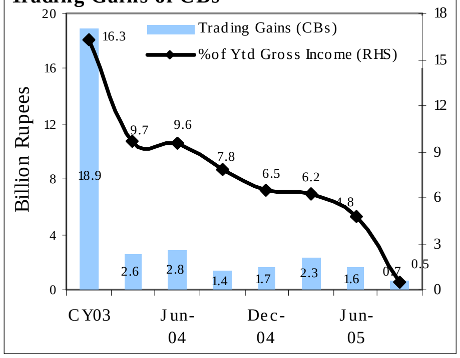
Figure-3.2.2: Sources of Expansion in Net Interest Income



billion exceeded the last year's figure of Rs76.7 billion. **Figure 3.2.2** shows the sources of rise in net interest income over the last year.

The expansion in the net interest income of CBs is well reflected in its improved share in gross income. Besides strengthening of net interest income, the major reason for the declining share of non-interest income was lower gains in gains on sale of securities. These gains contributed less than 1 percent in the year-to-date gross income as compared to 6.5 percent last year and 16.3 percent in CY03 (see **Figure-3.2.3**). The other non-interest incomes like fee and commission and currency dealing income, however, further strengthened on the back of healthy business activity and higher foreign trade. The dividend income of banks also registered strong growth because of the improved performance of corporate sector. All this also led to change in the composition of non-interest income from non-recurring to core and recurring incomes.

Figure-3.2.3: Periodic Growth in Trading Gains of CBs



The commercial banks have been following a growth strategy. Over the last couple of years their branch network as well as the human and technical resources have witnessed a significant expansion. Accordingly, their administration expense grew at faster pace over these years. However, even stronger growth in earnings resulting from expanded volume of business far outweighs the growth in expenses – a phenomenon that is well reflected in consistently falling cost income ratio. During the quarter banks have been quite successful in containing these expenses, which showed only a patterned growth over the last quarter's level. And due to strengthened gross incomes the cost income ratio improved to 43.5 percent from 47.2 percent in last quarter. Year-to-date provisions for loan losses though are in line with last year levels i.e. 6 percent of gross income, the recent strengthening of provisioning requirements by SBP are likely to burden the provision expense bill by the end of outgoing quarter.

Group-wise, the PSCBs for the first time took the lead as ROA inched up to 2.2 percent, followed by FBs and LPBs with ROA of 2.1 and 1.8 percent, respectively. The SBs, mainly due to high provision and administrative expenses, remained in red.

The banking system is all set to achieve all times high results by the end of this year. However, there is caveat to this otherwise favourable outlook. That is, in line with a general up tick in the economic activity in the country, the banks' exposure to credit risk has increased significantly. So far they have been able to contain the risk quite efficiently, however, the need for a cushion in the form of provision for loan losses to counter anyslow down in economic activity cannot be over emphasized. SBP's recent move to make the loan loss provision requirements stricter in these relatively more profitable and easy times would help in addressing the concern.

4. Risk Assessment of the Banking System

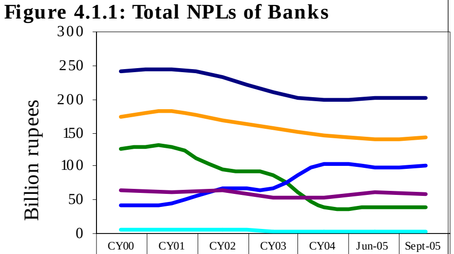
4.1 Credit Risk

The quarter under review depicted a mixed picture on credit risk front. Despite the fact that total non-performing loans (NPLs) of the banking system declined by Rs0.2 billion, commercial banks (CBs) which account for around 97 percent of the banking system's assets, experienced an increase of Rs2.1 billion in their NPLs (see **Figure 4.1.1**). However, this increase was mainly due to increase in the NPLs of one weak bank.

The net NPLs, however, continued the declining trend not only for all banks but more importantly for commercial banks also (see **Figure 4.1.2**). During the quarter under review, the banking system as a whole recorded further reduction of Rs5.3 billion in its net NPLs, while commercial banks reduced their net NPLs by Rs0.6 billion, because banks continued making provision against their infected loan portfolio.

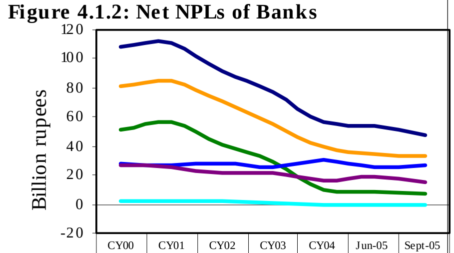
The key indicators also show improvement for all banks. The ratio of NPLs to loans decreased for all banks while for commercial banks it remained unchanged as the impact of increase in their NPLs was neutralized by simultaneous rise in loans (see **Figure 4.1.3**). However, the ratio of net NPLs to net loans shows improvement not only for all banks but also for commercial banks

Figure 4.1.1: Total NPLs of Banks



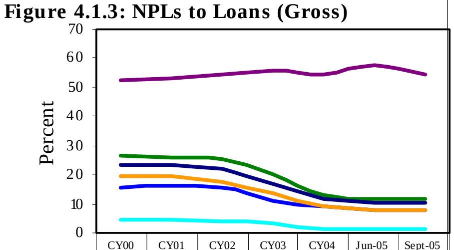
	CY00	CY01	CY02	CY03	CY04	Jun-05	Sept-05
PSCBs	125.2	129.6	95.5	85.9	40.1	39.8	39.5
LPBs	43.4	45.7	66.9	67.4	103.4	97.3	99.7
FBs	6.5	6.1	5.2	4.0	2.5	2.4	2.4
CBs	175.1	181.4	167.6	157.2	146.1	139.5	141.6
SBs	65.0	62.7	63.9	54.1	53.7	61.9	59.6
All	240.1	244.1	231.5	211.3	199.8	201.4	201.2

Figure 4.1.2: Net NPLs of Banks



	CY00	CY01	CY02	CY03	CY04	Jun-05	Sept-05
PSCBs	51.1	56.2	41.0	29.4	9.2	8.5	7.5
LPBs	27.4	27.2	27.7	25.1	30.8	25.8	26.5
FBs	2.2	1.6	1.4	0.9	(0.0)	(0.4)	-0.7
CBs	80.8	85.0	70.1	55.4	40.0	33.9	33.3
SBs	27.2	25.6	21.2	21.2	16.8	19.4	14.6
All	108.0	110.5	91.3	76.7	56.8	53.2	47.9

Figure 4.1.3: NPLs to Loans (Gross)

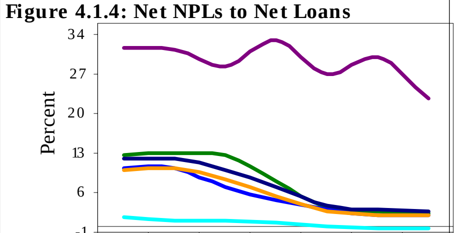


	CY00	CY01	CY02	CY03	CY04	Jun-05	Sept-05
PSCBs	26.3	25.9	25.5	20.4	13.3	11.8	11.7
LPBs	15.4	16.3	15.4	11.3	9.0	7.5	7.6
FBs	4.7	4.3	3.8	3.1	1.6	1.5	1.4
CBs	19.5	19.6	17.7	13.7	9.0	7.8	7.8
SBs	52.4	53.0	54.7	55.6	54.1	57.7	54.5
All	23.5	23.4	21.8	17.0	11.6	10.6	10.5

(see **Figure 4.1.4**). Again this owes primarily to the greater provisions against NPLs. This is shown by the persistently improving coverage ratios (see **Figure 4.1.5**).

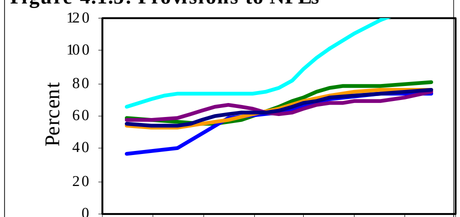
Group-wise analysis shows that LPBs witnessed rise in their NPLs by Rs 2.4

Figure 4.1.4: Net NPLs to Net Loans



	CY00	CY01	CY02	CY03	CY04	Jun-05	Sept-05
PSCBs	12.7	13.1	12.8	8.1	3.4	2.8	2.4
LPBs	10.3	10.4	7.0	4.5	2.8	2.1	2.1
FBs	1.7	1.1	1.1	0.7	(0.0)	(0.3)	(0.4)
CBs	10.1	10.3	8.3	5.3	2.6	2.0	1.9
SBs	31.6	31.5	28.5	33.0	27.0	29.9	22.6
All	12.2	12.1	9.9	6.9	3.6	3.0	2.7

Figure 4.1.5: Provisions to NPLs



	CY00	CY01	CY02	CY03	CY04	Jun-05	Sept-05
PSCBs	59.2	56.6	57.1	65.8	77.0	78.5	81.1
LPBs	36.9	40.5	58.6	62.7	70.2	73.5	73.4
FBs	65.9	74.1	73.3	77.4	101.9	118.6	129.5
CBs	53.9	53.2	58.2	64.7	72.7	75.7	76.5
SBs	58.1	59.2	66.9	60.8	68.6	68.7	75.6
All	55.0	54.7	60.6	63.7	71.6	73.6	76.2

billion over the last quarter. As earlier mentioned, this is largely attributable to surge in the NPLs of one weak bank of this group. That bank accounted for around 89 percent of the total increase. Factoring out that bank, the rise in NPLs of this group reduced to just Rs0.3 billion. However, the systemic significance of that bank is very low, as it constitutes only a negligible fraction of the entire system.

The key indicators i.e. NPLs to loans and net NPLs to net loans ratios of LPBs, almost remained flat over the quarter. NPLs to loans ratio deteriorated marginally to 7.6 percent from 7.5 percent in the previous quarter while net NPLs to net loans ratio remained static at 2.1 percent. It shows that LPBs, to some extent, have offset the impact of increase in NPLs by making concomitant provision against them.

All the remaining groups recorded decrease in their NPLs during the quarter. SBs were the front-runner followed by PSCBs and FBs. The key ratios for these groups also show improvement. SBs despite experiencing relatively more improvement continue to carry a large burden of NPLs. SBs' share in total NPLs of the banking system at around 30 percent is highly disproportionate to their relative size of the system. The share of PSCBs in total NPLs, on account of persistent reduction in their NPLs, has been falling over the last many quarters.

The segment-wise analysis shows that agriculture sector witnessed substantial improvement in its NPLs, which had a salutary impact upon its NPLs to loans ratio (see **Table 4.1**). The main reason for this conspicuous improvement is the substantial reduction made by one of the specialized banks in its NPLs. On the contrary, the share of corporate sector in total NPLs increased to 46.6 percent from 46.1 percent in the previous quarter because of an increase of Rs0.9 billion in its NPLs. However, healthy growth in loans prevented what other wise might have been greater deterioration. The SMEs sector also saw a slight deterioration of 0.02 percentage points in its NPLs to loans ratio on account of increase in its NPLs.

Table-4.1 Segmentwise NPLs to Loans Ratios

(Domestic operations) (Percent)

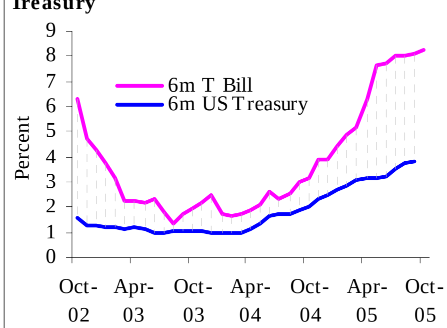
	CBs		SBs		All Banks	
Segment	**Jun-05**	**Sep-05**	**Jun-05**	**Sep-05**	**Jun-05**	**Sep-05**
Corporate	8.5	8.5	98.8	99.0	8.9	8.9
SMEs	9.5	9.7	95	93.7	13.1	13.1
Agriculture	7.8	7.3	52.3	48.5	37.0	33.3
Consumers	0.9	1.0	13.9	13.3	0.9	1.0
Credit Cards	1.4	0.9	0	0.0	1.4	0.9
Auto Loans	0.7	0.9	7.1	18.8	0.7	0.9
Consumer Durables	5.6	4.6	16.5	22.3	6.2	5.2
Mortgage Loans	0.3	0.3	0	0.0	0.3	0.3
Others	1	1.2	0	0.0	1	1.2
Commodity Finance	1.2	1.3	0	0.0	1.2	1.3
Staff Loans	1.5	1.4	0.1	0.0	1.4	1.3
Others	17.2	14.8	6.2	7.6	16.9	15.4
Total	7.1	7.1	57.9	54.5	10.1	10.0

In spite of increase in the NPLs portfolio of commercial banks during the quarter, the banking system so far has succeeded in managing its credit risk reasonably if seen in the backdrop of rapid expansion in loans over the last few quarters. Banks will have to closely adhere to the risk management and credit appraisal and monitoring standards to maintain the high quality of loans, particularly those extended to the emerging sectors. The recently introduced stringent criteria for loans classification and provisioning by SBP might pressurize banks' profits and capital in the short-term, however, it has positive connotations from the long-run credit risk perspective.

4.2 Market Risk

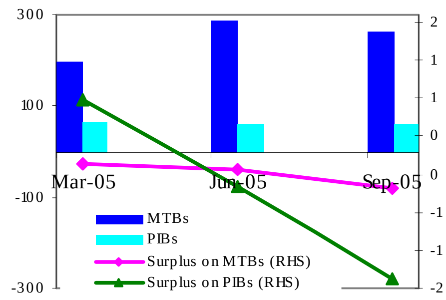
Interest rate risk, being the dominant risk factor among all others, continued to be the sensitive area for this quarter as well. Despite the rising interest rates in US economy, our major trading partner, on the way to bridge the saving-investment gap and to check in the inflationary prospects, the differential between the benchmark US Treasury and T. Bills has been on rise since the beginning of CY-04 **(**see **Figure 4.2.1)**. Though this rise in domestic interest rates was to keep in check the domestic inflationary pressures in the economy, however, it is posing serious challenge to the banks to manage their interest rate risk.

Figure-4.2.1: Differential b/w 6m MTB & US Treasury



This significant rise in the interest rates has heightened **interest rate risk** especially for the banks with large chunk in fixed income securities. The higher *revaluation risk* is reflected in the falling market values of such instruments. Despite the fact that the banks have categorized a major chunk of their risky securities in the held-to-maturity category, which is not required to be marked to market, the revaluation deficits against PIBs portfolio have been increasing (see **Figure 4.2.2)**.

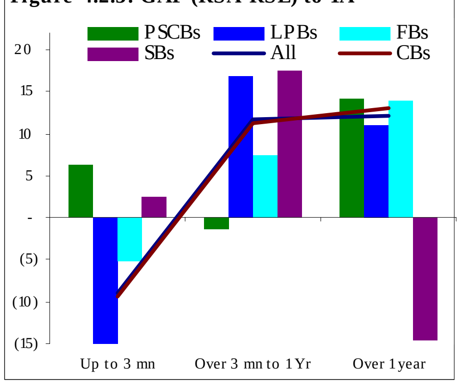
Figure-4.2.2: PIBs* and MTBs* Vs Revaluation Surplus/(Deficit) (Billion Rs.)



**Only those which are subject to mark-to-market*

For the overall balance sheet portfolio, since the effective maturity of all the assets is higher than that of liabilities, every single basis point rise in interest rate adds to the fall in the market value of equity of the banks. This GAP in the effective maturities or duration of all the assets and liabilities is reflected in the repricing GAPs between the rate sensitive assets and rate sensitive liabilities. For all banks, this GAP is negative for the shorter time period of 3-months maturity bucket and significantly high for 1 year or more (see **Figure 4.2.3)**. This negative repricing GAP is quite undesirable especially in the prevalent rising interest rate scenario since the liabilities would have to be repriced at higher rate while the earnings on the assets would remain same thus squeezing the margins for the banks. While at the same time if the assets would need to be repriced as well, they would carry a lesser value. Group-wise, LPBs are more prone to this risk since the GAPs are well above the acceptable level of +/-10 percent of total assets.

Figure-4.2.3: GAP (RSA-RSL) to TA



Since the rise in interest rates has not been equal across all the maturities, *yield curve risk* would be another area of concern. The interest rates for shorter-term maturities have been rising more thus making the yield curve more flattened, hence the spread between 3 year and 10 year benchmark rates has been shrinking *(*see **Figures 4.2.4 & 4.2.5***)*. This may be in response to the lower inflationary expectations for the long term. This present move in the yield curve may provide some comfort to the value of longer-

Figure-4.2.4: Shift in Yield Curve

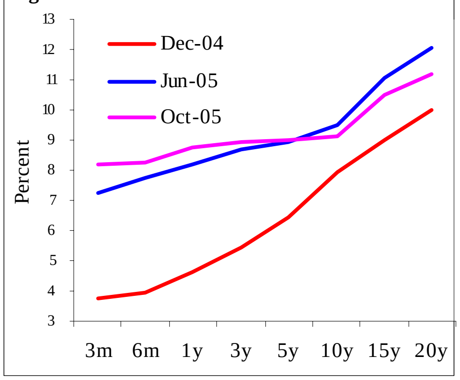
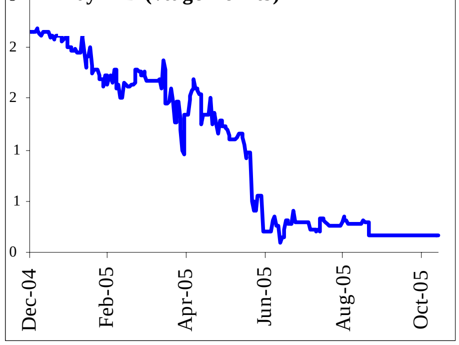


Figure-4.2.5: Yield spread b/w 3y & 10y PIB (%age Points)

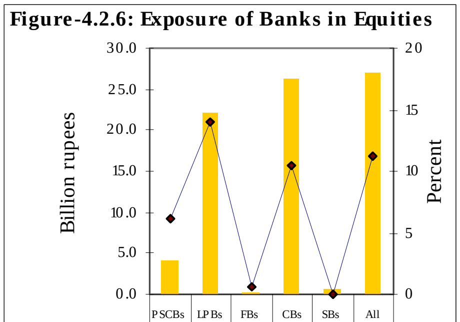


term asset. However, it would become quite risky if the yield curve again gets steeper.

The *exchange rate* against major currencies remained almost stable during the quarter. The rupee dollar exchange rate showed a little volatility and stayed at average of Rs59.80. Though the trade deficit has been rising due to increasing import bills especially for oil payments, the steady inflows of remittances has made up the demand for foreign currency. The net open position (NOP) of the banks stayed within the limits. As for the direct foreign exchange risk, since the banks have net long position in the foreign exchange denominated assets, any depreciation of rupee would add to their value. However, any appreciation of rupee against dollar would be of concern.

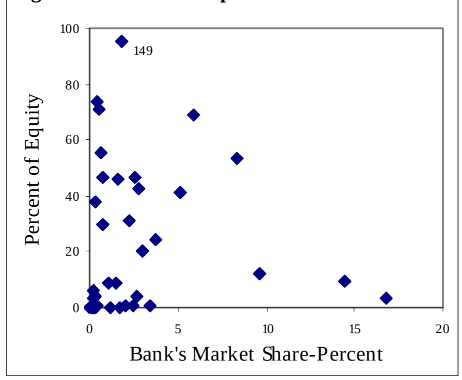
During the Sep-05 quarter, the ***equity price risk*** of the banking system slightly

Figure-4.2.6: Exposure of Banks in Equities



	PSCBs	LPBs	FBs	CBs	SBs	All
Actual Exposure	4.1	22.1	0.2	26.4	0.6	27.0
Exp. to Capital - Percent (RHS)	6.1	14.0	0.7	10.5	0.0	11.3

Figure-4.2.7: Total Exposure of Banks

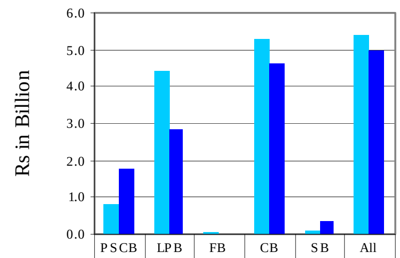


increased. The absolute investments in shares[4] of the banks increased to Rs27.0 billion from Rs24.4 billion in the last quarter (see **Figure 4.2.6**). This increase is also reflected in the overall exposure in terms of capital of the banking sector that rose to 11.3 percent from 11.0 percent in the last quarter. Its share in the total investment, however, remained miniscule at 3.5 percent.

Group-wise, LPBs continued to carry the highest exposure as percentage of their capital, however, for all the groups, equities exposure remained below 15 percent of capital.

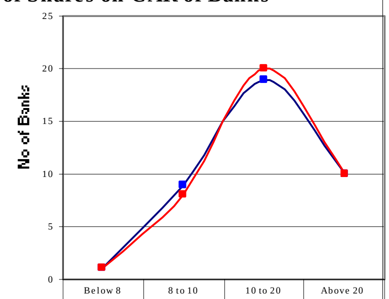
The overall exposure[5] of most of the banks as percentage of their capital remained within reasonable limits. However, a few banks with relatively smaller share in the banking system were carrying high exposures (see **Figure 4.2.7**).

Figure-4.2.8: Impact of Adverse Movement of KSE-100 Index by 20 Percent



	PSCB	LPB	FB	CB	SB	All
Fall in the Value of Shares	0.8	4.4	0.0	5.3	0.1	5.4
Surplus on Shares	1.8	2.9	0.0	4.6	0.4	5.0

Figure-4.2.9: Impact of 20% Fall in Market Value of Shares on CAR of Banks



	Below 8	8 to 10	10 to 20	Above 20
Revised CAR	1	9	19	10
Actual CAR	1	8	20	10

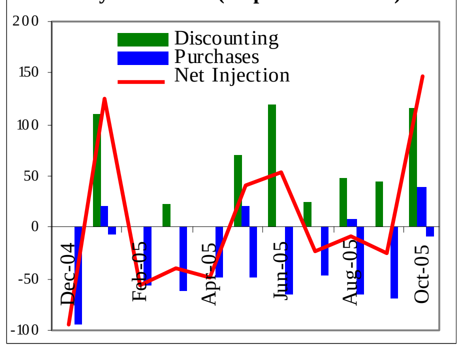
The revaluation of investments in shares shows that 11 banks were carrying deficit against these investments. In a stress testing exercise, it was seen that with a hypothetical fall in the value of shares by 20 percent on Sep-05 position, 13 more banks would have their surplus converted into deficit. Group wise, the surplus available with the LPBs might completely wipe out as a result of this shock (see **Figure 4.2.8**). The impact of this fall in the value of shares on the capital adequacy of the banks reveals that one bank will shift to the lower capital adequacy bracket (see **Figure 4.2.9**).

[4] At market value

[5] Including indirect exposure in continued financing system (CFS), margin financing and other financing to brokers

4.3 Liquidity Risk

Figure-4.3.1: OMOs by SBP Vs Discounting availed by the banks (Rupees in billion)



In response to the inflationary pressures, the central bank continued with its tighter monetary policy, which is reflected in the consistently rising domestic interest rates and frequent liquidity mop ups through OMOs. This has drained a sizeable portion of surplus liquidity available with the banks. Resultantly, the banks had to resort to the SBP discount window quite a few times to have short-term liquidity supports (see **Figure 4.3.1**). Other key liquidity indicators also show tightening of the liquidity position. The liquid assets as percentage of total assets declined to 34.9 percent in Sep-05 from 36.4 percent in Jun-05. Loan to deposit ratio increased to 68.2 percent in Sep-05 from 66.6 percent in Jun-05 (see **Figure 4.3.2**).

The *funding liquidity risk* has become a concern now, since the banks are running negative liquidity cushion in the short term. The liabilities maturing within three months bucket far exceed the assets maturing within the same period (see **Figure 4.3.3**). This negative GAP between the maturity of assets and liabilities in terms of

Figure 4.3.2 Liquidity Indicators

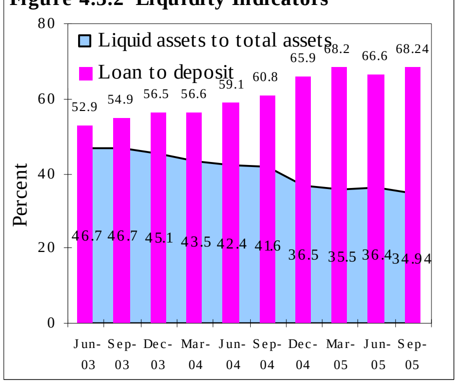
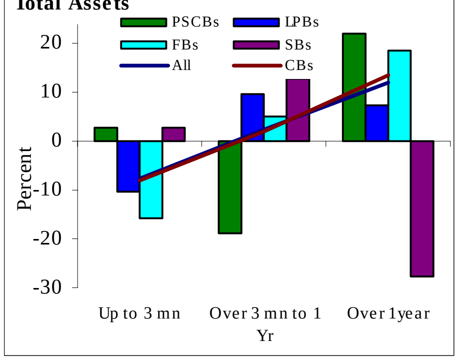
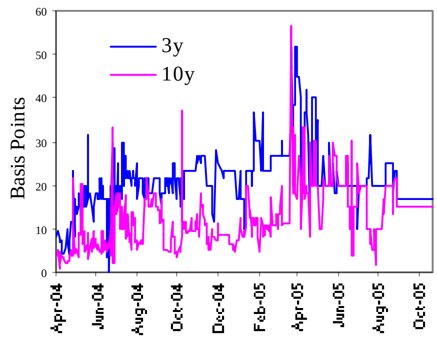


Figure-4.3.3: GAP (Assets - Liabilities) To Total Assets



total assets is on higher side. In such a scenario, when interest rates are rising, the banks would either need to generate the funds at higher costs or would meet the same from their liquid assets. Group wise, the FBs and PSCBs are more prone to this risk. The assets of these banks have longer-term maturities than those of their liabilities. That is why, the banks are experiencing large positive GAPs in the longer term buckets.

Figure-4.3.4: Secondary market bid/ask rate spread of PIBs



This calls for the need of market based liquidity of such longer-term assets. Increasing interest rates, significant holdings of investment in held-to-maturity category have an impact on the secondary market activity. The reduced market based liquidity has been reflected in the higher bid-ask spreads (see **Figure 4.3.4**) in the secondary market, which in turn, creates a liquidity concern for the banks having large exposure in long term assets.

5. Performance of Islamic Banking

The pace of increase in the Islamic banking outreach continued in the September quarter as well. During the quarter under review, the number of full fledged Islamic banks increased to 4 with the licensing of one more Islamic bank viz. Emirates Global Islamic Bank. Resultantly, as of end of September 2005, there were 4 full-fledged Islamic banks[6] and 9 conventional banks licensed to conduct Islamic banking business. In September 05, the branch network of Islamic banking participants increased to 67 as against 62 in June 05. Going further, in the post quarter period, an Islamic banking license was issued[7] to a Dubai-based bank viz. Dubai Islamic Bank Pakistan Limited, which increases the number of licensed Islamic banks to 5.

This expansion in branch network is reflected in the total assets base of Islamic banking which now stands at Rs57 billion after posting a growth of 5.7 percent over the quarter (see **Table 5.1**). However, given the increase in the assets of banking system as a whole, the share of Islamic banking in the overall banking system slightly increased to 1.7 percent from 1.6 percent in the last quarter.

Table-5.1: Sources and Uses of Funds

(Million rupees)	Jun-05		Sep-05	
SOURCES:	Amount	Percent	Amount	Percent
Deposits	37,834.6	70.0	37,662.1	65.9
Borrowings	6,664.5	12.3	7,370.3	12.9
Capital & other funds	6,076.6	11.2	6,452.5	11.3
Other liabilities	3,441.3	6.4	5,635.9	9.9
	54,016.9	**100.0**	**57,120.7**	**100.0**
USES:				
Financing	34,946.0	64.7	39,862.4	69.8
Investments	2,224.8	4.1	2,175.0	3.8
Cash, bank balances, placements	13,325.6	24.7	10,817.0	18.9
Other assets	3,520.5	6.5	4,266.3	7.5
	54,016.9	**100.0**	**57,120.7**	**100.0**

The sources and uses of funds reveal that the deposits and financings continue to dominate the balance sheet of the Islamic banks. The share of deposits though slightly declined to 65.9 percent from 70.0 percent in the last quarter, due to the increase in the share of other respective heads, still remains the highest. On the uses side, the asset composition primarily remained on the previous quarter patterns. The share of financings further increased to 69.8 percent from 64.7 percent

Table-5.2: Key Performance Indicators

	Jun-05	Sep-05
NPFs to total financing	1.0%	1.1%
Net NPFs to net financing	0.3%	0.4%
Provision to NPFs	74.4%	66.0%
Net Markup Income to total assets	2.5%	2.7%
Non Markup Income to total assets	1.5%	1.7%
Operating Expense to Gross Income	58.6%	55.5%
ROA (average assets)	1.1%	1.4%

[6] Meezan Bank Limited and AlBaraka Islamic Bank are fully operating whereas the Bank Islami Pakistan Limited and Emirates Global Islamic Bank Limited have yet to start their operations

[7] Issued on November 26, 2005

in the June quarter. This can be attributed to the increasing demand for the Islamic banking products. However, the increase in financings is also coupled with slightly deteriorated NPLs to loans ratios (see **Table 5.2**). A major chunk of this increase in the non-performing financings (NPFs) however falls in the OAEM category; hence the provisioning against the NPFs did not increase at the same rate. Resultantly, the non-performing financings coverage ratio has reduced to 66.0 percent from 74.4 percent in the last quarter. This, however, calls for vigilance on part of the Islamic banks as the NPLs to loans ratios, though still at a lower level, are on a rising trend over the last few quarters.

Figure-5.1: Breakup of Financings- Sep-05

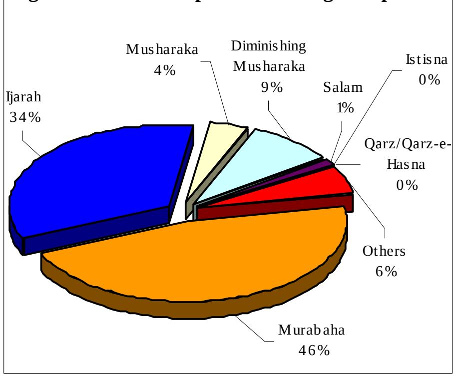
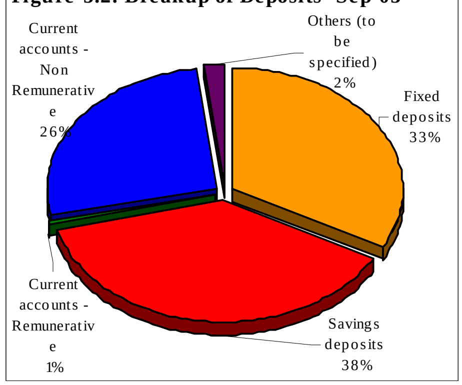
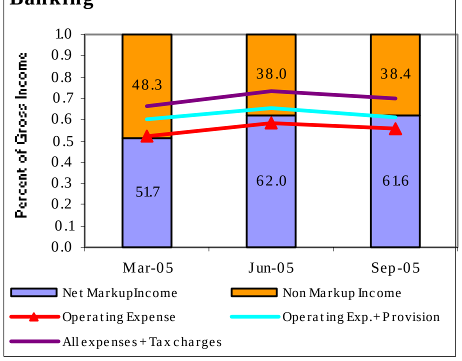


Figure-5.2: Breakup of Deposits- Sep-05



The break-up of financings continued to show the dominance of Murabaha and Ijarah (see **Figure 5.1**). On the deposits side, the savings deposits carry highest share of 38 percent, while the share of fixed deposits and current non-remunerative accounts stands at 33 percent and 26 percent respectively (see **Figure 5.2**).

Figure-5.3: P & L Structure of Islamic Banking



As regards the liquidity position, although the cash and bank balances witnessed some decline due to increase in financings, the Islamic banks are quite comfortable in meeting the liquidity requirements.

During the quarter, despite the increase in the share of financings, the share of mark-up income in the gross earnings slightly came off; however, the major contribution to

Table-5.3: Profit & Loss Statement

(Million rupees)	Jun-05		Sep-05	
	Amount	Percent	Amount	Percent
Markup Income	1,215.3	100.0	2,120.4	100.0
Markup Expense	(546.8)	45.0	(960.2)	45.3
Net Markup Income	668.5	55.0	1,160.2	54.7
Provision Expense	(75.7)	6.2	(102.7)	4.8
Non Markup Income	409.6	33.7	724.5	34.2
Operating Expense	(631.5)	52.0	(1,045.8)	49.3
Profit Before Tax	370.2	30.5	736.2	34.7
Tax	(86.1)	7.1	(166.3)	7.8
Profit After Tax	284.0	23.4	570.0	26.9

the income of the Islamic banks remained from the core income side (see **Figure 5.3**). As the operating expenses of the Islamic banks as a percentage of gross income came down, the profit after taxes improved during the quarter (see **Table 5.3**). This is reflective from the profit after tax to gross income ratio that rose to 30 percent as against 26 percent in the last quarter. Moreover, the ROA (annualized) also improved to 1.4 percent from 1.1 percent in June 05.

The performance of the September quarter suggests that the Islamic banks need to monitor their asset quality, as the increase in NPLs to loans ratios, may have effect on the profitability of the banks in case of increase in the provisioning requirements if strong recovery efforts are not made to control the non performing financings at the very first stage.

6. Stress testing of the Banking System

The results of stress test exercise show that the banking system has added significant resilience to both univariate and multivariate shocks over the first three quarters of the outgoing year. Major factors underlying this improvement have been improved solvency position as well as the containment of exposure to risks covered in the exercise. The exercise employs the macro-prudential approach and focuses primarily on systemically significant 12 largest commercial banks, which together hold 81 percent of the market share, and three groups of commercial banks viz. PSCBs, LPBs and FBs. The shocks have been devised in the light of different historical and hypothetical scenarios to measure the system's vulnerability in terms of deterioration in the quality of credit portfolio, adverse movements in exchange rate, interest rate, equity price and liquidity withdrawals.

The stress scenarios have been classified in three types of instantaneous shocks, including credit quality, market and liquidity shocks (see **Box 6.1**).

Box 6.1
Reference Scenarios

Credit Risk

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

Scenario 2 assumes a shift in categories of classified loans (all loans classified as OAEM become substandard, all substandard loans become doubtful, and all doubtful loans become loss).

Scenario 3 assumes a 50 percent decline in the value of real estate collateral held by banks.

Scenario 4 assumes a cumulative impact of all shocks used in Scenarios 1, 2, and 3.

Scenario 5 refers to the NPLs to total loans ratio, which would wipe out capital (with a 50 percent provisioning rate for additional NPLs).

Market Risk: Interest Rate Risk

Scenario 6 assumes an increase in interest rates by 200 basis points.

Scenario 7 assumes an increase in interest rates of outlying maturities (by 100, 200, and 300 basis points)

Scenario 8 assumes a shift coupled with flattening of the yield curve by increasing 150,100 and 50 basis points in the outlying maturities respectively.

Scenario 9 assumes a shift coupled with steepening of the yield curve by increasing 50,100 and 150 basis points in the outlying maturities respectively

Market Risk: Exchange Rate Risk

Scenario 10 assumes a depreciation of ER by 25 percent (around double of the change in the monthly average PRS/US$ exchange rate (12.83) over the period from Jan 1994 to Dec 2003, in September 2000).

Scenario 11 is based on the hypothetical assumption of appreciation of rupee by 20 percent.

Scenario 12 assumes a 10 percent depreciation of the rupee and deterioration in the quality of 10 percent of unhedged foreign currency loans with 50 percent provisioning requirement.

Scenario 13 assumes a 10 percent depreciation of the rupee and deterioration in the quality of 20 percent of unhedged foreign currency loans with 100 percent provisioning requirement.

Market Risk: Equity Price Risk

Scenario 14 assumes the impact of a 20 percent fall in the index, based on largest percent change in the monthly Karachi Stock Exchange Index (KSE100 Index) over the period from Jan 2000 to Dec 2003, in May 2000 (19.2 percent), on the total direct and indirect exposure of banks on Stock Market-assuming equal percentage fall in the value of the overall exposure.

Scenario 15 assumes the impact with a 40 percent decline in the Stock Market Index.

Liquidity Risk

Scenario 16 assumes a 10 percent decline in the liquid liabilities.

Scenario 17 assumes a 20 percent decline in the liquid liabilities.

Calibration of Shocks

The results of the stress tests have been summarized in the **Box 6.2**. For each type of stress scenario, the impact has been calibrated on the solvency i.e. the CAR of the banks. The results for the quarter have been compared with that of Dec-04 so as to capture a trend in the banks' vulnerability to these shocks.

Box 6.2

Results of "Stress Tests" of Pakistani Banking System

			Dec-04		Sep-05	
Single and multifactor sensitivity tests			***%age Point Change in CAR***	***Revised CAR- After Shock***	***%age Point Change in CAR***	***Revised CAR- After Shock***
Credit Shocks						
Scenario	1	Deterioration in the qualityof loan	(0.7)	10.7	(0.3)	12.0
Scenario	2	Shift in categories of classified loans	(0.3)	11.1	(0.0)	12.3
Scenario	3	Decline in the value of real estate collateral	(0.3)	11.1	(0.0)	12.3
Scenario	4	Cumulative impact of all shocks in 1,2 and 3	(1.5)	9.9	(1.0)	11.3
Scenario	5	Level of NPLs to loans ratio where capital wipes out (i.e. 34.4% in Sep-05 and 32.4% in Dec-04)	(11.4)	-	(12.3)	-
Market Shocks; Interest Rate Shocks						
Scenario	6	Shift in the yield curve	(0.9)	10.5	(0.7)	11.6
Scenario	7	Shift and steepening of the yield curve (large shock)	(1.2)	10.2	(1.1)	11.2
Scenario	8	Shift & flattenining of the yield curve	(0.2)	11.2	(0.2)	12.1
Scenario	9	Shift and steepening of the yield curve	(0.6)	10.8	(0.5)	11.8
Market Shocks; Exchange Rate Shocks						
Scenario	10	Depreciation of Rs/US$ exchnage rate (double of the historical high)	0.4	11.8	1.5	13.9
Scenario	11	Appreciation of Rs/US$ exchnage rate (hypothetical)	(0.3)	11.1	(1.2)	11.1
Scenario	12	Depreciation in ER along with deterioration of quality of FX Loans (50 % Provisioning)	(0.0)	11.4	0.0	12.3
Scenario	13	Depreciation in ER alongwith deterioration of quality of FX Loans (100 percent provisioning)	(0.6)	10.8	(0.2)	12.1
Market Shocks; Equity Price Shocks						
Scenario	14	Fall in the KSE index (historical high)	(0.3)	11.1	(0.4)	12.0
Scenario	15	Fall in the KSE index (hypothetical scenario)	(0.6)	10.8	(1.0)	11.4
Liquidity Shocks						
Liquidity Coverage Ratio			***Actual***	***After Shock***	***Actual***	***After Shock***
Scenario	16	Fall in the Liquid Liabilities (1)	40.1	33.5	41.5	35.0
Scenario	17	Fall in the Liquid Liabilities (2)	40.1	25.2	41.5	26.9

Note: The results are not adjusted for deferred tax benefits accruing on these losses

Analysis of the Results

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

Credit Shocks

Banks ability to withstand plausible credit shocks have significantly improved since the end of last year (see **Figure-6.1**). This improvement has been realized on the back of strengthening of solvency position and containment of exposure to credit risk reflecting in significantly lowered infection and capital impairment indicators.

Of the different credit risk scenarios envisaged in the exercise, **Scenrio-1** (10 percent increase in NPLs with 100 percent provisioning requirements) has the highest impact on the banks' CAR. However, the intensity of this shock, given the adequate coverage of general provisions and consistent decline in levels of NPLs, is quite contained and the stressed CAR remains well above standard of 8 percent at 12 percent. The impact of the other two credit risk scenarios i.e. **Scenario-1** and **2** that capture the exposure of the banking system to deterioration in the quality of existing stock of NPLs in terms of category of classification and value of collateral is even more subdued (see **Figure-6.2**). The combined impact of all these three scenarios (**Scenario-4**) slash CAR by 1 percentage point, but this combined impact is also quite modest given the strong solvency ratio of the system.

Group-wise, LPBs show the highest sensitivity to credit risk shocks mainly due to relatively lower CARs.

Figure- 6.1: Resilience to Credit Shocks Dec-04 to Sep-05

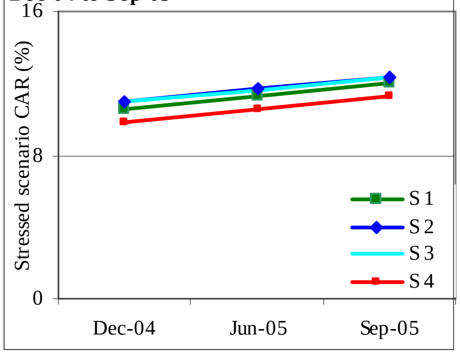


Figure-6.2: Impact of Credit Shocks on CAR, Sep-05

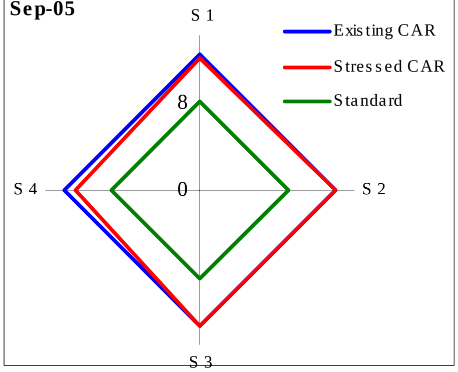
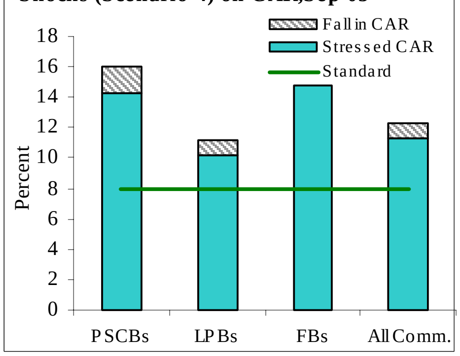
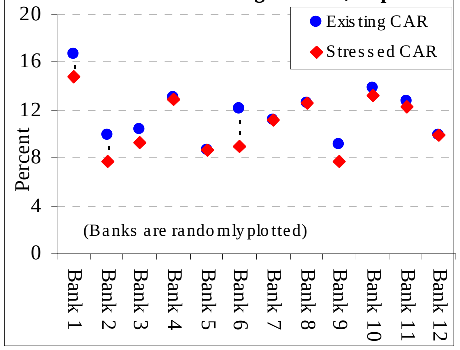


Figure-6.3: Combined Impact of Credit Shocks (Scenario-4) on CAR,Sep-05



However, the group maintains its solvency ratio above the minimum standard in all individual as well as combined credit shocks scenarios (i.e. scenario 1, 2, 3 and 4). Foreign Banks as a group, by virtue of its strong CAR and prudent provisioning practices show the highest resilience, and all the credit shocks have no impact on its CAR (see **Figure-6.3**).

Figure-6.4: Combined Impact of Credit Shocks on CAR of 12 Large Banks, Sep-05



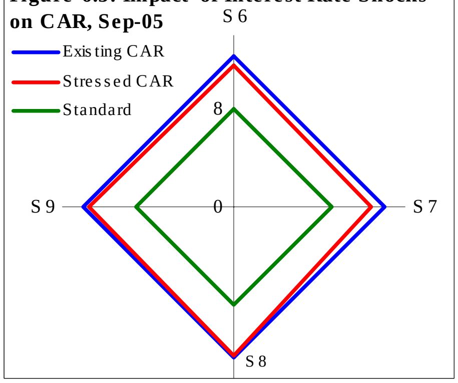
Bank-wise analysis of the twelve large banks, which are strategically significant for the system's stability, shows that all these banks preserve their CARs above the 8 percent standard in three individual shock scenarios. However, the CAR of the two banks, which together hold 18 percent of the system's deposits, would marginally fall below 8 percent standard under scenario 4, which combines the impact of the three individual credit shocks (see **Figure-6.4**).

Market Shocks

In line with improved resilience to credit shock, the system shows strong resilience towards all the four ***interest rate*** shocks including parallel shift, the flattening and steepening of the yield curves.

Among the interest rate shocks, highest impact, i.e. 1.1 percentage points fall in banks' CAR, is delivered by the steepening in yield curve with a 100, 200 and 300 bps rise in outlying maturities ***(Scenario-7)***. However, the stressed CAR of the commercial banks stays at 11.3 percent. The PSCBs due to high asset sensitive gaps in the longer-term time buckets show the highest susceptibility to this shock, and their CAR comes off by 2.4 percentage points to 13.6 percent.

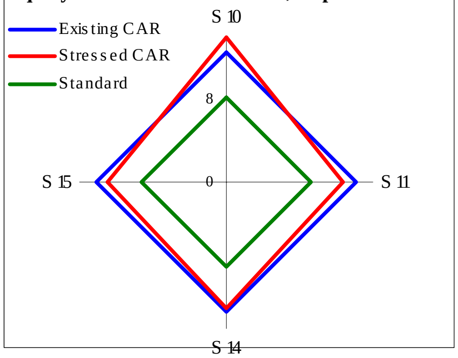
Figure-6.5: Impact of Interest Rate Shocks on CAR, Sep-05



The second highest stress is put by the parallel shift in yield curve by 200 basis points ***(Scenario-6)***. Commercial banks' CAR sheds 72 bps to 11.6 percent. PSCBs show the highest susceptibility to this shock also and their CAR with a fall of 1.4 percentage points declines to 14.6 percent. The impact of lower level of shocks under scenarios 8 & 9 remains contained (see **Figure-6.5**).

Group wise, PSCBs due to their stronger capital adequacy ratio show the highest resilience towards interest rate shocks. Individual banks also show strong resilience to these interest rate shocks as only one bank face a fall in CAR below 8 percent in **Scenario-7**.

Figure-6.6: Impact of Exchange Rate & Equity Price Shocks on CAR, Sep-05



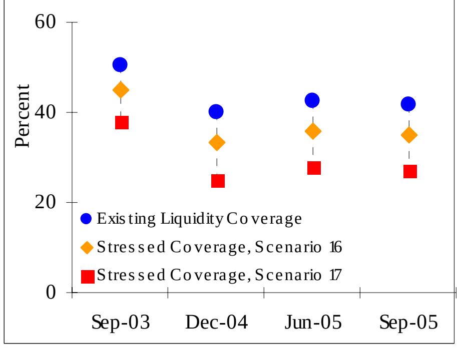
The ***exchange rate*** shocks also do not pose any significant threat to the already strengthened CAR of commercial banks. Since the banks are holding long position in foreign currency, any depreciation in rupee value ***(Scenario-10)*** would in fact benefit them. However, under the hypothetical scenario of 20 percent appreciation in rupee value (**Scenario-11**) the CAR of the commercial banks would fall by 1.3 percentage points to 11.1 percent (see **Figure-6.6**). The results after taking into account the indirect impact of depreciation, i.e. deterioration in the credit quality of the foreign currency loans due to exchange rate movements, are also not a source of concern ***(Scenario 12 & 13)***. All the groups and individual banks also show resilience to these shocks, and the CAR of all groups as well as the 12 largest banks stay well above 8 percent.

The ***equity price*** shocks cover both the direct and indirect exposure of the banks towards the stock market. The results of simple univariate shocks of decline in the stock market index show a slight increase in exposure in terms of fall in CAR, strengthened CAR of the system however gives improved resilience to these shocks. The CAR under extreme shock scenario i.e. 40 percent fall in the value of equity holdings (**Scenario-15**) would lower to 11.4 percent (see **Figure-6.6**), while one of the 12 largest banks might face a fall in their CAR below 8 percent. Group wise, LPBs are carrying highest exposure, nevertheless their overall CAR remains above the 8 percent level in the extreme shock scenario.

Liquidity Risk:

Two scenarios i.e. **Scenarios-16** and **-17** have been identified to assess the system's ability to withstand severe withdrawals of funds. The scenarios assume 10 and 20 percent withdrawal in the liquid liabilities, respectively, and the impact has been calibrated in terms of stressed liquidity coverage ratio. In recent quarters banks have significantly expanded their lending portfolio. This has squeezed the excess liquidity cushion, which the system was enjoying in the recent past; though the system continued to have sufficient liquidity cushion for ensuring continuity of operations. This quarter's results also signify a slight squeeze in the liquidity coverage (see **Figure-6.7**). All the groups and 8 of the 12 systemically important banks would have their liquid assets to liquid liabilities ratio above 20 percent in extreme shock scenario.

Figure-6.7: Impact of Liquidity Shocks on Liquidity Coverage Ratios



Conclusion:

The banking system shows an overall resilience to the historical and hypothetical shocks of both the univariate and multivariate types. Among the univariate shocks, exchange rate shock of rupee appreciation is likely to have the highest strain on the solvency ratio of the system, which though maintains the ratio above 8 percent standard. The other scenarios like increase in NPLs, negative shift in the categories of NPLs, fall in the value of collateral, shift and movements in yield curve, and fall in stock market index would have a limited effect on the capital adequacy ratio. Group wise, LPBs, though with a double digit CAR, are more susceptible to the large shocks due to comparatively lesser cushion in their CARs and the high credit and market exposures, followed by FBs and PSCBs. Nonetheless, in all the stress scenarios these groups preserve the CAR over the required standard.

Financial Soundness Indicators **Annex-I**

Indicators	2000	2001	2002	2003	2004	Jun-05	Sep-05
CAPITAL ADEQUACY							
Risk Weighted CAR							
Public Sector Commercial Banks	10.4	9.6	12.3	11.0	13.4	14.1	16.0
Local Private Banks	9.2	9.5	9.7	9.0	10.1	10.8	11.2
Foreign Banks	18.0	18.6	23.2	23.0	17.4	15.0	14.7
Commercial Banks	**11.4**	**11.3**	**12.6**	**11.1**	**11.4**	**11.8**	**12.3**
Specialized Banks	(3.3)	(13.9)	(31.7)	(28.2)	(9.0)	(10.2)	(13.2)
All Banks	**9.7**	**8.8**	**8.8**	**8.5**	**10.5**	**10.9**	**11.4**
Tier 1 Capital to RWA							
Public Sector Commercial Banks	7.7	7.1	8.6	8.2	8.6	9.3	11.0
Local Private Banks	8.1	8.4	6.6	7.1	7.5	8.3	8.6
Foreign Banks	17.9	18.6	23.0	23.0	17.1	14.5	14.2
Commercial Banks	**9.8**	**9.7**	**9.7**	**9.1**	**8.6**	**9.1**	**9.6**
Specialized Banks	(3.4)	(13.9)	(31.7)	(28.7)	(15.0)	(16.3)	(19.3)
All Banks	**8.3**	**7.3**	**6.2**	**6.5**	**7.6**	**8.1**	**8.5**
Capital to Total Assets							
Public Sector Commercial Banks	4.6	3.7	5.6	6.1	8.2	8.8	9.7
Local Private Banks	3.5	3.8	5.2	5.1	6.5	6.6	7.0
Foreign Banks	8.8	8.5	10.6	10.0	9.0	7.7	8.2
Commercial Banks	**4.9**	**4.6**	**6.1**	**6.0**	**7.1**	**7.2**	**7.7**
Specialized Banks	(1.1)	(10.3)	(23.0)	(9.5)	(11.3)	(9.2)	(11.7)
All Banks	**4.5**	**3.8**	**4.8**	**5.4**	**6.5**	**6.6**	**7.1**
ASSET QUALITY							
NPLs to Total Loans							
Public Sector Commercial Banks	26.3	25.9	25.5	20.4	13.3	11.8	11.7
Local Private Banks	15.4	16.3	15.4	11.3	9.0	7.5	7.6
Foreign Banks	4.7	4.3	3.8	3.1	1.6	1.5	1.4
Commercial Banks	**19.5**	**19.6**	**17.7**	**13.7**	**9.0**	**7.8**	**7.8**
Specialized Banks	52.4	53.0	54.7	55.6	54.1	57.7	54.5
All Banks	**23.5**	**23.4**	**21.8**	**17.0**	**11.6**	**10.6**	**10.5**
Provision to NPLs							
Public Sector Commercial Banks	59.2	56.6	57.1	65.8	77.0	78.5	81.1
Local Private Banks	36.9	40.5	58.6	62.7	70.2	73.5	73.4
Foreign Banks	65.9	74.1	73.3	77.4	101.9	118.6	129.5
Commercial Banks	**53.9**	**53.2**	**58.2**	**64.7**	**72.7**	**75.7**	**76.5**
Specialized Banks	58.1	59.2	66.9	60.8	68.6	68.7	75.6
All Banks	**55.0**	**54.7**	**60.6**	**63.7**	**71.6**	**73.6**	**76.2**
Net NPLs to Net Loans							
Public Sector Commercial Banks	12.7	13.1	12.8	8.1	3.4	2.8	2.4
Local Private Banks	10.3	10.4	7.0	4.5	2.8	2.1	2.1
Foreign Banks	1.7	1.1	1.1	0.7	(0.0)	(0.3)	(0.4)
Commercial Banks	**10.1**	**10.3**	**8.3**	**5.3**	**2.6**	**2.0**	**1.9**
Specialized Banks	31.6	31.5	28.5	33.0	27.0	29.9	22.6
All Banks	**12.2**	**12.1**	**9.9**	**6.9**	**3.6**	**3.0**	**2.7**
Net NPLs to Capital							
Public Sector Commercial Banks	124.5	160.2	83.4	50.0	17.2	14.2	11.2
Local Private Banks	153.5	125.2	54.8	40.5	24.1	17.6	16.8
Foreign Banks	9.0	5.8	4.7	3.3	(0.2)	(1.8)	(2.6)
Commercial Banks	**96.7**	**100.7**	**54.2**	**37.5**	**19.2**	**14.6**	**13.2**
Specialized Banks	-	-	-	-	-	-	-
All Banks	**131.3**	**150.5**	**85.5**	**55.4**	**28.8**	**24.1**	**20.1**
EARNINGS							
Return on Assets (Before Tax)							
Public Sector Commercial Banks	0.5	-	1.3	1.8	2.4	2.7	3.3
Local Private Banks	(0.1)	0.9	1.4	2.2	1.7	2.4	2.6
Foreign Banks	1.4	1.7	2.3	2.6	2.5	2.7	3.2
Commercial Banks	**0.4**	**0.6**	**1.5**	**2.1**	**1.9**	**2.5**	**2.8**
Specialized Banks	(2.3)	(8.4)	(10.2)	(2.5)	(2.5)	(3.5)	(4.8)
All Banks	**0.3**	**0.1**	**0.9**	**1.9**	**1.8**	**2.3**	**2.6**
Return on Assets (After Tax)							
Public Sector Commercial Banks	0.2	(0.5)	0.6	1.0	1.3	1.6	2.2
Local Private Banks	(0.7)	0.4	0.7	1.4	1.2	1.6	1.8
Foreign Banks	0.6	0.8	1.5	1.5	2.0	1.8	2.1
Commercial Banks	**(0.0)**	**(0.0)**	**0.8**	**1.2**	**1.3**	**1.6**	**1.9**
Specialized Banks	(2.3)	(8.8)	(12.1)	(3.2)	(2.6)	(3.7)	(4.9)
All Banks	**(0.2)**	**(0.5)**	**0.1**	**1.1**	**1.2**	**1.4**	**1.7**

Financial Soundness Indicators Annex-I

Indicators	2000	2001	2002	2003	2004	Jun-05	Sep-05
ROE (Avg. Equity & Surplus) (Before Tax)							
Public Sector Commercial Banks	10.9	0.5	26.3	29.9	32.1	31.8	37.7
Local Private Banks	(3.2)	25.4	32.3	42.2	28.5	36.9	39.8
Foreign Banks	15.6	19.3	24.2	25.2	26.7	31.3	37.7
Commercial Banks	**8.8**	**12.2**	**27.5**	**34.0**	**29.1**	**35.0**	**39.0**
Specialized Banks	-	-	-	-	-	-	-
All Banks	**5.7**	**1.4**	**21.1**	**36.4**	**29.4**	**34.9**	**39.0**
ROE (Avg. Equity & Surplus) (After Tax)							
Public Sector Commercial Banks	4.9	(12.2)	11.5	17.3	18.0	19.1	25.7
Local Private Banks	(17.4)	10.3	17.3	26.2	20.1	24.8	26.3
Foreign Banks	6.1	9.1	15.2	14.9	21.5	20.8	25.3
Commercial Banks	**(0.3)**	**(0.3)**	**14.3**	**20.5**	**19.8**	**22.9**	**26.0**
Specialized Banks	-	-	-	-	-	-	-
All Banks	**(3.5)**	**(12.6)**	**3.2**	**20.5**	**19.5**	**22.1**	**25.2**
NII/Gross Income							
Public Sector Commercial Banks	61.8	69.9	69.5	64.1	64.1	69.7	69.7
Local Private Banks	63.2	72.1	65.5	56.8	62.8	71.8	72.9
Foreign Banks	54.0	59.4	57.5	55.3	57.6	64.5	63.0
Commercial Banks	**61.2**	**68.9**	**66.1**	**59.4**	**62.5**	**70.6**	**71.1**
Specialized Banks	78.6	86.7	78.0	75.8	90.9	86.8	89.1
All Banks	**62.3**	**70.4**	**67.1**	**60.5**	**64.0**	**71.1**	**71.7**
Cost / Income Ratio							
Public Sector Commercial Banks	70.1	62.3	56.9	42.8	39.4	40.2	34.9
Local Private Banks	80.9	67.3	60.0	53.2	56.3	49.4	46.5
Foreign Banks	59.4	54.5	45.4	48.3	49.0	46.5	42.4
Commercial Banks	**71.6**	**62.7**	**56.7**	**48.6**	**51.8**	**47.2**	**43.5**
Specialized Banks	70.5	59.0	84.7	55.6	47.9	63.1	60.2
All Banks	**71.6**	**62.4**	**59.1**	**49.1**	**51.6**	**48.2**	**43.8**
LIQUIDITY							
Liquid Assets/Total Assets							
Public Sector Commercial Banks	37.1	36.5	49.0	49.0	43.4	39.5	36.0
Local Private Banks	34.0	39.8	47.1	42.9	34.3	35.0	34.1
Foreign Banks	45.2	50.3	48.5	49.8	39.9	42.0	40.6
Commercial Banks	**37.5**	**39.9**	**48.1**	**46.0**	**36.9**	**36.6**	**35.1**
Specialized Banks	12.7	13.6	16.4	22.2	25.7	29.9	28.8
All Banks	**36.0**	**38.5**	**46.7**	**45.1**	**36.5**	**36.4**	**34.9**
Liquid Assets/Total Deposits							
Public Sector Commercial Banks	45.0	43.4	59.6	59.0	51.7	46.5	45.4
Local Private Banks	44.3	49.6	60.2	54.5	42.3	43.2	42.5
Foreign Banks	67.7	78.3	74.2	69.7	53.4	57.8	55.9
Commercial Banks	**48.0**	**50.3**	**61.5**	**57.9**	**45.5**	**45.2**	**44.4**
Specialized Banks	90.8	79.8	98.5	131.5	153.2	233.7	241.6
All Banks	**48.5**	**50.7**	**61.8**	**58.5**	**46.3**	**46.3**	**45.3**
Advances/Deposits							
Public Sector Commercial Banks	54.0	53.8	44.3	45.6	49.8	52.7	56.6
Local Private Banks	67.5	57.9	52.3	58.3	67.6	67.9	68.7
Foreign Banks	71.5	66.8	72.0	63.9	70.1	67.0	67.9
Commercial Banks	**60.5**	**56.9**	**51.0**	**53.6**	**63.7**	**64.5**	**66.1**
Specialized Banks	553.0	450.5	453.8	381.5	359.3	449.0	491.4
All Banks	**66.2**	**61.7**	**54.9**	**56.5**	**65.9**	**66.6**	**68.2**

Annex-II

Selected Indicators for Different Categories of Banks, Sep-30, 2005

Indicators	Top 5 Banks	Top 10 Banks	Top 20 Banks	Industry
Share of Total Assets	55.0%	73.1%	93.0%	100%
Share of Total Deposits	58.8%	77.2%	94.4%	100%
Share of Gross Income	57.0%	75.9%	95.1%	100%
Share of Risk Weighted Assets	50.6%	69.7%	92.2%	100%
Capital Adequacy				
Capital/RWA	12.0%	12.0%	12.1%	11.4%
Tier 1 Capital / RWA	8.5%	8.7%	9.1%	8.5%
Net Worth / Total Assets	7.4%	7.3%	7.4%	7.1%
Asset Composition				
Sectoral Distribution of Loans (Domestic)				
- Corporate Sector	47.6%	70.8%	92.3%	100%
- SMEs	53.5%	70.5%	87.9%	100%
- Agriculture	29.6%	32.2%	94.4%	100%
- Consumer Finance	60.0%	82.4%	95.9%	100%
- Commodity Financing	71.0%	87.0%	96.8%	100%
- Staff Loans	67.0%	84.2%	94.8%	100%
- Others	44.5%	59.5%	88.3%	100%
- **Total**	**50.6%**	**70.4%**	**92.4%**	**100%**
NPLs / Gross Loans	9.7%	8.8%	9.4%	10.5%
Net NPLs / Capital	13.4%	13.6%	15.6%	20.1%
Earning & Profitability				
ROA	1.9%	2.0%	1.8%	1.7%
ROE	27.9%	29.0%	25.1%	25.2%
Net Interest Income / Gross Income	73.2%	72.5%	72.2%	71.7%
Income from Trading & Foreign Exchange / Gross Income	7.3%	7.0%	7.3%	7.7%
Non-Interest Expense / Gross Income	44.4%	43.0%	42.5%	43.8%
Liquidity				
Liquid Assets / Total Assets	36.7%	35.0%	34.8%	34.9%
Liquid Assets held in Govt. Securities / Total Liquid Assets	54.3%	54.1%	52.6%	51.6%
Liquid Assets / Total Deposits	44.6%	43.0%	44.5%	45.3%

Annex-III

Bank-wise Major Statistics (Unaudited) September 30, 2005

(Million Rs)

S. No.	Name of Bank	Total Assets	Deposits	Equity
1	Bank of Khyber	22,043	14,196	2,305
2	Bank of Punjab	88,387	70,836	11,547
3	First Women Bank Limited	8,845	7,504	686
4	National Bank of Pakistan	565,028	449,832	52,174
5	Industrial Development Bank of Pakistan	7,795	9,526	(26,261)
6	Zarai Taraqiati Bank Limited	81,644	1,789	9,533
7	Pumjab Provincial Cooperative Bank	13,343	1,432	1,770
8	SME Bank	7,179	355	2,140
9	Allied Bank of Palistan	174,083	149,423	12,259
10	Bank Alfalah Limited	199,728	172,253	7,072
11	Bank Alhabib Limited	85,406	70,362	4,633
12	Askari Commercial Bank Limited	127,182	97,629	7,740
13	Crescent Commercial Bank Limited	9,146	4,701	1,905
14	Dawood Bank Limited	6,611	1,033	1,525
15	Habib Bank Limited	485,701	400,741	37,013
16	Faysal Bank Limited	93,121	65,341	12,218
17	KASB Bank Limited	16,529	11,298	1,719
18	MCB Bank Limited	279,614	224,799	20,105
19	Meezan Bank Limited	24,621	16,659	2,569
20	Metropolitan Bank Limited	75,176	52,180	5,009
21	Mybank Limited	14,032	10,212	1,917
22	NDLC-IFIC Bank Limited	25,707	16,379	4,205
23	PICIC Commercial Bank Limited	62,156	50,661	3,901
24	Prime Commercial Bank Limited	52,141	37,387	3,303
25	SaudiPak Commercial Bank Limited	35,901	24,252	2,331
26	Soneri Bank Limited	54,899	41,352	3,487
27	United Bank Limited	323,626	278,660	20,028
28	Union Bank Limited	100,520	76,516	4,641
29	ABN Amro Bank	59,443	46,662	3,634
30	Rupali Bank Limited	570	176	106
31	Oman International Bank	1,865	579	1,028
32	Habib Bank AG Zurich	40,869	28,069	2,422
33	HongKong & Shanghai Banking Corporation	11,828	7,619	1,726
34	Deutche Bank Limited	4,871	1,931	1,312
35	Bank of Tokyo	6,031	3,923	1,935
36	Citibank	68,727	47,827	5,286
37	Bank Albaraka	12,016	8,220	1,928
38	Standard Chartered Bank	115,464	88,787	6,715
39	American Express Bank	7,613	4,915	1,052

Annex-IV

Group-wise Composition of Banks, September 30, 2005

1997-1998	2003	2004	Sep-2005
A. Public Sector Comm. Banks (6) - Habib Bank Ltd. - National Bank of Pakistan - United Bank Ltd. - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **B. Local Private Banks (16)** - Askari Commercial Bank Ltd. - Bank Al-Falah Ltd. - Bank Al Habib Ltd. - Bolan Bank Ltd. - Faysal Bank Ltd. - Metropolitan Bank Ltd. - Platinum Commercial Bank Ltd - Prime Commercial Bank Ltd. - Prudential Commercial Bank Ltd - Gulf Commercial Bank Ltd. - Soneri Bank Ltd. - Union Bank Ltd. - Muslim Commercial Bank Ltd - Allied Bank of Pakistan - Trust Bank Ltd. - Indus Bank Ltd. **C. Foreign Banks (20)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - ANZ Grindlays Bank - Bank of America - Bank of Ceylon - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - Credit Agricole Indosuez - Deutsche Bank A.G. - Doha Bank - Emirates Bank International - Habib Bank A. G. Zurich - The Hongkong & Shanghai Banking Corporation Ltd. - IFIC Bank Ltd. - Mashreq Bank PJSC - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Societe Generale - Standard Chartered Bank **D. Specialized Banks (4)** - Agriculture Development Bank of Pakistan - Industrial Development Bank of Pakistan - Federal Bank for Co-operatives - Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks (42)** Include A + B + C **All Banks (46)** Include A + B + C + D	**A. Public Sector Comm. Banks (5)** - Habib Bank Ltd[1] - National Bank of Pakistan - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **B. Local Private Banks (18)** - Askari Commercial Bank Ltd. - Bank Al-Falah Ltd. - Bank Al Habib Ltd. - Bolan Bank Ltd. - Faysal Bank Ltd. - Metropolitan Bank Ltd. - KASB Bank Ltd. - Prime Commercial Bank Ltd. - Saudi Pak Commercial Bank Ltd - PICIC Commercial Bank Ltd. - Soneri Bank Ltd. - Union Bank Ltd. - Muslim Commercial Bank Ltd. - Allied Bank of Pakistan - United Bank Ltd. - Meezan Bank - NDLC-IFIC Bank Ltd - Crescent Bank Ltd. **C. Foreign Banks (14)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - Bank of Ceylon[2] - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - Credit Agricole Indosuez[3] - Deutsche Bank A.G. - Doha Bank[4] - Habib Bank A. G. Zurich - The Hongkong & Shanghai Banking Corporation Ltd. - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Standard Chartered Bank **D. Specialized Banks (3)** - Zari Taraqiati Bank Ltd. - Industrial Development Bank of Pakistan - Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks (37)** Include A + B + C **All Banks (40)** Include A + B + C + D	**A. Public Sector Comm. Banks (4)** - National Bank of Pakistan - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **B. Local Private Banks (20)** - Askari Commercial Bank Ltd. - Bank Al-Falah Ltd. - Bank Al Habib Ltd. - Bolan Bank Ltd. - Faysal Bank Ltd. - Metropolitan Bank Ltd. - KASB Bank Ltd. - Prime Commercial Bank Ltd. - Saudi Pak Commercial Bank Ltd - PICIC Commercial Bank Ltd. - Soneri Bank Ltd. - Union Bank Ltd. - Muslim Commercial Bank Ltd. - Allied Bank of Pakistan - United Bank Ltd. - Meezan Bank - NDLC-IFIC Bank Ltd - Crescent Bank Ltd. - Habib Bank Ltd - Dawood Bank **C. Foreign Banks (11)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - Deutsche Bank A.G. - Habib Bank A. G. Zurich - The Hongkong & Shanghai Banking Corporation Ltd. - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Standard Chartered Bank **D. Specialized Banks (3)** - Zari Taraqiati Bank Ltd. - Industrial Development Bank of Pakistan - Punjab Provincial Co-operative Bank Ltd. **All Commercial Banks (36)** Include A + B + C **All Banks (38)** Include A + B + C + D	**A. Public Sector Comm. Banks (4)** - National Bank of Pakistan - First Women Bank Ltd. - The Bank of Khyber - The Bank of Punjab **B. Local Private Banks (20)** - Askari Commercial Bank Ltd. - Bank Al-Falah Ltd. - Bank Al Habib Ltd. - My Bank Ltd. - Faysal Bank Ltd. - Metropolitan Bank Ltd. - KASB Bank Ltd. - Prime Commercial Bank Ltd. - Saudi Pak Commercial Bank Ltd - PICIC Commercial Bank Ltd. - Soneri Bank Ltd. - Union Bank Ltd. - MCB Bank Ltd. - Allied Bank of Pakistan - United Bank Ltd. - Meezan Bank - NIB Bank Ltd - Crescent Bank Ltd. - Habib Bank Ltd - Dawood Bank **C. Foreign Banks (11)** - ABN Amro Bank - Al Baraka Islamic Bank - American Express Bank Ltd. - The Bank of Tokyo – Mitsubishi - Citibank, N.A. - Deutsche Bank A.G. - Habib Bank A. G. Zurich - The Hongkong & Shanghai Banking Corporation Ltd. - Oman International Bank S.A.O.G - Rupali Bank Ltd. - Standard Chartered Bank **D. Specialized Banks (4)** - Zari Taraqiati Bank Ltd. - Industrial Development Bank of Pakistan - Punjab Provincial Co-operative Bank Ltd. - SME Bank Limited **All Commercial Banks (35)** Include A + B + C **All Banks (39)** Include A + B + C + D

1. *HBL stands as local private bank after being privatized on 26-02-2004.*
2. *Bank of Ceylon was merged with Dawood Commercial Bank on 25-03-2004.*
3. *Credit Agricole was merged with NDLC-IFIC Bank on 19-04-2004.*
4. *Doha Bank was merged with Trust Commercial Bank, which was later merged with Crescent Commercial Bank.*
5. *SME Bank Ltd has been included in Specialized Banks category after it has been granted the banking license during Jun 2005 quarter*