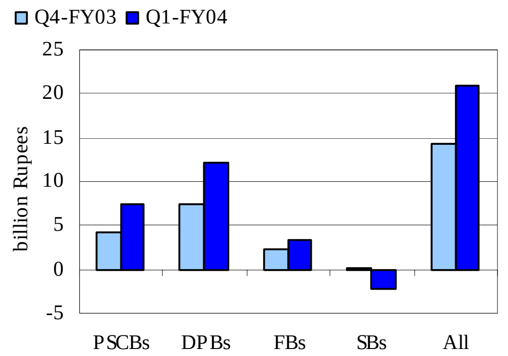
6 Banking Developments

In aggregate, the banking sector witnessed robust growth during Q1-FY04 for yet another quarter, with strong net credit expansion. Moreover, although interest rates remained weak, the continuing growth in investments, improved asset quality, and strengthening consumer loans, together with substantial capital gains, helped banks to significantly improve profitability during Q1-FY04 (see **Figure 6.1**).[1]

Figure 6.1: Net Profit After Tax of the Bnaks

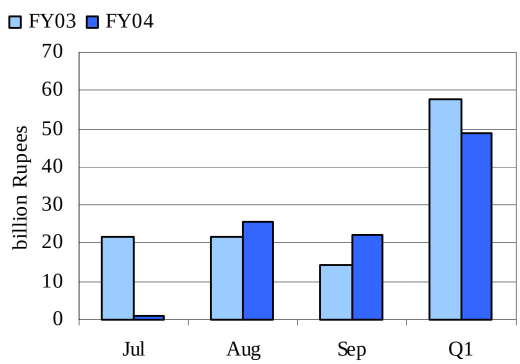


Of the above, the most remarkable development was the quite unusual rise in net credit. The initial months of the fiscal year generally witness a net retirement of credit, and the quarter therefore typically records a weak net credit outcome. Thus, the Rs 0.8 billion increase in net credit during Q1-FY04 against a Rs 35.5 billion retirement in Q1-FY03 marked a sharp departure from this trend, marking the emergence of the *personal/consumer finance* as a major market segment for the domestic industry.

6.1 Deposit Mobilization

In nominal terms, the Q1-FY04 increase in deposits was only a little lower than the increase seen in Q1-FY03. This deceleration in nominal deposits is entirely due to a very substantial decline in the deposit growth during July 2003 (see **Figure 6.2**). The difference in the July deposit growth is partially caused by an

Figure 6.2: Deposit Mobilization during Q1



[1] For detailed analysis, see Quarterly Performance Review of the Banking System September 2003, Banking Supervision Department, SBP.

unusual rise in July 2002 deposits, and partially by an exceptional decline in July 2003 deposits. In particular, July 2002 had seen a Rs 5.3 billion rise in Foreign Currency Deposits largely related to the privatization transactions. On the other hand, during July 2003, Rupee deposits witnessed net withdrawals (due to net withdrawals from one of the old privatized banks; after adjusting for this, total deposits grew by Rs 6.5 billion).

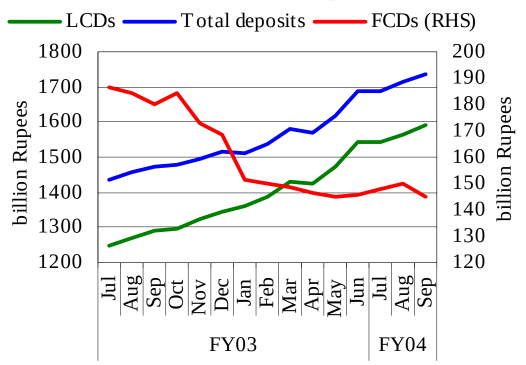
In subsequent months of Q1-FY04, the deposit growth remained higher than in the corresponding period of FY03. This was not only due to the continued flows of remittances, but also on account of the improved financial health of public sector enterprises (PSEs). In particular, the rise in personal deposits is probably linked with the strong remittance inflows, while a Rs 9.4 billion increase in PTCL deposits led the surge in PSE's deposits. Government deposits also grew significantly on account of fiscal discipline practiced by the government (see **Table 6.1**).

Table 6.1: Change in Deposits Holdings during Q1-FY04
billion Rupees

	FY03	FY04
Government sector	4.1	6.0
PSEs	9.4	20.6
Private sector (business)	-3.0	-39.8
Trust funds and NPOs	5.8	7.3
Personal deposits	45.5	58.7

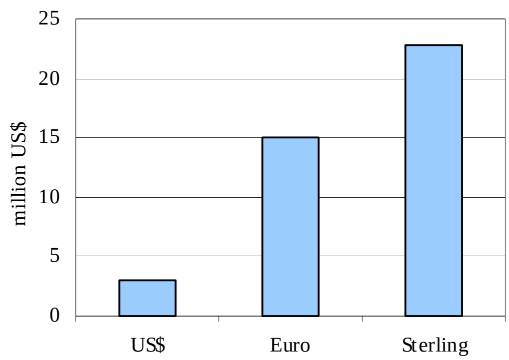
In terms of the currency composition, the profile of deposit growth during Q1-FY04 was similar to that in Q1-FY03; all of the growth was through Rupee deposits, as forex deposits declined in both periods (see **Figure 6.3**). However, there are interesting differences in the contribution of changes in FCDs during the respective quarters. In Q1-FY03, these deposits had been falling sharply due to expectations of a large appreciation of the Rupee, and a large drop had been avoided only because of a temporary inflow of privatization-related deposits. In contrast, during Q1-FY04, not only had the conversion of forex deposits into Rupee deposits slowed, the FE-25 deposits had *increased*. The former is explained by: (1) the lower outstanding stock of old forex deposits; and

Figure 6.3: Scheduled Banks' Deposits



(2) weakened expectations of a Rupee appreciation; while the latter reflects the increased interest in currencies other than the US dollar, against which the Rupee was depreciating (see **Figure 6.4**).

Figure 6.4: Rise in FCDs during Q1-FY04



A dis-aggregation of deposits growth by different banking groups reveals that while only specialized banks registered a fall in deposits (see **Table 6.2**), the rise in Domestic Private Banks (DPB) and Public Sector Commercial Banks' (PSCBs) deposits nonetheless decelerated. The fall in PSCBs' forex deposit growth, largely due to the absence of non-recurrent privatization inflows, was more than offset by an improvement in Rupee deposits (because of the replenishment of deposits of PSEs, especially those of PTCL and OGDC[2] as well as the higher flow of remittances through these banks - see **Figure 6.5**).

Table 6.2: Deposits Growth in Q1

billion Rupees

	LCDs		FCDs		Total Deposits	
	FY03	**FY04**	**FY03**	**FY04**	**FY03**	**FY04**
PSCBs	15.3	18.5	6.9	-0.6	22.2	17.9
DPBs	43.6	24.6	-2.8	-1.3	40.8	23.2
FBs	0.4	7.1	-5.4	1.0	-5.1	8.1
SBs	-0.3	-0.3	0.0	0.0	-0.3	-0.3
All Banks	58.9	49.8	-1.3	-0.9	57.6	48.9
Adjusted for Emirates Bank						
DPBs	33.5	24.6	-6.0	-1.3	27.5	23.2
FBs	10.4	7.1	-2.2	1.0	8.2	8.1

DPBs recorded the biggest deposits rise amongst the various groups. In fact, even though the Q1-FY04 deposit growth of DPBs was substantially lower than in Q1-FY03 deposit growth, this phenomenon was principally a function of a one-time accounting impact of the merger of a foreign bank into a DBPs.[3] Adjusting for this impact, Q1-FY03 deposit growth drops to Rs 27.5 billion, which narrows the

[2] During Q1-FY04, there was an increase of Rs 5 billion in OGDC's deposits with HBL, whereas, an increase of Rs 7 billion was registered in PTCL's deposits placed with NBP.
[3] The merger of Emirates bank with Union bank w.e.f. September 10, 2002, shifted its deposits from the FB category into the DBPs category.

growth difference to just Rs 4.3 billion. This difference may be attributed to lower remittances recorded by this group during the quarter (see **Figure 6.5**).

Similarly, a corresponding adjustment in the "headline" deposit growth of foreign banks (FBs) shows that, in aggregate, banks in this group saw little change in the deposit growth pattern during the two quarters.

Figure 6.5: Bank-wise Workers' Remittances in Q1

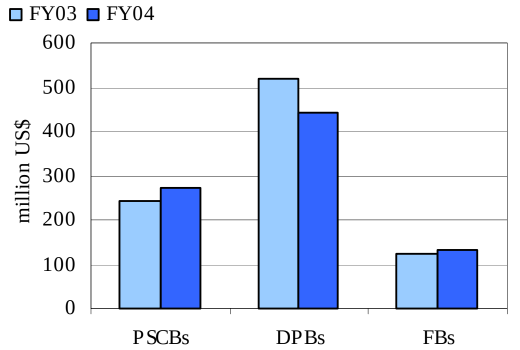
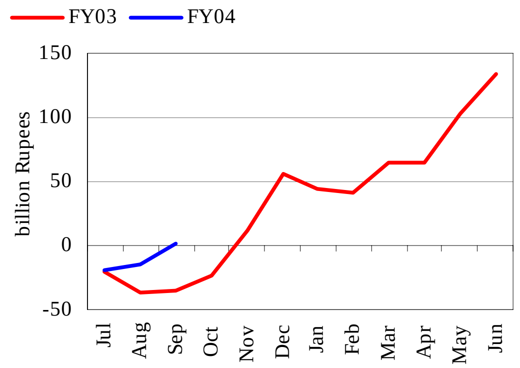


Figure 6.6: Net Credit Growth



6.2 Credit Expansion

The Q1-FY04 net credit expansion is in sharp contrast to the Q1-FY03 picture; not only is the seasonal credit contraction shallower, but the credit growth cycle appears to have begun much earlier than customary (see **Figure 6.6**).[4] As a result, total net credit witnessed an expansion of Rs 0.8 billion during Q1-FY04 against a net retirement of Rs 35.5 billion seen in Q1-FY03.

The prime factor behind this unusual net credit growth was the continued private sector credit demand that overshadowed the net retirements from PSEs,[5] autonomous bodies, as well as government's commodity operations loans (see **Table 6.3**). During Q1-FY04, credit to private sector recorded an expansion of Rs 23.1 billion, as compared to (more usual) net retirement of Rs 26.8 billion in Q1-FY03.

[4] The contrast with FY03 is particularly vivid as the contractionary cycle that year was particularly pronounced due to expectations of an interest rate cut.

[5] Especially, Pakistan Steel that retired Rs 7 billion to the banks because of its higher profitability.

In turn, the strong growth in private sector credit, despite the net retirement of trade related loans,[6] was primarily driven by the surge in banks' consumer financing activities (see **Figure 6.7**) (especially mortgage and auto loans), lending to small and medium enterprises (SMEs–the working capital loans to these institutions grew by Rs 13.2 billion against net retirements of Rs 0.9 billion from corporate sector), rise in investments in the equity market, and higher credit demand by the agriculture sector (see **Section 2.1.4** on **Agricultural Credit** for details). The source of the private sector credit expansion indicates that the bank have begun to diversify their asset base into new business areas in line with the SBP's credit policy.

A dis-aggregation of the net credit growth by banking groups shows that all groups contributed to the improvement during Q1-FY04 relative to Q1-FY03 (see **Figure 6.8**). But the major contributions were from DPBs and PSCBs.

Table 6.3: Break-up of Credit Growth during Q1

billion Rupees

	FY03	FY04
Autonomous bodies	-9.9	-8.9
Commodity operations	-4.8	-7.5
PSEs	0.2	-8.6
Private sector	-26.8	22.1

Figure 6.7: Private Sector Credit Expansion during Q1-FY04

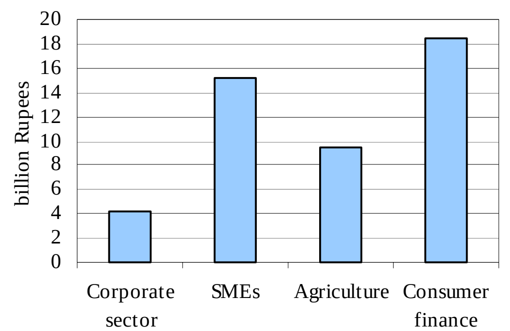
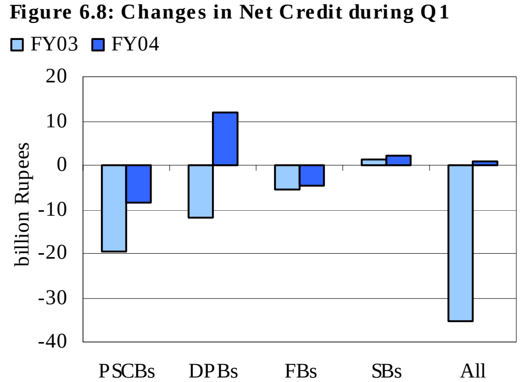


Figure 6.8: Changes in Net Credit during Q1



[6] Net retirements of Rs 13.6 billion in foreign currency loans more than offset the increase of Rs 7.6 billion in outstanding export finance loans.

The high net credit expansion by DPBs was primarily through a jump in consumer financing loans and increased exposure to the securities market (see **Table 6.4**) as well as increased lending to the SME sector. In fact, DPBs accounted for 55.4 percent of the total credit extended to private sector SMEs during Q1-FY04.

Table 6.4: Increase in Investment in Stock Market

million Rupees

	Outright purchases	Badla	Total
PSCBs	-52.2	276.5	224.3
DPBs	1,797.9	3,207.3	5,005.2
FBs	11.3	0.0	11.3
SBs	-1.5	0.0	-1.5
All Banks	1,755.4	3,483.8	5,239.2

In contrast to the DPBs, the PSCBs registered contraction of Rs 8.6 billion in net credit during Q1-FY04. However, this reduction was much lower than the seasonal decrease in net credit witnessed in the corresponding period of FY03.

During Q1-FY04, the government borrowing for commodity operations recorded retirement of Rs 7.5 billion reflecting an improved fiscal performance[7] (allowing retirement of existing stocks of loans) as well as the increasing shift of these activities to the private sector (reducing the need for fresh loans). This gain was compounded by the net retirement of credit by PSEs (especially Pak Steel). Thus, while the PSCBs increased net credit to the private sector by Rs 5.9 billion during Q1-FY04, this was offset by the relatively greater retirements by the government sector.

6.3 NPLs of the Banking Sector

After declining in the preceding two quarters, banking sector NPLs witnessed a rise of Rs 3.0 billion during Q1-FY04, pushing up the outstanding total to Rs 230.7 billion. However, this rise, in large part, is attributable to the continuing problems of specialized banks (see **Table 6.5)**. Commercial banks continued their path toward reducing the stock of NPLs and shed off Rs 8.7 billion in the Q1-FY04. A substantial Rs 9.2 billion fall was recorded in the aggregate NPL stock of PSCBs and DPBs. Furthermore, while the

Table 6.5: NPLs of the Banking Sector

billion Rupees — End-period

	Dec-02	Mar-03	Jun-03	Sep-03
PSCBs	95.3	98.6	94.1	86.8
DPBs	63.1	65.5	61.4	59.5
FBs	7.1	6.9	6.9	7.4
Commercial banks	165.5	171.0	162.4	153.7
SBs	78.8	71.3	65.2	77.0
All Banks	244.2	242.2	227.7	230.7

[7] PSCBs account for over 60 percent of such loans, the impact of these retirements is more pronounced in the credit figures of this group.

three largest private banks showed considerable improvement, NPLs of few financially good banks increased due to their aggressive credit activities in relatively less developed market segments such as consumer finance.

Interestingly, foreign banks, which usually post a decline in their NPLs, registered a rise of Rs 0.4 billion during this quarter. This departure from trend was primarily attributable to a surge in NPLs of a single bank (that is being merged with another institution). Only two other foreign banks made (relatively small) contributions to the increase in aggregate NPLs of the group, as the NPLs of all other foreign banks declined.

Given the overall position of NPLs, a look on the infection and coverage ratios may be more instructive, as these ratios help in gauging the intensity of the impact of NPLs on the banking sector. A quick glance at **Table 6.6** shows that while the *gross NPLs to gross advances* ratio has inched-up for Q1-FY04 on account of rise in overall NPLs, the *net NPLs to Net advances* ratio remained unchanged. The coverage ratio (provision to NPLs) improved considerably, indicating that a substantial amount of NPLs has been provided for.

Table 6.6: NPLs of the Banking Sector

	NPLs to gross advances	Net NPLs to net advances	Coverage ratio
Dec-02	23.7	11.7	63.1
Mar-03	23.6	11.4	63.2
Jun-03	20.7	9.5	65.7
Sep-03	21.0	9.5	67.3

Figure 6.9: Composition of NPLs as on End Sep-03

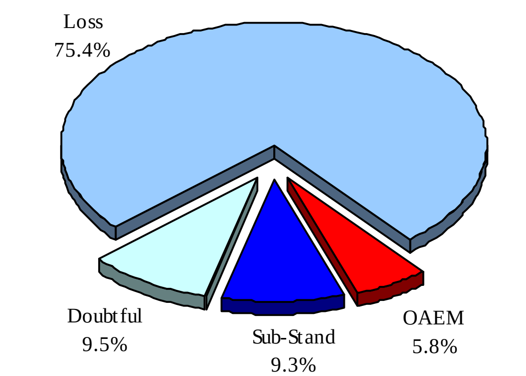
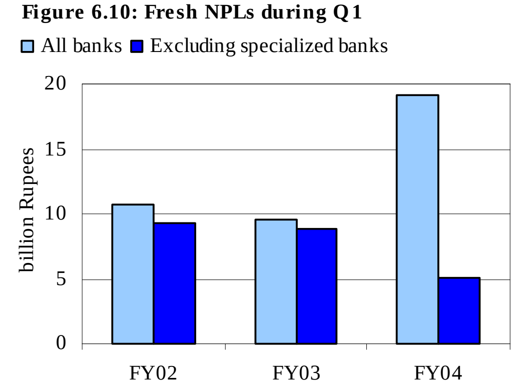


Figure 6.10: Fresh NPLs during Q1



The roots of this considerably high ratio can be traced to historical evolution of the NPLs. It is evident from **Figure 6.9** that the share of loss category i.e., mainly those stuck up for a long time, is over 75 percent, which require full provisioning. The lower share of other categories suggests that the fresh lending is of better quality. The point is reinforced by the fact that fresh NPLs have substantially declined over the past two years (see **Figure 6.10**).