6 Banking Sector

6.1 Overview

Aggressive marketing, coupled with the rising demand emanating from increasing economic activity, helped banks to sharply raise net credit extension during Q2-FY04 to a quite remarkable Rs 136.3 billion.[1] Banks funded this surge in credit demand through: (1) a continuing strong deposits growth (Rs 67.7 billion during the quarter); (2) higher borrowings; as well as (3) depleting a portion of excess liquidity held in the form of low yielding government securities.

The exceptional rise in advances *within* the credit growth coupled with the decline in aggregate bank investments (due to the lower T-bill holdings) underpinned a small rise in the interest rate spread during Q2-FY04. This, together with the declining burden of NPLs, a big jump in fee based income, the greater contribution of capital gains and the reduction in the tax rate helped banks' maintain profitability, despite the YoY decline in interest rates.

The quarter also witnessed the continuation of the SBP focus on the banking sector reforms aimed at strengthening supervision capabilities, improving soundness of the banking system and facilitating the enhancement of banking services. Two important milestones achieved during the quarter include the privatization of one the biggest public sector banks and the issuance of new business specific prudential regulations to facilitate lending to non-corporate borrowers.

Privatization

During the quarter under review, the government off-loaded its 51 percent stake in Habib Bank Limited through competitive bidding (December 29, 2003). A week earlier, Rs 9.8 billion worth bonds were issued against the impaired tax assets on demand of the prospective investors of the bank to make the institution more viable. With this privatization, the share of public sector commercial banks in the asset holdings of the banking sector dropped to only 21.7 percent.

Prudential Regulations

In an effort to facilitate increasing banking services in new business areas and to ensure minimum prudence, the SBP has issued separate set of prudential regulations for consumer, SME, microfinance, and corporate financing. The

[1] To put this in perspective, the Rs 134.8 billion net growth during H1-FY04 was *greater* than the sum of the net credit growth in the two preceding years (Rs 55.2 billion for H1-FY03 and Rs 56.6 billion for H1-FY02).

regulations have been developed with intensive consultation of stakeholders, so that the smooth transition from old to new regulations could take place.

6.2 Developments in Relatively New Segments

6.2.1 Microfinance Institutions (MFIs)

The SBP along with the government has chalked out a comprehensive plan to increase micro-credit access on a sustainable basis. Two private sector micro-finance institutions have been established during the last couple of years and appropriate prudential regulations put in place.

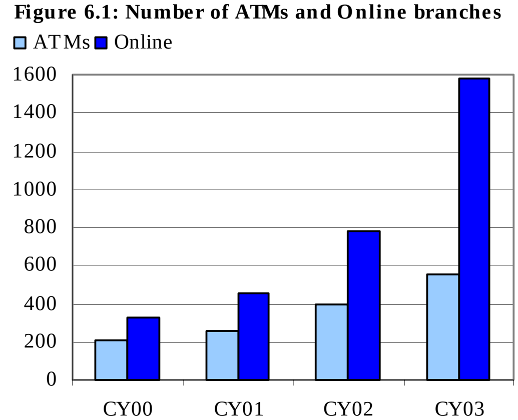
Both institutions have increased their outreach during the last two years, expanding their branch network (see **Table 6.1)**. As a result, the number of borrowers accessing these institutions has almost doubled during CY03, with advances rising by Rs 243.3 million during the year, up 49.3 percent from the Rs 493.1 million by end-CY02.

It should be noted that while advances still constitute only 17.0 percent of total assets of MFIs, this is probably a consequence of the narrow institutional base, limited retail capacity in this initial stage of operations, as well as the small average loan size.

Table 6.1: Outreach of Micro finance Institutions

	Khushali Bank		FMB	
	Dec-02	**Dec-03**	**Dec-02**	**Dec-03**
No. of branches	31	36	8	20
Total No. of borrowers	56,324	92,862	713	3,558
No. of new depositors	0	0	1,880	1,834
Average loan size - Rs	8,796	7,696	24,697	18,492

Figure 6.1: Number of ATMs and Online branches



6.2.2 Automated Retail Transactions

Over the last five years, e-banking has witnessed substantial growth in Pakistan with the number of online and computerized branches rising steadily. Q2-FY04 in particular saw online branches increased by 409 to reach 1581(see **Figure 6.1**).

The use of Automatic Teller Machines (ATMs) has paralleled this development (see **Table 6.2**). During Q2-FY04, 67 new ATMs have been installed and there was an increase of 0.2 million in ATM card holders. The amount of ATM transactions during the quarter also is showing significant increase. However, these transactions are concentrated heavily in domestic private banks with a single large bank capturing over 50 percent of the total ATM transitions of the banking sector.

Table 6.2: ATM Transactions during the period
billion Rupees

		FY04	
	H2-FY03	**Q1**	**Q2**
Public sector commercial banks	1.8	2.5	2.4
Domestic private banks	10.2	11.7	13.6
MCB	*7.1*	*8.0*	*9.1*
Others	*3.1*	*3.7*	*4.5*
Foreign banks	3.3	3.5	3.8
Total	15.3	17.7	19.8

6.3 Core Banking Activities

6.3.1 Deposit Mobilization

Despite the negative real rate of return offered, the banking sector deposits rose by Rs 67.7 billion during Q2-FY04, in contrast to the Rs 44.5 billion growth in Q2-FY03. This rise appears to be driven by the continuing large remittance inflows,[2] improving economy, and higher credit off take. Another important contributor to the stronger deposit growth during Q2-FY04 is the sharp fall in NSS inflows during the period. Specifically, the NSS recorded an investment of Rs 27.6 billion during Q2-FY03 compared to negligible Rs 0.1 billion during the quarter under review.

The strong 3.9 percent Q2-FY04 deposit growth, pushed up the H1-FY04 growth to 6.9 percent, close to the 7.2 percent recorded during H1-FY03 (see **Figure 6.2**).[3]

Rise in FCDs after Declining for Six Successive Quarters

An interesting development was the abrupt reversal of the downtrend in aggregate foreign currency deposits (FCDs) of banks. However, a closer look reveals that this reversal is primarily due to one-off factors such as: (1) the temporary placement of 'earnest money' for the privatization of Habib Bank Limited; and (2)

[2] However, the role of remittance in deposit growth has been reduced, as is suggested by the fact that deposit mobilization during Q2-FY04 was greater than that in the corresponding period last year (when the rise in workers' remittance was more pronounced - deposit growth during Q2-FY04 was 3.9 percent against 3.02 percent in Q2-FY03)

[3] In fact, last quarter of FY03 recorded exceptional rise of Rs 109.4 billion in deposits, which increased the base for FY04. Nonetheless, in absolute terms, the deposits mobilization during H1-FY04 is higher than that in HI-FY03.

the transfer of Crescent Investment Bank's FCDs to Mashreq Bank after the merger of the two institutions.

The one off developments also explain the sharp jump in US Dollar denominated deposits during Q2-FY04, in contrast to the trends in preceding quarter when most of the growth in FE-25 deposits comprised of Euro and Sterling deposits (see **Figure 6.3**).

Figure 6.2: Cumulative Deposit Growth

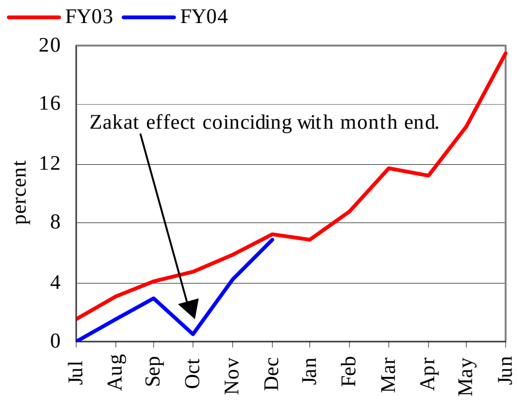
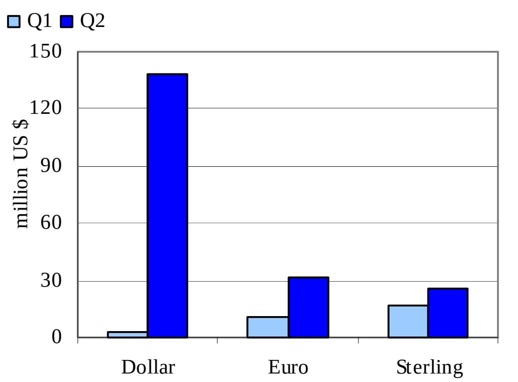


Figure 6.3: Increase in FE-25 Deposits during FY04



Deposit Growth vs. Deposit Rates

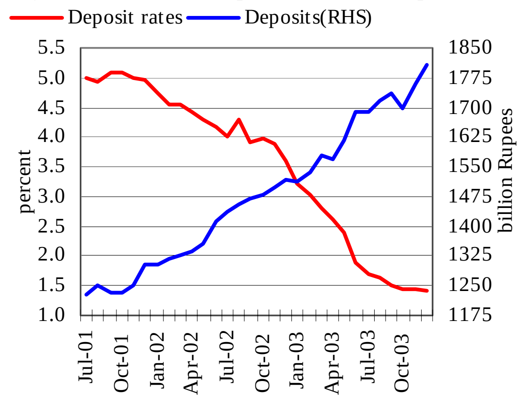
Although the weighted average returns on deposits have declined steadily over the last two years, the corresponding growth in banking sector deposits has remained strong (see **Figure 6.4**). In fact, the growth in deposits has even been sustained after the real weighted average return on deposit, turned negative in December 2002. This rise in deposits despite declining deposit rates indicates the predominance of factors other than the interest rate in determining deposit growth (at least in the short run).

Deposits by Banks

All the banking groups, other than specialized banks, registered an improvement in deposit mobilization during the quarter under review (see **Table 6.3**).

Amongst these, the domestic private banks (DPBs) outperformed the other groups, despite the sharpest reduction in deposit rates among commercial banks. This appears to be largely a result of the greater outreach of these banks.

Figure 6.4: Trend in Deposit Rates and Deposits



The increase in deposits of PSCBs (public sector commercial banks) during the quarter is also significant as compared to Q2-FY03. Growth in Rupee deposits of this group, however, seem subdued due to large net withdrawals from government and PSE's deposits.[4] On the other hand, increase in FCDs of these banks was largely due to one-off factors mentioned earlier.

The foreign banks, which were severely hit by declining FCDs during Q2-FY03, performed relatively better in the current quarter.[5] This is because, not only is the declining trend absent in FY04, but the FCDs have started rising.

Table 6.3: Banks Deposit Mobilization

billion Rupees

	LCD		FCD		Overall	
	FY03	FY04	FY03	FY04	FY03	FY04
During Q2						
PSCBs	2.2	5.2	-2.7	2.2	-0.6	7.4
DPBs	50.3	54.7	-3.3	3.1	46.9	57.7
FBs	2.4	0.7	-5.5	1.3	-3.1	1.9
SBs	1.2	0.6	0.0	0.0	1.2	0.6
All Banks	56.1	61.1	-11.6	6.5	44.5	67.7
During H1						
PSCBs	17.4	23.7	4.2	1.7	21.6	25.3
DPBs	94.0	79.6	-6.1	1.7	87.9	81.3
FBs	2.7	7.4	-11.0	2.2	-8.3	9.6
SBs	0.9	0.4	0.0	0.0	0.9	0.4
All Banks	115.0	111.0	-12.9	5.6	102.1	116.6

6.3.2 Credit Expansion

Coinciding with the period of usual credit take-off, overall credit expansion during Q2-FY04 was Rs 136.3 billion as compared to Rs 90.6 billion in the same quarter

[4] Deposits of PSEs and government declined by Rs 7 and Rs 3 billion respectively, during Q2-FY04.
[5] Foreign currency deposit to total deposit ratio is highest for this banking group.

last year. As a result, H1-FY04 credit expansion was more than twice that in H1-FY03 (see **Figure 6.5**).

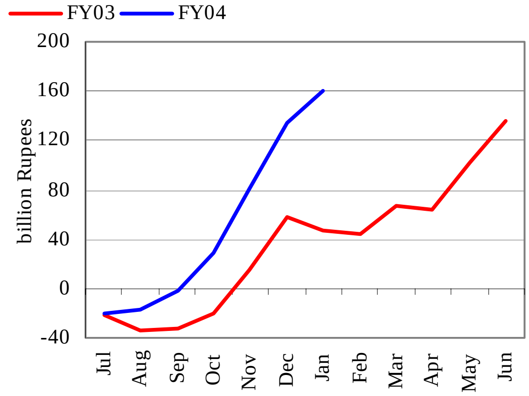


Figure 6.5: Banks Credit Expansion-cumulative

A sectoral distribution of the credit growth indicates that the increase in credit emanated from all major sectors including corporate, SME, consumer and commodity finance (see **Figure 6.6**). This is contrary to the preceding quarter, when consumer finance and SMEs were the major recipients. The difference between the two quarter is largely due to the fact that second quarter usually is the peak season for credit demand from the corporate/industrial sector.

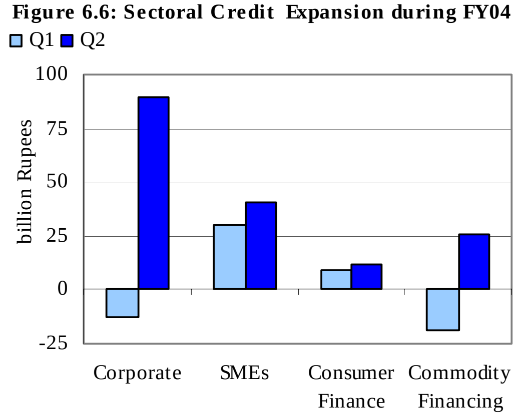


Figure 6.6: Sectoral Credit Expansion during FY04

Significantly, 88.0 percent of H1-FY04 credit expansion was contributed by advances; by contrast this ratio was 75.3 percent for H1-FY03 reflecting that considerable portion of the rise in credit in the latter period was due to increased banking sector exposure towards the equity markets and TFCs. Another important component of overall credit is banks' investments in the equity, which grew by Rs 3.0 billion during Q2-FY04 compared to Rs 5.2 billion in the preceding quarter largely because of SBP regulation requirement for banks to limit their equity investments up to 20 percent of capital (see **Figure 6.7**).

The rise in credit was also shared by foreign currency loans for trade related purposes. These loans saw a rise of Rs 8.4 billion against net retirements in the preceding quarter (see **Figure 6.8**). In fact, most of this increase came during December 2003 amidst expectations of a rupee appreciation.

The **Table 6.4** shows that most of Q2-FY04 credit expansion was due to DPBs, which accounted for 71.7 percent of total expansion. This was followed by the PSCBs that captured most of the growth in fixed investment. Foreign banks, however, did not see comparable growth despite offering lowest lending rates to their customers. Although, banks in this group have expanded business with SME and consumer sector, heavy net retirements of corporate sector led to a decline in the net credit figures of foreign banks during the quarter.

Figure 6.7: Banks' Investments in Stocks-Chnages during FY04

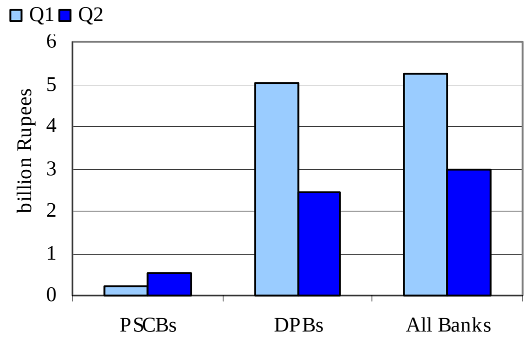


Figure 6.8: Changes in Banks' Foreign Currency Lending

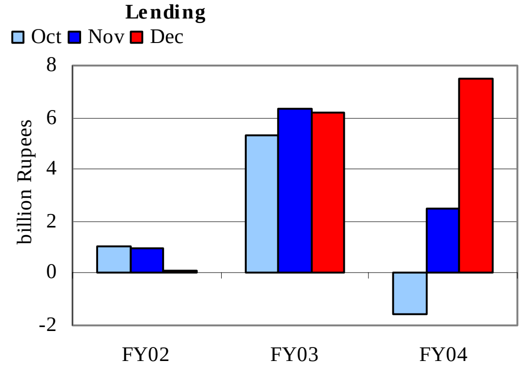


Table 6.4: Banks' Credit Expansion
billion Rupees

	Q2		H1	
	FY03	**FY04**	**FY03**	**FY04**
PSCBs	12.8	47.7	-3.5	36.8
DPBs	61.5	97.8	57.1	111.5
FBs	14	-2.6	1	-8.9
SBs	2.4	-6.7	3.8	-4.6
All Banks	**90.6**	**136.3**	**58.5**	**134.8**

6.4 Non-Performing Loans[6]

The reporting/accounting of NPLs has witnessed a significant change during Q2-FY04. In fact, earlier banks were using slightly different approaches for accounting/reporting of their loans/advances, accrued

[6] This section is based on overall NPLs of the banking sector (both domestic and overseas operations). Since the reporting/accounting procedure has been changed, the time series data on new methodology is not available.

mark-up and non-performing loans. For example, various banks were reporting accrued mark up as a part of their "other assets" while others were making it a part of advances. Furthermore, Quarterly Statement of NPLs was related to only domestic operations of the banks.

In view of these issues, clear accounting/ reporting guidelines, consistent with international practices, were issued vide BSD Circular No. 9 dated November 12, 2003. Moreover, in order to reduce the number of returns and to streamline data reporting, banks were now required to submit their NPLs position as Part-B of the Quarterly Report Condition, instead of submitting a Quarterly Statement of NPLs separately.

According to revised guidelines, NPLs of the banking sector recorded an impressive decline of Rs 5.6 billion during Q2-FY04 to reach Rs 210.1 billion by end-December 2003. NPLs related to both domestic and overseas operations saw a decline of Rs 3.2 billion and Rs 2.4 billion respectively during the quarter under review. The decline in NPLs seems more impressive in the presence of substantial provisions held with banks against these NPLs.

Adjusting for provisions held, the net NPLs of the banking sector turn out to be Rs 76.7 billion by end-December 2003. In other words, the coverage ratio for end-December 2003 is 63.5 percent, suggesting that significant portion of NPLs have been provided for.

Another important point to be highlighted is the position of fresh NPLs.[7] The banking sector has registered a rise of Rs 15.9 billion during the quarter under review, which are Rs 3.2 billion lower than the fresh NPLs recorded during Q1-FY04 even for the domestic operations only. This, together with declining trend in fresh NPLs from domestic operations over the last three years suggests that the problem of NPLs is subsiding due to adherence to a pro-active multi-pronged policy to contain NPLs.

6.5 Financial Highlights

During the quarter under review, assets of the banking industry increased significantly, largely at the back of a surge in advances during the period (see **Table 6.5**). This strong growth was funded by impressive rise in deposits and to some extent by higher borrowings.

[7] This must be kept in mind, the fresh NPLs can not calculated by subtracting outstanding amount at two points of times. This variation will take into account of the impact of cash recovery, restructuring of loans, loans written off, upgraded NPLs, and new addition during the specified time period.

Table 6.5: Operating Position during Q2-FY04
billion Rupees

		FY04	
	CY02	**Q1**	**Q2**
Balance sheet			
Total assets	2225.2	2387.4	2541.3
Net-investment	701.5	829.2	786.7
Net-advances	923.4	965.3	1103.5
Liabilities	2117.6	2268.3	2412.8
Financial highlights			
Net interest income	69.3	54.2	72.5
Total non interest income	32.2	37.3	48.4
Profit after tax	2.4	20.9	28.6
Performance indicators (percent)			
ROA	0.1	1.2	1.2
ROE	2.7	24.0	24.0
NIM	4.4	3.7	4.4

However, investments declined sharply due to Rs 81 billion fall in banks' T-bills holdings. This was due to both, expectations of an interest rate reversal, and low acceptances by the SBP in auctions to stabilize interest rates (see **Section** on **Money Market** for details). This change in the asset composition of the banking sectors, switching low yielding assets (government securities) with relatively high return assets (advances, particularly to SME and consumers) helped banks to widen net interest margin and improve their profitability.

6.4.1 Net Interest Income

Following the spurt in banking activities (both in terms of deposit mobilization and credit expansion), banks' interest income and interest expense both grew sharply during Q2-FY04. However, the rise in former was more pronounced on the back of strong credit growth. As a result, net interest income during the quarter was Rs 18.1 billion higher than the Rs 54.4 billion in Q1-FY04.

Interest expenses of the banking sector saw a rise of Rs 8.3 billion during Q2-FY04. Of this, a rise of Rs 5.4 billion was on account of interest paid on deposits and Rs 2.1 billion on borrowing. While higher deposit growth led to rise in former, the later surged due to: (1) the tremendous increase in bank borrowings during Q2-FY04 (by Rs 65 billion as compared to net retirements in the preceding quarter), and (2) the high overnight rates, which often touched the discount rate during the quarter.

Interest income of the banking sector surged to Rs 113.9 billion by end Q2-FY04, recoding a rise of Rs 14.0 billion during the quarter under review. This increase was the largely attributed to huge expansion in the volume of credit. However, the support also came from a 39 bps rise in weighted average lending rates during the month of December 2003 (largely reflecting the higher exposure to consumer credit and the increased agri-sector lending).

Higher net interest income together with increased non-interest income in the presence of relatively small rise in expenditures helped the banking sector to increase their profitability. Furthermore, the decreasing burden of NPLs and lower burden on taxation liabilities due to a cut in tax rate are also contributor factors.