

## REVIEW OF THE BANKING SECTOR – 2005 & BEYOND

The year 2005 represents a landmark year for the commercial banking sector in Pakistan both in terms of profitability and business growth. There was a significant increase in system deposits, which expanded by 23%, as well as in profitability, which almost doubled in this period. The increase in profitability was driven by increase in advances (29%) and also in spreads. The robust credit demand led to a higher advances/deposits ratio in the system. Banks' profitability was also stimulated by increasing fee-based income as well as capital gains in the stock market. Meanwhile, the improvement in equity-to-assets not only demonstrates the increase in risk absorption capacity but also provides room for future growth. While the aforesaid indicators reflect the improved financial health of the sector, the extent of improvement varied from bank to bank. In terms of various classes of banks, the foreign banks showed a decline in their share of deposits and advances. The large banks also found it difficult to maintain their system share, particularly of deposits. On the other hand, the medium-sized banks showed impressive growth with improving system share of deposits and advances. Within these banks, six banks have emerged as significantly ahead of the pack with asset size crossing over PKR 100 billion.

2. While the large banks are well-positioned to sustain growth and profitability, the relatively smaller banks are coming under increasing competitive pressure not only for maintaining their system share but also for consolidating their position in individual business segments. The intensifying competitive pressure is generating added momentum to

the process of mergers and acquisitions. As a consequence, several proposals of M&A are in various stages of implementation. The successful conclusion of the proposed M&A process is likely to bring a significant change in the banking landscape.

3. Meanwhile, the increasing interest in Islamic banking has added another dimension to the sector. During 2005, two new Islamic banks were licensed with another two licensed in the current calendar year making the total to six. At the same time, nine conventional banks were licensed to conduct Islamic banking in designated branches. It is expected that by year-end 2006, there would be over 100 Islamic banking branches in the country. This number could increase progressively in subsequent years with roll-out of the planned 50 branches of Dubai Islamic Bank. These branches could attract a significant amount of deposits thereby increasing the system share of deposits from the nominal current level of less than 2%. In the short-to-medium term, however, the deployment of these deposits into core banking assets may be a slow process owing to limited availability of Sharia compliant assets, currently confined mainly to *Murabaha* and *Ijara*.

4. Prospects for 2006 suggest that it would be difficult to replicate the deposit and advances growth recorded in 2005. Likewise, it might not be possible to maintain the high spreads of the previous year. The pattern of deposit growth during the first half of 2006 indicates a considerable slowdown primarily due to tight monetary policy leading to slower M2 growth. This slowdown is more likely to affect relatively smaller banks; and

particularly those with a limited branch network. In the longer term, however, growth in saving and term deposits could also affect larger banks, as higher expected return on debt securities, mutual funds and NSS could lead to a process of disintermediation.

**5.** The advances growth recorded during the first half of 2006 also suggests a slowdown in credit off-take. This may not, however, be entirely representative of prospects for the full year. While there are indications of limited growth in credit demand from the large corporate sector, the potential for increased demand for SMEs, consumer financing and from the agriculture sector continues to be buoyant. However, these areas of potential growth are more likely to be tapped effectively by those banks that have in place the technology infrastructure, adequate network outreach and in-depth understanding of the target markets.

**6.** Spread management would be yet another challenge for commercial banks. The inclining interest rate trend witnessed in 2005 is likely to continue during 2006, though gradually. While banks would be able to pass on the increased costs to borrowers, they are likely to be under increasing pressure for upward adjustment in return on deposits, as the time lag for adjustment is likely to narrow down. Cognizant of this emerging scenario, most banks are focused on increasing the proportion of current (non-remunerative) deposits. The ability to achieve this objective would again be a function of the banks' size and infrastructure. Meanwhile, efforts are also in hand to reduce intermediation costs by enhancing employee productivity as well as technological upgradation. The increasing emphasis on expanding the ATM

infrastructure is a critical element in this context with ATMs showing an annual increase of 55% from 786 to 1,217. Not only do ATM transactions provide a lower cost alternative, they also enhance the service quality image of banks.

**7.** The foregoing observations clearly underscore the likely plan that banks are expected to follow in 2006 and beyond: volume growth with increasing emphasis on higher return, but relatively riskier, SME and consumer financing. This strategy would obviously strain the risk management capacity of banks. In this changing environment, banks which are likely to emerge successful are those who already have in place robust risk management systems and who also have the vision and resources to keep them aligned with the changing risk profile of the asset portfolio. In terms of the regulatory framework, the risk management capability of the banking sector has continuously improved in recent years. The State Bank of Pakistan has continued to play an effective role in strengthening the capacity of banks to manage risk. Beyond prescribing substantial enhancement in paid-up capital, SBP is also actively pursuing its agenda of making all banks compliant with Basel II framework. In fact, SBP was among the first central banks in the region to formulate a comprehensive roadmap for Basel II specifying actionable points as well as timeline for completion. The roadmap was notified as early as March 2005 and since then the prescribed implementation steps are being taken within the identified timeline. More importantly, SBP continues to have frequent consultations with the banking sector for ensuring that the requirements are fully understood. At the same time, SBP continues to monitor progress made by individual banks in aligning their technology

platforms and risk management systems to be compliant with milestones specified in the roadmap. During its interaction with a large cross-section of commercial banks, PACRA finds that the level of preparation for Basel II varies from bank to bank. This variation is principally on account of the quality of technology platform and also on the size of the loan book of a particular bank. The latter factor is important because banks that have a larger advances portfolio would find it more difficult to analyze their portfolio according to parameters prescribed under Basel II due to limited or non-availability of required information on all borrowers.

**8.** SBP's multiple and continuous initiatives at enhancing banks' capacity to manage risk have already led to an improving trend in the risk profile of banking assets. This is reflected in continuous improvement in NPL related ratios. It is, however, important to analyze whether the improving asset quality is sustainable, as more and more banks increase their focus on consumer financing. In the case of some banks, the share of consumer financing has already grown to over 30% of total lending with plans to increase it to as high as 50% in the medium term. While so far the high growth in consumer financing has not led to any material increase in NPLs, it is important to note that a large proportion of these exposures represent 'unseasoned loans', that is, loans of recent origin. The default pattern of other countries suggests that the incidence of default increases in the third year and beyond. At this stage, therefore, the controlled NPLs may not be a reliable indicator of future trends.

**9.** The extent of potential risk in consumer financing is also a function of the nature of such loans with auto financing

representing the lower end of risk followed by mortgage financing with the potential risk increasing exponentially in the case of unsecured personal loans and even more in the case of credit cards. The pattern of consumer financing growth in Pakistan indicates the highest contribution of auto financing. However, unsecured loans, particularly in the form of credit cards, are also growing at a high rate. While the principal issuing banks of credit cards have the requisite human resource base and adequate technology infrastructure both for credit evaluation and monitoring, the high rate of inflation as well as rising interest rate scenario in the country could impact the repayment capacity of borrowers and increase the incidence of defaults. However, the availability of positive data on potential borrowers, started recently, is expected to help in risk management though the extent of usefulness remains to be seen. At this stage, therefore, it is difficult to forecast the extent of additional provisioning that banks might have to make for coping with any increased incidence of defaults. Currently, most banks' managements feel that the prescribed provisioning standards are adequate and even if the default incidence were to increase, the considerably higher spreads on consumer loans would enable banks to meet potential losses without any material impact on the bottom line.

**10.** There is a general perception in Pakistan that the increasing focus on consumer financing could, in the long run, undermine banks' asset quality and even solvency. This concern is not entirely warranted. The exposure in consumer financing in Pakistan is still at a low level, as compared to other countries in Asia. With consumer financing representing around 15% of total loans and around 4% of GDP, Pakistan ranks amongst the lowest

within the Asian region. Even in India, consumer financing represents 10% of GDP and 24% of bank loans. In other, more developed countries, like Malaysia, Taiwan and Korea, consumer financing represents 60% of the GDP. It follows, therefore, that the growth potential in consumer financing in Pakistan remains very high. However, given the high rate of inflation and rising un-employment in the middle class, the repayment capacity of borrowers remains under stress. Under these circumstances, lending banks which are likely to remain relatively unscathed in the event of increasing default incidence are those who have strong monitoring and recovery systems in place, as such banks are likely to recover larger proportions in comparison to banks which may not have structured early warning signals in place.

**11.** While the banking sector in Pakistan has come of age and has acquired a fair degree of stability, it is not entirely insulated from challenges ahead. Although some banks are better equipped than others to effectively respond to these challenges, the intensifying competitive environment precludes the luxury of complacency even among the best-managed banks. Overall, performance prospects of individual banks would continue to remain a function of a number of bank-specific variables. The asset size and capital structure of the bank, its geographical outreach, the financial standing and credibility of bank sponsors, the technological base and, most importantly, the quality of human resources are all key elements. A number of medium-sized banks have come out successfully in the fast evolving competitive environment and seem well placed for sustaining their performance and asset quality. However, they continue to face the threat of greater competition from the large privatized banks

with extensive geographical outreach, as these banks are rapidly overcoming their inefficiencies and adopting a more market-based business approach. There is, thus, an increasing awareness that, in order to maintain their historic performance, the medium sized banks will have to remain committed to continuous improvement in service quality as well as product innovation. These factors would inevitably lead to greater efficiency in financial intermediation and provide a wider choice to banking customers.