



## **PRESS RELEASE**

### **PACRA'S REVIEW OF PRIVATE COMMERCIAL BANKS**

**Lahore: October 31, 2003**

As part of its ongoing rating review process, PACRA has reviewed the performance of the banking sector during the first half of the current financial year. As PACRA's rating universe consists predominantly of private banks, this review focuses on the private bank segment.

Private banks maintained the deposit-led growth momentum during the current year. Benefiting from the continuing consolidation process in nationalized banks and the cautious stance of foreign banks, private banks have managed to marginally increase their system share. This has largely been due to continuing improvement in service quality and the expanding geographical outreach.

The major challenge faced by the banking sector is the efficient deployment of funds into earning assets, given the increasingly competitive environment and less than robust growth in credit demand. However, most private banks managed to maintain their position and the overall credit-to-deposit ratio remained almost static. For a majority of these banks, considering their focus on trade finance, the growth in imports/exports business of the country provided the required impetus for expansion and the trend is likely to continue. Meanwhile, the increasing focus on consumer financing is expected to emerge as a major catalyst in volume growth, going forward. Housing finance is yet another area that is being targeted for credit expansion. A few of the banks have already launched their housing finance products, while some others are in the development stage. The impact towards credit expansion is expected to be more pronounced in the near-term, the prospects of which, with prevailing low interest rates, appears promising. However, at this stage it is difficult to forecast the extent of the success of these initiatives.

Contrary to expectations, the sector managed to resist the pressure on spreads, particularly the medium-sized private banks which, in fact, witnessed a slight improvement in spreads during the first half of the current year. This was made possible through lowering of deposit rates. Although with re-pricing of assets the benefit would progressively decline, a modest increase in return on government securities, though expected to be in a narrow range with an overall stable outlook, is expected to somewhat help in spread management. Going forward, while the increase in mark-up revenue is not expected to sustain profitability, the increasing contribution of non mark-up income is likely to lead to higher profitability levels by year-end. However, a major portion of non mark-up income – gain on securities – is not likely to be sustainable in the long run.

The asset quality of the loan portfolio of most banks has remained almost unchanged with risk of potential loss marginally declining through additional provisioning. Most banks largely maintained their equity to assets position. However, for certain individual banks this was made possible through realizing substantial capital gains to support their weakening equity against continued growth in total assets. On the other hand, banks, which continue to carry large unrealised surplus on their balance sheets, may not be able to maintain this level owing to erosion in market value of listed securities subsequent to 30<sup>th</sup> June and likely inching up of interest rates on government securities. This in turn could impact negatively on the risk absorption capacity. Going forward, entering into relatively new credit avenues requires further strengthening of risk management systems for ensuring that credit quality is not undermined by the pursuit of volume growth.

In PACRA's view, individual banks will face a critical testing time and some might find it difficult to replicate past performance. This is due to the current sluggish economic environment and particularly limited growth in private sector credit demand despite improving trends in recent months. Nonetheless, in the short-term, the traditional trade finance business is expected to provide volumes for credit expansion, particularly in the textile sector which is making substantial investment in anticipation of emerging opportunities as a consequence of the liberalised WTO trade regime. Meanwhile, the recent increase in cotton prices will help banks to increase the level of financing for meeting seasonal working capital requirements.

The State Bank of Pakistan continues to play a proactive role in bringing greater financial discipline and improving risk management within the banking sector. The SBP has issued three new Prudential Regulations covering (i) Corporate/Commercial Banking, (ii) SME Financing and (iii) Consumer Financing, which would come into effect from 1<sup>st</sup> January 2004. These regulations cover key areas of risk management, corporate governance, "know-your-customer" and anti-money laundering and operations, providing greater flexibility and authority to banks. The Central Bank has also issued detailed guidelines on risk management, which provide an overview of the control procedures that could be put in place to guard against risks that may be faced by the financial institutions. The objective is to build up internal capacity of the banks to prepare for Basle II Accord. All these measures are expected to promote self-regulation and bring more transparency to the banking sector.