osec Business Network Switzerland

Pakistan
Banking sector

Compiled by:

Consulate General of Switzerland

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1. ECONOMIC OVERVIEW:

Pakistan's economy has been predominantly agrarian. Since Pakistan came into existence, the contribution of the agricultural sector to the GDP has declined gradually from over 50 percent in 1949-1950 to about 22 percent in the fiscal year 2009-10 (July 2009-June 2010). However, agriculture still remains the major sector of the GDP composition. Other economic sectors include industry and services, contributing to the GDP about 25 percent and 53 percent respectively.

Since its independence in 1947, Pakistan has transformed itself from a low skilled agrarian economy to a semi-industrialized economy. On the other hand, Pakistan has a long way to go in economic and social development as a large portion of its 180 million inhabitants is still living below poverty line.

During the last decade, economic developments in Pakistan have been - to a significant extent - influenced by the Government's Program for poverty reduction and the development of markets and the real economy. Following the liberalization of markets and the implementation of economic reforms, the following developments in the economic and social sector have been identified:

- High GDP growth resulting from output and sales growth;
- Monetary stability;
- Developments of money and securities markets;
- Improvements in the standard of living and poverty reduction (based on economic growth);
- Development and reinforcement of the banking sector and enhancement of its role in the social and economic development of the country.

However, the economic development has been slowed down since 2008, as the macroeconomic situation deteriorated significantly owing to adverse security developments, large price increase of some commodities such as oil and food, global financial turmoil, and national political and security issues. Other challenges being faced by Pakistan's economy include energy deficiency and growing population etc.

Furthermore, recent unprecedented floods and torrential rains (July-August 2010) in the country to some extent have intensified the effects of an already fragile macroeconomic environment.

Currency: Pakistani Rupee (Rs.) is the official currency of the country. The notes are in denominations of 5000, 1000, 500, 100, 50, 20 and 10, while coins are available in denomination of 5, 2 and 1.

Rupee CHF parity/Exchange rate: 1 CHF = 92.47 Rs. as on February 25th 2011.

2. OVERVIEW OF FINANCIAL SECTOR:

A sound and well functioning financial sector is essential to support economic growth of a country. Pakistan possess a wide range of financial institutions; commercial banks, specialized banks, national savings schemes, insurance companies, development finance institutions, investment banks, stock exchanges, corporate brokerage houses, leasing companies, discount houses, micro-finance institutions and Islamic banks. They offer a whole range of products and services both on the assets and liabilities side.

Prior to 1971, the primary focus of the Governments was on developing commercial banks in the private sector and creating development institutions backed by Government. The private sector development, however, almost closed during the period 1971-1990, due to the nationalization policy of the Government. During this period, the banking sector came under the Government's control. Since 1990s, the Government has followed more liberal and market-based reforms.

The current structure of the financial sector in Pakistan is the result of several policy shifts and developments. Like many other developing countries, Pakistan also undertook the process of financial restructuring through reforms in early 1990s to establish a more market-based system of financial intermediation and Government financing, conduct the monetary policy more efficiently through greater reliance on indirect instruments and increase the contribution to the rapid development of the stock markets.

During the last few years, financial markets and institutions in Pakistan have witnessed significant changes in terms of consolidation as well as diversification. Since 2000, more than 40 transactions of mergers and acquisitions have been executed within banks and between banks and non-bank finance companies. On the other hand, a number of banks/development financial institutes as well as their holding groups have expanded their activities into the areas where the banks hitherto were either not allowed or not interested. These include insurance, asset management, brokerage, leasing and other non-banking finance services essentially through separate entities. Along with financial services, various groups that control different banks have also stakes in non-financial/real sector of economy.

In the World Economic Forum's "Financial Development Report 2009", Pakistan has been ranked 49 out of 55 countries. Under Factors, Policies and Institutions pillar, Pakistan ranks 52nd in institutional environment, 50th in business environment and 48th in Financial Stability. In the Financial Intermediation Pillar, Pakistan ranks 46th in banking, 51st non-banking and 25th in Financial Markets. Under Financial access, Pakistan ranked 50th.

State Bank of Pakistan (the central bank of the country) is the sole supervisory and regulatory authority of Commercial Banks, Islamic Commercial Bank, Development Financial Institutions (DFIs), Micro Finance Banks and foreign exchange companies in Pakistan. The remaining financial institutions are monitored by other authorities, such as the Securities and Exchange Commission.

3. BANKING SECTOR:

Pakistani banking sector has witnessed drastic changes over a period of 63 years since country's independence in 1947. Initially it suffered from acute shortage of resources and uncertainty due to prevailing political and socioeconomic conditions. Lack of trained human resource and professionals resulted into poor quality of products and services. State Bank of Pakistan was established as the central bank on July 1, 1948 to control the financial sector. Subsequent amendments were made to extend the control and functions of SBP through State Bank of Pakistan Act 1956. SBP encouraged the private sector to establish banks and financial institutions in the country. It resulted into unhealthy competition and unlawful practices due to bribe and corruption during the decades of 1950s and 1960s.

In 1974, all the existing banks were nationalized by the Government. The performance of nationalized banks deteriorated due to government protection to employees, resulting into the provision of inferior products and poor services. It also discouraged the private investors and foreign financial institutions. The poor performance of nationalized banks caused the reforms/privatization of banking sector in early 1990s.

Today, the Banking sector of Pakistan is playing pivotal role in the growth of country's economy. In accordance with the State Bank of Pakistan Act, the banking system of Pakistan is a two-tier system including the State Bank of Pakistan (SBP), commercial banks, specialized banks, Development Finance Institutions (DFIs), Microfinance banks and Islamic banks. As of June 2010, the banking sector comprised 36 commercial banks (including 25 local private banks, 4 public sector commercial banks and 7 foreign banks) and 4 specialized banks with a total number of 9,087 branches throughout the country. Among the banks, there are 6 fully fledged Islamic banks as at end of June 2010.

Scheduled Banks Operating in Pakistan, as on 30th June, 2010

	Bank Name	Total Branches	Website
A.	**Public Sector Commercial Banks**	**1,621**	
1	First Women Bank Ltd.	39	www.fwbl.com.pk
2	National Bank of Pakistan	1,267	www.nbp.com.pk
3	The Bank of Khyber	42	www.bok.com.pk
4	The Bank of Punjab	273	www.bop.com.pk
B.	**Local Private Banks**	**6,850**	
1	Allied Bank Ltd.	786	www.abl.com.pk
2	Arif Habib Bank Ltd.*	36	www.summitbank.com.pk
3	Askari Bank Ltd.	204	www.askaribank.com.pk
4	Atlas Bank Ltd.*	40	www.atlasbank.com.pk
5	Bank Al-Falah Ltd.	309	www.bankalfalah.com
6	Bank Al-Habib Ltd.	267	www.bankalhabib.com
7	BankIslami Pakistan Ltd	70	www.bankislami.com.pk
8	Dawood Islamic Bank Ltd.	42	www.dawoodislamic.com
9	Dubai Islamic Bank Pakistan Ltd	36	www.dibpak.com
10	Emirates Global Islamic Bank Ltd.	58	www.egibl.com
11	Faysal Bank Ltd.	136	www.faysalbank.com.pk
12	Habib Bank Ltd.	1,457	www.habibbankltd.com
13	Habib Metropolitan Bank Ltd	120	www.hmb.com.pk
14	JS Bank Ltd.	40	www.jsbl.com
15	KASB Bank Ltd.	70	www.kasbbank.com

16	MCB Bank Ltd.	1,085	www.mcb.com.pk
17	Meezan Bank Ltd.	180	www.meezanbank.com
18	mybank Ltd.	80	www.mybankltd.com
19	NIB Bank Ltd.	204	www.nibpk.com
20	Samba Bank Ltd.	28	www.samba.com.pk
21	Silk Bank Ltd.	85	www.silkbank.com.pk
22	Soneri Bank Ltd.	156	www.soneri.com
23	Standard Chartered Bank (Pakistan) Ltd.	162	www.standardchartered.com
24	The Royal Bank of Scotland Ltd.	79	pwkww.rbs.com.pk
25	United Bank Ltd.	1,120	www.ubl.com.pk
C.	**Foreign Banks**	**80**	
1	Al- Baraka Islamic Bank B.S.C (E.C)	29	www.albaraka.com.pk
2	Barclays Bank PLC	15	www.barclays.pk
3	Citibank N.A	17	www.citibank.com.pk
4	Deutsche Bank AG	3	www.db.com
5	HSBC Bank Middle East Ltd.	12	www.hsbc.com.pk
6	Oman International Bank S.A.O.G	3	www.oiboman.com
7	The Bank of Tokyo-Mitsubishi UFJ, Ltd.	1	www.btm.co.jp
D.	**Specialized Banks**	**536**	
1	Industrial Development Bank of Pakistan Ltd.	15	www.idbp.com.pk
2	Punjab Provincial Cooperative Bank Ltd.	159	www.ppcbl.punjab.gov.pk
3	SME Bank Ltd.	13	www.smebank.org
4	Zarai Traqiati Bank Ltd.	349	www.ztbl.com.pk
Commercial Banks (A+B+C)		**8,551**	
All Banks (A+B+C+D)		**9,087**	

Source: State Bank of Pakistan

* Since December 2010, Atlas Bank Ltd. and Arif Habib Bank Ltd. have been merged and formed Summit Bank Ltd.

In addition to the above, the SBP has granted licences to the Industrial and Commercial Bank of China (ICBC) and Sindh Bank in December 2010. The ICBC aims to exploit opportunities in trade and project finance generated by a growing number of Chinese companies working in Pakistan while Sindh Bank aims to promote agricultural development and small scale businesses.

Besides the commercial banks, 8 Microfinance banks and 7 Development Finance Institutions (DFIs) are operating in the banking industry of Pakistan. Due to closing down of a number of Development Financial Institutions (DFIs) during the last decade, the government is currently re-considering to set-up either an “Infrastructure Bank” or “Infrastructure Institution” as this is requirement of the country.

The banks in Pakistan provide settlement and cash services to individuals and companies, including correspondent-banking. Banks also offer domestic and cross-border remittance services to the population. Furthermore, they provide depository services for the accounting and safekeeping of securities. During the last few years, banks have been paying great attention to the expansion of services rendered to households and the enhancement of their quality and efficiency. New forms and channels of making payments have also been introduced.

The services of State Bank of Pakistan include payments to banks, to and on behalf of the Federal and Provincial Governments, the Treasury and some other public institutes including collection of revenues etc., through its 16 field offices as well as through a countrywide network of currency chest/sub-chest branches of National Bank of Pakistan.

As mentioned earlier that the financial landscape of the country which was significantly altered in early 1970s has been transformed - through sector reforms initiated in the early 1990s - into an efficient, sound and strong banking system. The reforms have resulted in an efficient and competitive financial system. In particular, the predominantly state-owned banking system has been transformed into one that is predominantly under the control of the private sector. The legislative framework and the State Bank of Pakistan's supervisory capacity have been improved substantially. As a result, the financial sector is sounder and exhibits an increased resilience to shocks.

Today, almost 80 percent of the banking assets are held by the private sector banks and the privatization of nationalized commercial banks has brought about a culture of professionalism and service orientation in place of bureaucracy and apathy.

Banking Technology that was almost non-existent in Pakistan until a few years ago has revolutionized the customer services and access on-line banking, Internet banking, ATMs, mobile phone banking/ branchless banking and other modes of delivery have made it possible to provide convenience to the customers while reducing the transaction costs to the banks. The Credit Cards, Debit Cards, Smart Cards etc. business has also expanded.

The foreign exchange market that was highly regulated through a system of direct exchange controls over suppliers and users of foreign exchange has been liberalized and all purchases and sales take place through an active and vibrant inter-bank exchange market. All restrictions have been removed with full current account convertibility and partial capital account convertibility.

Since 1st July 2008 Real-Time Gross Settlement (RTGS) payment system has been put in place. The RTGS in Pakistan has been named as Pakistan Real-time Inter-bank Settlement Mechanism (PRISM). Using this system, the banks holding accounts at SBP are able to operate their accounts in real time from their own premises via computerized network between SBP and the participating Banks.

Prior to the recent financial crisis, the excess liquidity and competition among the banks prompted them to move away from the traditional limited product range of credit to the government and the public sector enterprises, trade financing, big name corporate loans, and credit to multinationals to an ever-expanding menu of products and services. The borrower base of the banks expanded many folds as the banks diversified into agriculture, SMEs, Consumers financing, mortgages, etc. The middle class that could not afford to buy cars or houses/apartments as they did not have the financial strength for cash purchases had been the biggest beneficiaries of these new products and services.

3.1 Current trends in Pakistan's banking sector:

Since late 2007, Pakistan faced a difficult macroeconomic environment, not as such due to the global crisis but rather due to a confluence of factors which had been brewing for a while, particularly due to the gradual build up of macroeconomic imbalances which led the country to embark on a macroeconomic stabilization program in November 2008 with the support of the IMF SBA.

The Global Financial Crisis (GFC) had an indirect impact in Pakistan which became evident in 2009 and manifested itself in various forms in the real sector of the economy. However, as said earlier, the major challenges facing the domestic economy can only be partly attributed to the GFC. Indeed there was a decline in exports due to recession in economies which are Pakistan's major trading partners, and there was pressure on capital flows where strained liquidity position in global financial markets impacted foreign portfolio investment.

However, factors such as the power shortages leading to under utilization of industrial capacity and rise in the cost of production, the long-standing issue of inter-corporate circular debt, considerable decline in foreign direct investment due to weak economic fundamentals, high inflation, security concerns and above all, the mounting fiscal deficit breaching previous records in the country's economic history, all had a role to play in keeping the process of economic recovery in Pakistan weak at best. The leading evidence of these various pressures on domestic firms and industries is that their loan repayment capacity has been compromised, with a consequent rise of non-performing loans (NPLs) on the banks' balance sheets.

Furthermore, due to the deteriorated fiscal situation, public sector borrowed heavily from banks for budgetary support, financing needs of Public sector Enterprises (PSEs) and commodity operations. Accordingly, there has been a shift in banks' asset-mix towards credit to the public sector along with increased performance for top rated corporations – over Small and Medium Enterprises (SMEs) and consumer that are generally less resilient to economic slowdown and fragility in operating environment. The heightened credit risk is reflected in a noticeable and persistent increase in NPLs – doubling over two years by the end of calendar year 2009.

Nevertheless, it has tested the resilience of the banking sector in that banks have been forced to build contingency reserves and provide for infected assets. Such requirements have been affecting their dividend payments and consequently putting pressure on their share prices.

4. BANKING SECTOR ASSESSMENT 2009:

4.1 Assets structure of banking system:

Assets of the banking system have been growing at an average of 14.8 percent since Calendar Year (CY) 2001. At the end of the year 2009, the total assets of the banking system reached Rs 6.5 trillion a growth of 15.8 percent. The increase in the asset base has been a remarkable achievement, especially given the growth of only 8.8 percent in CY 2008.

Highlights of the banking system

(In Billion Rs.)

	2005	2006	2007	2008	2009
Total Assets	3,660	4,353	5,172	5,628	6,516
Asset Growth in % (Year over Year)	20	17.1	18.8	8.8	15.8
Investments (net)	800	833	1,276	1,087	1,737
Advances (net)	1,991	2,428	2,688	3,173	3,240
Deposits	2,832	3,255	3,854	4,218	4,786
Equity	292	402	544	563	660
Profit before tax	94	124	107	63	81
Profit after tax	63	84	73	43	54
No. of banks in loss	7	7	10	16	18
Non performing loans	177	218	218	359	446
Non performing loans (net)	41	39	30	109	134
	Basel-I		**Basel-II**		
Capital Adequacy Ratio - CAR (All banks)	11.3	12.7	13.2	12.3	14.0

Source: State Bank of Pakistan

Trends in total Assets of banking system

(In Billion Rs.)

	2005	2006	2007	2008	2009
Commercial Banks	**3,547**	**4,162**	**5,044**	**5,496**	**6,376**
Public Sector Commercial Banks (PSCBs)	*724*	*836*	*1,036*	*1,042*	*1,230*
Local Private Banks (LPBs)	*2,483*	*3,102*	*3,836*	*4,220*	*4,905*
Foreign Banks (FBs)	*339*	*224*	*173*	*234*	*241*
Specialized Banks	**113**	**120**	**127**	**130**	**140**
All Banks	**3,660**	**4,282**	**5,171**	**5,627**	**6,516**

Source: State Bank of Pakistan

However, a key characteristic of this growth has been the significant increase of 60 percent in investments instead of the advances portfolio. Reasons attributed to the rise in the investment portfolio of banks include factors such as: (1) change in banks' risk perception due to mounting non-performing loans (NPLs), and (2) greater borrowing needs of the government from scheduled banks for budgetary purposes, for settling inter-corporate receivables and to finance commodity operations.

(In Billion Rs.)

	2005	2006	2007	2008	2009
Investments (net)	800	833	1,276	1,087	1,737
Investment Growth % (Year over Year)	18.1	4.1	53.1	(14.8)	59.9

Source: State Bank of Pakistan

4.2. Market share by size of banks:

In terms of concentration in the banking sector, the share of individual bank's assets in the total asset base continues to decline as the industry's competitive position gradually improves. A decline in the concentration of large banks is also evident from the fact that the market share of the big 5 banks decreased from 63.2 percent in 2000 to 50.8 percent during the year 2009. It has also been seen that during the last decade, the smallest 5 banks have a cumulative market share of less than 1.0 percent.

Top ten banks in Pakistan by their size of assets:

End December 2009, in thousand Rs.

Ranking	Name of Bank	Assets
1	National Bank of Pakistan	944,232,762
2	Habib Bank Limited	820,981,347
3	United Bank Limited	619,744,051
4	MCB Bank Limited	509,223,058
5	Allied Bank Limited	418,374,331
6	Bank Alfalah Limited	389,070,055
7	Standard Chartered Bank (Pakistan) Limited	312,874,212
8	Askari Bank Limited	254,327,466
9	Bank Al-Habib Limited	249,806,600
10	Habib Metropolitan Bank Limited	237,412,230

Source: State Bank of Pakistan

Market share by size of banks

Percent

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Share of top 5 banks	63.2	61.2	60.8	58.8	56.0	54.0	52.3	52.0	52.4	50.8
Share of top 10 banks	76.5	75.8	76.7	75.1	73.1	72.5	75.1	74.6	73.6	73.0
Share of smallest 5 banks	0.7	0.6	0.4	0.3	0.5	0.5	0.6	0.6	0.6	0.5

Source: State Bank of Pakistan

4.3. Liabilities:

On the liability side, banks' deposit base, the biggest source of funding for banks in Pakistan and inextricably linked to their liquidity position, grew by 13.5 percent to reach Rs. 4,786 billion during 2009, slightly lower than the average growth of 15.3 percent since 2001. Increase in deposits in 2009 is largely attributed to monetary expansion on the back of rising Net Domestic Assets (NDA) - due to substantial government borrowing - and an increase in home remittances, an important source of bank deposits.

In general, deposits of banks face stiff competition posed by instruments of the National Savings Schemes (NSS) as the Banks in Pakistan offer low returns to their depositors. As a result, low returns on deposits continue to hurt deposit growth. The State Bank of Pakistan is struggling to develop an appropriate response to the issue. (e.g. SBP introduced a minimum rate of return of 5.0 percent per annum on all categories of savings/PLS savings deposits with effect from 1st June 2008).

However, the dominance of a few large banks with sizeable market share, access to low cost funds due to their extended branch network, age-old captive clients and related economies of scale and scope impede efforts for achieving an efficient pricing of deposits even though mid-sized and smaller banks have made visible efforts to capture market share by offering attractive rates of return, their share in overall deposit mobilization remains relatively small.

(In Billion Rs.)

	2006	2007	2008	2009
Total Assets	**4,353**	**5,172**	**5,628**	**6,516**
Bills payable	60	82	70	73
Borrowings	438	452	459	654
Deposits	3,255	3,854	4,217	4,786
Other liabilities	197	239	317	344
Equity & Revaluation	402	544	563	660

Source: State Bank of Pakistan

Borrowings from financial institutions, another key component of liabilities, witnessed a substantial growth of 42.3 percent in CY09, in sharp contrast to the meagre growth of 1.7 percent in CY08. In CY09, these borrowings mainly constituted of borrowings from SBP (for EFS and LMM), and repurchase agreements in the inter-bank market.

4.4. Equity base:

The equity base of the banking sector increased by 17.3 percent during 2009 compared to only 3.4 percent in the previous year. Banks were required to increase their minimum capital to Rs. 6.0 billion by end-CY09 which contributed to this increase. Notably, banks' minimum capital requirement (MCR) was rationalized by the SBP in CY09. The MCR was revised in view of the prevalent challenging economic environment, which had negative implications for banks' profitability and consequently their reserve accumulation.

	2007	2008	2009
Equity (in billion Rs.)	544	563	660
Growth (in percent)	35.3	3.4	17.3

Source: State Bank of Pakistan

It is worth mentioning that, in order to meet the MCR, banking industry in Pakistan is currently under a wave of Mergers and Acquisitions (M & As) and there are on average 3 M & As per year. The financial liberalization which also led to a mushroom growth of banks, particularly the financially weak banks - which may cause financial instability – prompted the State Bank of Pakistan to instruct all banks, with the exception of microfinance banks (MFBs) to improve their financial health by increasing the minimum capital requirement (MCR) from Rs. 10 billion at end-2010 to Rs. 15 billion at end-2011 and Rs. 23.0 billion by the end of 2013. The MCR requirement for DFIs was to raise their paid up capital to Rs. 6.0 billion by December 2009. This has forced banks (and DFIs) either to consolidate further by finding merger partners or exit the market.

4.5. Credit Risk:

Credit risk is the key challenge of the banking system in Pakistan these days. The overall fragile economic situation and weaknesses in the operating environment has aggravated the credit risk since end 2008. As a result, Non Performing Loans (NPLs) have been mounting and the advances declining. The major factor for decline in overall advances is the risk-averse policies of banks in the face of heightened credit risk, especially by the bigger players. Due to subdued economic activity, banks have become cautious in their lending business. This is visible in the shift in their advances-mix from consumer and SME to the top-rated corporations and the public sector.

The structure of the interest rates in the economy is another important determinant of credit risk in the banking sector. From 1992 until 2010, Pakistan's average official interest rate (discount rate) was 12.78 percent reaching an historical high of 20.00 percent in October of 1996 and a record low of 7.50 percent in November of 2002. The official interest rate in Pakistan was last reported (in November 2010) at 14.00 percent. Therefore, interest rate volatility, besides affecting interest rate risk, alters the cost of borrowing which is inextricably linked to the repayment capacity of the borrowers. In this respect, high government borrowing, persistent fiscal deficits and the resultant rampant inflation are largely to blame for the lending rates remaining in double figures.

Official Interest/Discount rates in Pakistan (2006-2010)

(In percent)

	Months											
Years	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2006	-	-	-	-	-	-	9.50	-	-	-	-	-
2007	-	-	-	-	-	-	-	7.00	-	-	-	
2008	10.00	10.50	-	-	12.00	-	13.00	-	-	-	15.00	-
2009	-	-	-	14.00	-	-	-	13.00	13.00	-	12.50	-
2010	-	12.50	-	-	12.50	-	13.00	-	13.50	-	14.00	-

The following table shows the government as a dominant borrower of the banking sector in CY09 compared to the increase of 93.6 percent in CY08, government borrowing from commercial banks for commodity operations more than doubled during CY09. Compared to CY07, government has borrowed more than four times in CY09.

Classification of Advances by borrowers
(In Billion Rs.)

	2007	2008	2009	YoY Growth (%) 2008	YoY Growth (%) 2009
Government	77.7	150.5	333.4	93.6	121.6
Non-Financial Public Sector Enterprises (PSEs)	125.4	186.9	225.4	49.0	20.6
Private Sector	1,884.9	2,240.8	2,221.5	18.9	-0.9
- o/w manufacturing	1,091.8	1,299.4	1,282.4	19.0	-1.3
All others	525.2	478.3	411.5	-8.9	-14.0
Total	**2,613.2**	**3,056.4**	**3,191.9**	**16.9**	**4.4**

Source: State Bank of Pakistan

Banks' loan classification by major segments indicates that in line with the overall slow growth in advances, the shares of loans to the corporate sector, SMEs, Agriculture and Consumer Finance all declined in CY09. The only substantial increase seen was in the share of commodity finance which grew by around 78 percent during the year, with a corresponding increase in its share in total loans.

Segment-wise distribution of Loans
(Percent share in total loans)

	2007	2008	2009	Growth 2009
Corporate	56.3	63.2	61.9	2.5
SMEs	16.2	11.7	10.4	-7.2
Agriculture	5.6	4.9	4.7	0.7
Consumer	13.8	10.4	8	-19.1
Commodity	5.5	7.4	12.5	77.8
Miscellaneous	2.7	2.4	2.5	5.1
Percent share in Consumer Loans				
Credit cards	12.6	12.3	11.6	-23.3
Auto loans	30	28.7	24.7	-30.5
Durables	0.3	0.1	0.1	-51.8
Mortgage	18.1	20.2	22.9	-8.1
Personal loans	38.9	38.8	40.7	-15

Source: State Bank of Pakistan

Loan classification by end-use for Corporate and SMEs

	Percent Growth		
	2007	2008	2009
Fixed Investment	21.1	21.1	13.7
Trade Finance	23.6	15.6	8.1
Working capital	10.0	25.7	-9.9

Source: State Bank of Pakistan

Given the deterioration in the quality of loans for SMEs and consumer finance in particular, banks showed high risk aversion in extending new loans to these segments. As a result, their respective growth declined by -7.2 percent and -19.1 percent on Year over Year (YoY) basis. Notably, the negative growth in consumer finance is contributed by the sharp decline in the YoY growth of all its components, some more than others.

Given the strong correlation of NPLs with economic activities, a major portion of the increase in NPLs since CY08 was primarily of a cyclical nature due to the deceleration in real GDP growth, with negative implications on incomes and hence the repayment capacity of the average borrower.

During CY09, NPLs increased by Rs 87 billion to Rs 446 billion. Encouragingly though, after having increased by Rs. 141.3 billion in CY08, the growth rate of NPLs decelerated from 64.8 percent to 24.2 percent in CY09. Except for 3 specialized banks (whose lending facilities are relatively inactive as most of them are under restructuring) and private commercial bank, the rise in NPLs was observed across the entire banking system.

Trends in Non Performing Loans (NPLs)

(In Billion Rs.)

	2006	2007	2008	2009
Non Performing Loans (NPLs)	218	218	359	446
Segment-wise NPLs to Loan Ratio of the Banking Sector				
Corporate	6.5	7.2	8.9	12.6
SMEs	8.8	9.4	15.8	22.1
Agriculture	20.8	18.7	15.8	16.5
Consumers	2.2	4.4	6.9	12.2
Commodity finance	0.6	1.0	1.4	1.1
Overall	6.9	7.6	10.5	12.6

Source: State Bank of Pakistan

The infection ratio for the corporate sector, which constitutes 61.9 percent of total loans, has increased from 8.9 percent in CY08 to 12.6 percent in CY09. Consequently banks have showed reluctance in extending credit to the corporate sector which is also reflected from the increase of only 2.5 percent of corporate loans in CY09. As stated elsewhere, due to the general slowdown in economic activity, the loan repayment capacity of the corporate sector came under stress which is evident from the steep rise in its NPLs by 43.3 percent, which is in sharp contrast to previous years where the NPLs to loans ratio of the corporate sector was consistently below the overall infection ratio. This deterioration of the corporate sector's loan portfolio emanates largely from the high infection ratio of loans to the textile sector, and points to the need for close monitoring of these loans which are a likely source of systemic risk given their proportion in total loans.

The infection ratio for consumer finance, in particular, almost doubled in CY09. The main contributing factors to this include, in particular, NPLs from credit cards which have increased by 62.3 percent while facing a reduction of 23.0 percent in credit disbursement, resulting in more than doubling of the infection ratio in this sub-segment, and similarly NPLs for mortgage loans have increased by 98.4 percent. Given the overall share of 22.9 percent of mortgage loans in consumer loans, this is a reflection of the need for improvement in banks' credit risk appraisal systems.

NPLs to Loan Ratio of the Consumer Segment

	In percent			
	2006	2007	2008	2009
Consumer	**2.2**	**4.4**	**6.9**	**12.2**
Credit Card	1.4	3.4	5.5	11.6
Auto Loans	1.9	4.6	5.9	8.5
Durables	9.8	9.8	7.8	9.9
Mortgage	1.8	5.4	7.4	15.5
Personal Loan	2.7	4.1	7.8	12.4

Source: State Bank of Pakistan

Sector-wise distribution of loans to the private sector also highlights credit risk concentration as loans to the textile and sugar sector alone constitute almost 40 percent (about 20 percent each) of banks' loans portfolio. Hence both the high infection ratio of these loans (as evident in the below table) and the small number of big borrowers reflect the increasing element of credit concentration risk.

Infection Ratio by sectors

	Percent	
	2008	2009
Chemical & Pharmaceuticals	7.7	6.7
Agri business	8.9	8.9
Textile	14.6	19.6
Sugar	9.1	19.6
Cement	6.6	12.2
Shoes & Leather garments	8.6	13.3
Automobiles & Transportation equipment	7.5	16.6
Financial	5.4	12.6
Insurance	0.0	0.1
Electronic & Transmission of energy	3.4	7.4
Others	8.6	10.6

Source: State Bank of Pakistan

4.6. Profitability:

Profitability is imperative for the smooth functioning of the banking sector, serving as a cushion to absorb losses emanating from banks' operations. Profitability of the banking system posted a gain of 27.6 percent in CY09, with a (before tax) profit of Rs 80.7 billion. Overall, both Return on Assets (ROA) and Return on Equity (ROE) increased during CY09, a trend in contrast to the consistent decline in these ratios since CY06. However, the increase in banks earning during 2008 and 2009 have been driven primarily by a sharp rise in Net Interest Income (NII) and this was because of the high banking spread. The average share of interest income in the total income of banks in Pakistan remained 80 percent during the last decade (2000-09).

Share of Interest Income in Gross Income of Banks in Pakistan

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Interest income (In percent)	84	86	82	69	71	80	82	80	83	85

Lending & Deposit Rates of Banks in Pakistan (Weighted Average) %

	Lending rate	Deposit rate	Spread
End December 2009	13.49	6.14	7.35

The below table provides details of banks' profitability position over a decade (2000 – 2009). In line with the increase in the profit before tax, the profit after tax of the banking sector also posted a growth of 25.7 percent during CY09 to Rs. 54.4 billion. Bank-wise information of profit after tax reveals that 18 banks, with a cumulative share of 12.7 percent in assets, recorded losses during CY09. These include one mid-sized and 17 small-sized banks, where the cumulative market share of the latter is only 8.8 percent. However, the top 10 banks, with a market share of 73 percent, posted profits of Rs 70.6 billion in CY09, exhibiting a growth of 11.8 percent over the previous year. This indicates that banking sector profitability is dominated by the top players in the industry.

	Profit In billion Rs.									
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Profit Before Tax	4.5	1.1	19.0	43.8	52.1	93.8	120.8	106.9	63.2	80.7
Profit After Tax	-2.8	-9.8	2.9	24.7	34.7	63.3	81.9	73.1	43.3	54.4
No. of banks in loss	10	12	6	8	5	7	7	10	16	18

Source: State Bank of Pakistan

Indicators of Financial Soundness of Banks

(In percent)

Indicators	2007	2008	2009
CAPITAL ADEQUACY			
Risk Weighted Capital Adequacy Ratio (CAR)			
Public Sector Commercial Banks	16.1	13.4	15.1
Local Private banks	11.8	11.9	13.9
Foreign Banks	14.6	21.8	23.0
Commercial Banks	**12.8**	**12.6**	**14.5**
Specialized Banks	(6.29	(4.9)	(1.59

All Banks	**12.3**	**12.2**	**14.0**
Tier 1 Capital (Core capital) to Risk Weighted Assets (RWA)			
Public Sector Commercial Banks	12.2	10.9	12.6
Local Private banks	9.9	10.0	11.4
Foreign Banks	14.0	21.3	22.5
Commercial Banks	**10.5**	**10.6**	**12.0**
Specialized Banks	(12.5)	(10.19	(5.8)
All Banks	**10.0**	**10.1**	**11.6**
Capital to Total Assets			
Public Sector Commercial Banks	13.7	10.7	11.3
Local Private banks	10.2	10.0	9.9
Foreign Banks	11.2	14.5	14.8
Commercial Banks	**10.9**	**10.3**	**10.4**
Specialized Banks	(5.4)	(3.2)	(1.7)
All Banks	**10.5**	**10.0**	**10.1**
ASSETS QUALITY			
Non-Performing Loans to Total Loans			
Public Sector Commercial Banks	8.4	16.3	16.9
Local Private banks	6.5	8.7	11.1
Foreign Banks	1.6	2.9	6.7
Commercial Banks	**6.7**	**9.9**	**12.1**
Specialized Banks	34.3	28.8	25.5
All Banks	**7.6**	**10.5**	**12.6**
Provision to Non-Performing Loans			
Public Sector Commercial Banks	89.0	66.9	67.8
Local Private banks	88.5	70.2	71.0
Foreign Banks	157.0	81.9	75.2
Commercial Banks	**89.1**	**69.3**	**70.1**
Specialized Banks	68.6	72.4	65.7
All Banks	**86.1**	**69.6**	**69.9**
Net Non-Performing Loans to Net Loans			
Public Sector Commercial Banks	1.0	6.1	6.1
Local Private banks	0.8	2.7	3.5
Foreign Banks	(0.9)	0.5	1.8
Commercial Banks	**0.8**	**3.3**	**4.0**
Specialized Banks	14.0	10.0	10.5
All Banks	**1.1**	**3.4**	**4.1**
Net Non-Performing Loans to Capital			
Public Sector Commercial Banks	3.4	30.3	27.4
Local Private banks	4.1	15.9	17.4
Foreign Banks	(4.1)	1.6	4.4
Indicators	**2007**	**2008**	**2009**
Commercial Banks	**3.7**	**17.9**	**18.8**
Specialized Banks	-	-	-
All Banks	**5.6**	**19.4**	**20.4**
EARNINGS			
Return on Assets (Before Tax)			
Public Sector Commercial Banks	3.5	0.6	1.5

Local Private banks	2.0	1.3	1.3
Foreign Banks	1.5	0.0	(0.3)
Commercial Banks	**2.3**	**1.1**	**1.3**
Specialized Banks	1.4	3.2	3.1
All Banks	**2.2**	**1.2**	**1.3**
Return on Assets (After Tax)			
Public Sector Commercial Banks	2.5	0.5	1.3
Local Private banks	1.4	0.9	0.9
Foreign Banks	0.7	0.3	(0.3)
Commercial Banks	**1.6**	**0.8**	**0.9**
Specialized Banks	0.7	1.8	1.2
All Banks	**1.5**	**0.8**	**0.9**
Return on Equity (Average Equity & Surplus) (Before Tax)			
Public Sector Commercial Banks	27.2	5.2	13.3
Local Private banks	20.4	12.9	13.2
Foreign Banks	13.1	0.0	(2.4)
Commercial Banks	**21.8**	**10.6**	**12.4**
Specialized Banks	-	-	-
All Banks	**22.6**	**11.4**	**13.2**
Return on Equity (Average Equity & Surplus) (After Tax)			
Public Sector Commercial Banks	19.5	4.4	11.4
Local Private banks	13.8	4.4	8.6
Foreign Banks	6.0	8.5	(2.3)
Commercial Banks	**15.0**	**2.2**	**8.6**
Specialized Banks	-	7.3	-
All Banks	**15.4**	**7.8**	**8.9**
Net Interest Income/Gross Income			
Public Sector Commercial Banks	65.9	65.4	63.0
Local Private banks	70.7	73.2	75.9
Foreign Banks	59.1	61.3	64.8
Commercial Banks	**69.2**	**71.2**	**73.3**
Specialized Banks	42.8	46.6	44.7
All Banks	**68.2**	**70.3**	**72.4**
Cost/Income Ratio			
Public Sector Commercial Banks	30.2	39.1	47.5
Local Private banks	45.4	51.6	50.1
Foreign Banks	57.0	69.6	77.5
Commercial Banks	**42.8**	**50.0**	**50.9**
Specialized Banks	53.2	52.1	61.3
All Banks	**43.2**	**50.1**	**51.2**
LIQUIDITY			
Liquid Assets/Total Assets			
Public Sector Commercial Banks	37.0	30.6	31.1
Local Private banks	32.5	26.8	32.3
Foreign Banks	41.6	45.2	55.0
Commercial Banks	**33.8**	**28.3**	**32.9**
Specialized Banks	27.9	24.5	19.8
All Banks	**33.6**	**28.2**	**32.7**

Liquid Assets/Total Deposits			
Public Sector Commercial Banks	47.1	38.9	40.1
Local Private banks	42.9	35.0	43.4
Foreign Banks	61.1	71.6	82.4
Indicators	**2007**	**2008**	**2009**
Commercial Banks	**44.3**	**37.1**	**44.0**
Specialized Banks	247.7	229.4	167.1
All Banks	**45.1**	**37.7**	**44.5**
Advance/Deposits			
Public Sector Commercial Banks	60.0	68.4	65.2
Local Private banks	70.1	75.1	66.6
Foreign Banks	75.2	68.9	56.1
Commercial Banks	**73.8**	**73.6**	**66.0**
Specialized Banks	507.3	577.0	560.8
All Banks	**69.7**	**75.2**	**67.7**

Source: State Bank of Pakistan

5. ISLAMIC BANKING IN PAKISTAN:

In Pakistan, Islamic banking emerged as a response to both religious and economic needs as Islamic banks are primarily concerned to eliminate Riba (interest) from the economy by promotion of risk sharing practices for economic prosperity.

The Government of Pakistan had taken a number of initiatives during 1979-1992 to introduce interest free products in the market especially in the banking sector. In 1979, National Investment Trust (NIT), Investment Corporation of Pakistan (ICP) and House Building Finance Corporation (HBFC) started interest free transactions. Similarly, during 1980 a number of actions were taken as Modaraba companies were established, Participatory Term Certificates (PTC) was launched and Zakat ordinance was announced. In addition, nationalized banks were required to open interest-free counters for their customers in 1981. However, Usher ordinance came into force in 1983 throughout the Pakistan. In the same year, financial services ordinance was amended to introduce non-interest system. SBP was assigned the duty for transition of interest based financial institutions into interest-free financial institution till 1985.

During the decade of 1990s, Islamic banking practices were initiated all over the world especially in the Muslim dominated parts of the globe. SBP issued detailed criteria in December 2001 for the establishment of full-fledged Islamic bank in the private sector. Al Meezan Investment Bank received the license from SBP in January 2002 and started its operations with the name of Meezan Islamic bank as the first Islamic bank from March 20, 2002. Since its inception, the Islamic banking in Pakistan is increasing its share in the market with a number of Islamic banks coming into existence.

By end June 2010, there were 6 fully-fledged Islamic banks operating in Pakistan. During the CY09, there has been a robust growth in most of the indicators of Islamic banking, as the assets of the Islamic banks reached at Rs. 366.3 billion reflecting a share of 5.6 percent in banking assets. While the total deposits of Islamic banks reached to Rs 282.6 billions from Rs 30.2 billion in CY04, thus it contributed to 5.9 percent share in bank deposits as compared to 1.3 percent only in CY04.

Highlights of Islamic Banks

(Billion Rs.)

	2004	2005	2006	2007	2008	2009
Assets of the Islamic Banks	44.1	71.5	119.3	205.9	276.0	366.3
Deposits of the Islamic Banks	30.2	49.9	83.7	147.4	201.6	282.6
Share in Bank Assets (in percent)	1.45	1.95	2.79	3.98	4.90	5.60
Share in Bank Deposits (in percent)	1.26	1.75	2.62	3.82	4.78	5.90

Source: State Bank of Pakistan

Despite the remarkable achievement during the past few years, still the Islamic Financial Services Industry (IFSI) needs careful nurturing and development to make a significant impact on the financial landscape of Pakistan.

6. MICROFINANCING IN PAKISTAN:

Micro-financing has been identified as a powerful means to poverty alleviation as it aims at empowering individuals through the generation of sustainable livelihoods. It caters to micro-entrepreneurs and usually operates within a subset of the local population whose economic status falls below a pre-defined level of poverty. Therefore, many governments in the developing countries encourage setting-up of microfinance institutions (MFIs).
In Pakistan, a vast section of population is employed in the informal sector with little access to credit from banks and other financial institutions. According to some estimates the existing apparatus of micro-financing serves only a minuscule portion of its demand. The provision of Microfinance services in Pakistan comes from a multitude of providers such as Micro Finance Banks (MFBs), multidimensional Non-Government Organizations (NGOs) and specialized NGOs, Rural Support Programs (RSPs), commercial Banks, cooperatives and informal Providers. However, as MFBs and RSPs/NGOs cover the majority market. The Pakistan Microfinance Network is the representative body of Micro Finance Institutes (MFIs) in Pakistan and includes formal sector financial institutions in addition to a number of NGOs.

The demand of microfinance in Pakistan has been quoted as being in the range of 5.6 million households while merely 1 percent of them currently have access to such facility. The Government initiated support to this sector through the promulgation of The Khushhali Bank Ordinance in August 200 and the establishment of the first MFI "The Khushhali Bank", owned and controlled by the Government. The private sector was allowed to participate in the MF sector through the promulgation of the Micro Finance Ordinance 2001 (MFO).

Microfinance Institutions

Indicators		No. of MFBs	No. of Branches	Total No. of Borrowers	Gross Loan portfolio (Rs. In '000)	Average Loan Size (Rs.)	Total No. of Depositors	Deposits (Rs. In '000)
	MFBs	6	145	326,498	2,847,389	8,721	70,891	1,419,841
	MFIs	21	847	508,962	4,907,267	9,642	-	-
2006	**Total**	**27**	**992**	**835,460**	**7,754,656**	**92,82**	**70,891**	**1,419,841**
	MFBs	6	232	435,407	4,456,259	10,235	146,258	2,822,845
	MFIs	24	870	831,775	8,293,724	9,971	-	-

2007	**Total**	**30**	**1,102**	**1,267,182**	**12,749,983**	**10,062**	**146,258**	**2,822,845**
	MFBs	7	271	542,641	6,461,462	11,907	254,381	4,115,667
	MFIs	20	1,186	1,190,238	11,952,000	14,940	-	-
2008	**Total**	**27**	**1,457**	**1,732,879**	**18,413,462**	**10,626**	**254,381**	**4,115,667**
	MFBs	8	284	703,044	9,004,000	13,576	459.024	7,099,206
	MFIs	21	1,159	1,123,001	12,719,000	11,326	-	-
2009	**Total**	**29**	**1,443**	**1,826,045**	**21,723,000**	**12,131**	**459,024**	**7,099,206**

Source: State Bank of Pakistan

List of Micro Finance Banks in Pakistan (As on 30.3.2010)

S.N.	Micro Finance Banks
1	Kashf Microfinance Bank Limited
2	Khushhali Bank
3	Network Micro Finance Bank Limited
4	Pak- Oman Micro Finance Bank Limited
5	Rozgar Micro Finance Bank Limited
6	The First Micro Finance Bank Limited
7	Tameer Micro Finance Bank Limited

Source: State Bank of Pakistan

Today, Pakistan is amongst the few countries globally that have national strategy which identifies drivers and challenges to achieve both targets along with an implementation plan drawn along side with industry stakeholders to monitor progress against the national strategy.

As a result of endeavours of the past few years, microfinance in Pakistan has come a long way from a nascent stage to an industry, which is now well-poised to grow. With current outreach of 1.82 million borrowers, the sector saw phenomenal growth of almost 43% in years 2007 and 2008. Similarly, in the year 2009 the industry witnessed an overall positive trend, albeit mild, in respect of growth in all of its major indicators, with a healthy growth in the deposits indicator that grew by 72% on year over year (YoY) basis. It is encouraging that the Microfinance Banks (MFBs) have made progress on a number of fronts during the year. A mix of vibrant and mature MFBs primarily contributed to the overall deposit growth of the sector. Gross Loan Portfolio (GLP) recorded a significant a 15% growth during the year of 2009. Given the tight liquidity situation in the market, it is now imperative for MFBs to develop their internal deposit base. The borrowings by MFBs have declined to Rs. 4.76 billion from Rs. 5.069 billion during the year 2009.

A recent publication of the Economist Intelligence Unit's **"Global Microscope on the microfinance business environment 2010"** ranks Pakistan among the top five countries globally and number one in terms of regulatory environment, number 20th in terms of investment climate and number 12th in terms of institutional development.

7. BANKING SECTOR SUPERVISION IN PAKISTAN:

State Bank of Pakistan (SBP) which is the Central Bank of the country has been entrusted with the responsibility for an ongoing effective supervision of the banking sector. The relevant provisions of law which vest powers in State Bank of Pakistan (SBP) to carry out inspection of banks are contained in the Banking Companies Ordinance, 1962. Besides, State Bank of Pakistan Act, 1956 and the Bank's Nationalization Act, 1974, The Financial Institutions (Recovery of finances) Ordinance, 2001, Companies Ordinance, 1984 and Statutory Regulatory Orders (SROs) are the relevant legislations, which cover the activities concerning the banking sector.

Under the WTO commitments the operational status of branch network of foreign banks operating in Pakistan as on 31-12-1997 has been protected and frozen. However, existing foreign banks having less than 3 branches can have branches to the extent of maximum number of 3 only. New foreign banks desirous of entering banking business in Pakistan will now be required to incorporate as domestic bank under the local laws. The branches of foreign banks operating in Pakistan can also be converted into a local commercial bank by incorporating under the local laws and subject to a minimum paid up capital of Rs.1 billion provided foreign share holding is restricted to a maximum of 49%.

Under the Banking Companies Ordinance, 1962 the State Bank of Pakistan is fully authorized to regulate and supervise banks and development finance institutions. During the year 1997 some major amendments were made in the banking laws, which gave autonomy to the State Bank in the area of banking supervision. Under Section 40(A) of the said Ordinance it is the responsibility of State Bank to systematically monitor the performance of every banking company to ensure its compliance with the statutory criteria, and banking rules & regulations. In every case in which the management of a bank is failing to discharge its responsibility in accordance with the applicable statutory criteria or banking rules & regulations or is failing to protect the interests of the depositors or for advancing loans and finance without due regard for the best interests of the bank or for reasons other than merit, the State Bank is empowered to take necessary remedial steps. The State Bank of Pakistan can, interalia, exercise the following powers vested upon it under the Banking Companies Ordinance:-

Prohibiting the bank from giving loans, advances & credits, accepting deposits and cancel license of a bank. Give directions to the bank as it deem fit. Remove chairman, directors, chief executive or other managerial persons from the office and appoint a person as chairman, director or chief executive.

Supersede the Board of Directors and direct prosecution of directors, chief executive or other officer. Caution or prohibit bank against entering into any particular transaction(s). Require bank to make changes in management. Appoint its officers to observe the manner in which affairs of bank/its branches/office are conducted. Winding up the bank through high court and apply to Federal Government for an order of moratorium in respect of a bank and to prepare scheme of reconstruction or amalgamation. Impose penalties including civil money penalties.

The State Bank has framed Prudential Regulations for banks and Rules of Business for DFIs that present a prudent operating framework within which banks and DFIs are expected to conduct their business in a safe and sound manner taking into account the risks associated with their activities. These regulations incorporate the spirit and essence of BIS regulations and are constantly watched for possible improvement so that their enforcement yields the best results to promote the objectives of supervision.
The State Bank is empowered to determine Statutory Liquidity and Cash Reserve Requirements for banks/DFIs. Presently the Cash Reserve Requirement is 5% on weekly average basis subject to daily minimum of 4% of Time & Demand Liabilities. In addition to that banks are required to maintain Statutory Liquidity Requirement (SLR) @ 15% of their Time & Demand Liabilities. Similarly, Islamic banks and DFIs are required to maintain SLR of 14% and Cash Reserve of 5 % and 1% respectively of their specified liabilities. Additionally, The Banking Companies Ordinance had been amended in 1997 which empowers the State Bank to prescribe capital requirements for banks. In exercise of these powers the State Bank has laid down Minimum Capital Requirements for banks based on Basle capital structure. The banks have to maintain a Capital Adequacy Ratio in a way that their

capital and unencumbered general reserves are, at the minimum, 8% of their risk weighted assets, and effective from 1st January, 2003 banks are required to maintain a minimum paid up capital level of Rs.1 Billion.

While the off-site monitoring aspect is looked after by the State Bank of Pakistan's Banking Supervision Department the responsibility for the on-site examination of the banking system in Pakistan lies on the shoulders of the Banking Inspection Department. This has been designed to ensure that institutions operate in a safe and sound manner. The focus of the supervisory efforts by the State Bank of Pakistan is on the health and stability of the banking system in Pakistan.

8. GUIDELINES AND CRITERIA FOR SETTING UP OF A COMMERCIAL BANK:

8.1. Introduction:

8.1.1. State Bank of Pakistan (the central bank of the country) is the sole supervisory and regulatory authority of commercial banks, Islamic Commercial Bank, Development Financial Institutions (DFIs), Micro Finance Banks and exchange companies in Pakistan. The authorization/issuance of a commercial banking licence has been vested in State Bank of Pakistan (SBP) under Section 27 of the Banking Companies Ordinance, 1962. In line with Basle Core Principle No. 3 a detailed guidelines and criteria for setting up of a commercial bank in Pakistan, both by local as well as foreign institutions/entities/strategic investors are given in the following paras for the ease of different stake holders and general public. The guidelines on setting up of Islamic Commercial Bank, Micro Finance Bank and Exchange Company have been given separately.

8.1.2. It may be added that powers of authorization/issuance of licence to other than banks, i.e. non banking finance companies (NBFCs) and insurance companies, have been vested in regulatory authority.

8.2. General Guidelines:

8.2.1. The financial sector in Pakistan was opened to private sector (both for local and foreign investment) in 1989 as a part of Federal Government's policy of deregulation and privatization of financial sector. Till the end of the year 1994, a good number of commercial banks and NBFCs were given authorization/licence to commence business. Therefore, in order to consolidate and strengthen the banking sector, as a first step, a moratorium was placed on setting up of commercial banks owned 100% by the local sponsors, which is still continuing. However, under World Trade Organization commitments undertaken by Pakistan, foreign financial institutions/entities either directly or in collaboration with local partners/sponsors, are permitted to open commercial banks.

8.2.2. The detailed guidelines for opening of a commercial bank in Pakistan are as under:-

i) The proposed bank should be a public limited company and listed on the stock exchange(s) in Pakistan. In case it is not listed at the time of commencement of its business, the listing should be completed within a maximum period of two years from the date of commencement of business.

ii) A minimum of 50% shares have to be offered to general public.

iii) To be able to commence business of banking, the locally incorporated banks as well as subsidiary of a foreign bank should have a minimum paid up capital (free of losses) of Rs 10 billion or any other amount as prescribed by SBP from time to time. However, foreign banks desirous to conduct banking business in branch mode should have a minimum paid up capital (free of losses) of Rs. 3 billion or any other amount as prescribed by SBP from time to time, subject to following conditions;

a) The foreign bank holds paid up capital (free of losses) of at least equivalent to US$ 300 million and have a CAR of at least 8% or minimum prescribed by their home regulator, whichever is higher.
b) The bank will operate with a branch network of 5 branches; in case the bank intends to commence business with more than 5 branches or expands its operations in future, the Minimum Capital Requirement (MCR) would be as follows;

Branch Network	**MCR**
From 6 to 50 branches	Rs. 6 billion or any other amount as prescribed by SBP from time to time.
More than 50 branches	Rs. 10 billion or any other amount as prescribed by SBP from time to time.

iv) The bank shall at all times maintain a minimum capital adequacy ratio (CAR) of 10% or any other percentage as specified by the SBP from time to time.
v) At least 20% of the total paid up capital shall have to be subscribed personally by the sponsor directors.

vi) The number of sponsor directors shall not be less than seven.
vii) Sponsor directors shall not dispose off their shares in any manner whatsoever for a minimum period of three years and thereafter only with the specific written approval of the SBP.
viii) The dividend on foreign shareholding can be remitted freely abroad as per prevailing Foreign Exchange Rules.
ix) The following categories are allowed to conduct banking business in branch mode as well as a wholly owned locally incorporated subsidiary: -

a) Banks from countries belonging to regional groups and associations of which Pakistan is a member.
b) Foreign banks having a global tier-1 paid up capital of US$5 billion or more.

x) Apart from the category mentioned at (ix) above, a foreign corporate entity/body desirous of conducting banking business in Pakistan must incorporate a locally incorporated company with a maximum of 49% share holding by the foreign strategic investor/entity/financial institution.
xi) The board of directors and chief executive should meet the prescribed fit and proper test.
xii) The bank shall not provide any accommodation, fund based or otherwise, to its directors, chief executives and major shareholders, including their spouses, parents and children, or to the firms and companies in which they are interested as partners, directors or major share holders. Major share holding in this context would mean any person holding 5% or more of the paid up share capital of the bank.
xiii) A group, as defined in Prudential Regulation, shall not be eligible to own more than one commercial bank.
xiv) The opening of up to 10 branches immediately after the commencement of business till 31st December of the Calendar year in which bank has commenced business may be considered on merit and as per the choice of sponsors subject to provisions of branch licensing policy. The opening of subsequent branches during a calendar year shall be subject to annual branch expansion plan in accordance with the branch licensing policy enforced.

8.3. Fit and Proper Criteria for Sponsor Directors:

The sponsor directors of the proposed bank have to qualify the following "Fit & Proper Test":-

i) The sponsor director(s) should not be a director in another commercial bank in Pakistan i.e. he/she is not on the board of directors of another commercial bank in Pakistan.
ii) The sponsor director(s) has declared personal net worth which should not be less than the amount to be subscribed by him individually.
iii) No sponsor director shall subscribe more than 5% of the total paid up capital of the bank. Special permission has to be obtained separately from SBP with proper justification for holding more than 5% of the total paid up capital.
iv) Not more than 25% of the sponsor directors shall be from the same family as defined in Section 5 (ff) of the Banking Companies Ordinance, 1962.
v) The sponsor director shall stand disqualified if he/she:
  a) has been convicted on account of any criminal or financial irregularity whatsoever;
  b) has been associated with any illegal activity concerning banking business, deposit taking, financial dealing and other business;
  c) has failed in re-payment of obligation(s) to a bank(s) or financial institution(s);
  d) has defaulted in payment of Government taxes and duties etc;
  e) has been/is associated as director and/or chief executive with the corporate bodies whose corporate and tax record, including custom duties, central excise and sales tax has been unsatisfactory;
  f) in the opinion of the sanctioning authority, have adverse reputation regarding integrity and performance;
  g) is associated with the business of brokerage, stock exchange, money changing etc. as stipulated in BPRD Circular No.4 of 2007.

8.4. Information/Documents required for processing application:

The applicant shall apply for establishment of a commercial bank in private sector to the Banking Policy & Regulations Department of SBP along with the following information/documents:-

i) Feasibility study for setting up of a bank, including organizational structure.
ii) Name of each sponsor director and chief executive along with attested copies of Computerized National Identity Card. In case of foreign sponsors, their national identification card and copy of passport duly authenticated by the Embassy of Pakistan in that country.
iii) Short term and long term business plan.
iv) The amount proposed to be subscribed by each sponsor director is required to be indicated separately to consider his interest in the bank.
v) List of companies/firms and their bankers in which sponsor directors and their family members are interested as directors, chief executive, partners, proprietors or major shareholder holding 5% or more shares.
vi) Personal net worth of each sponsor director, duly supported with the certified copies of income tax and wealth tax statements, filed during the last three years.
vii) Balance sheets and accounts of the companies in which sponsor directors and their family members have interest and hold 5% or more shares.
viii) Previous experience in banking or other business.
ix) In case of foreign bank/entity/investor or sponsor director resident of countries where filing of wealth statement is not a requirement of law, two certificates of personal net worth and general reputation issued by international banks of repute should be submitted. This facility

will also be available for Pakistanis who have recently returned to Pakistan after a stay of more than 10 years abroad. The foreign bank shall also submit the following:-

a) A letter from their home country supervisors indicating permission to conduct banking business in Pakistan.
b) Credit rating by an international credit rating agency.
c) Global tier I&II capital in US$ and capital adequacy ratio.
d) Ranking of bank by total assets and tier II capital in home country and globally.
e) Number of domestic and international branches.
f) Name of countries in which bank has presence as representative office, subsidiary and/or branches along with their number.
g) Details of supervisory arrangements in home country.

x) Last three years balance sheets/accounts of all those concerns in which sponsor directors have controlling interest.
xi) Certified copies of Memorandum and Articles of Association of the banking company.
xii) The applicant (sponsor) shall furnish the name of the banks and financial institutions, along with account number and name of branches, with which they have been dealing, along with the credit reports from these banks in a separate confidential envelope.

8.5. Other documents/Information:
Before commencement of banking business by banking company, who has been granted license/authorization by SBP, shall provide following information/documents:-

a) Name of chief executive and other key executives as indicated in BPRD Circular No. 4 of 2007.
b) Risk management guidelines.
c) Plans for internal control system and scale of authority.
d) Working system and procedure for business operations

8.6. Estimated time for processing application:
The application will be processed as quickly as possible. However, the estimated minimum time for processing an application, which is complete in all respect, may take six to eight weeks. In case permission is to be refused, SBP shall give an opportunity to the applicant for a representation in writing.

8.7. Validity of Licence:
The licence for establishment of a commercial bank, once issued by SBP under Section 27, of Banking Companies Ordinance, 1962 shall be valid for a period of six months from the date of its issuance. The licence shall automatically stand cancelled / withdrawn without any notice, in case commencement of banking business has not started within six months from the date of issue of licence. SBP may, however, consider a request received in writing for an extension in commencement of business on merit supported by valid reasons.

8.8. Application processing Fee:
The applicant shall deposit a sum of Rs 4,000,000 (Rupees four million) or equivalent in US dollars along with the application as processing fee. The fee deposited shall be nonrefundable. Incomplete applications shall neither be entertained nor returned. The processing fee in such cases shall also be non-refundable. The fee may be deposited through demand draft or pay order.

Corporate income tax rate on banks' profits: 35 percent.

8.9. Consultation with home supervisor:
The sponsor directors/financial institutions/entities interested in conducting banking business in Pakistan can contact the following for consultation, clarification or additional information before submission of the formal application:-

The Director
Banking Policy and Regulations Department
State Bank of Pakistan
I.I. Chundrigar Road
Karachi.
Ph: 92-21- 99213580
92-21-111-727-111
Fax No: 92-21-99212438, 99212506
www.sbp.org.pk

9. IMPORTANT ADDRESSES:

Ministy of Finance
(Government of Pakistan) Room # 514, Block-'Q', Finance Division,
Pak. Sectt. Islamabad
Tel.:+92 51 9206382
E-mail: so_coord1@finance.gov.pk (Section Officer - Coordination)
Website: www.finance.gov.pk

Securities and Exchange Commission of Pakistan (SECP)
National Insurance Corporation Building,
Jinnah Avenue,
Islamabad-44000
Tel.:+92-51-111-117-327
Fax:+92-51-9204915

E-mails:
General Information: enquiries@secp.gov.pk
International Correspondence: international.affairs@secp.gov.pk

Competition Commission of Pakistan
4-C, Sector G-5, Diplomatic Enclave,
Islamabad
Tel.:+92-51-9247530
Fax:+92-51-9247547
Website: www.cc.gov.pk

Pakistan Banks' Association
D-126 (Near Chinese Consulate), Block 4, Clifton,
Karachi, Pakistan

Tel: 92-21-3582-2986-87
Fax: 92-21-3582-3418
E-mail: pba@pakistanbanks.org
Website: www.pakistanbanks.org/

Investment Banks Association of Pakistan
606, 6th Floor, Uni Towers,
I.I. Chundrigar Road,
Karachi-74000
Website: www.ibap.biz

Modaraba Association of Pakistan
Suite No.602, 6th Floor,
Progessive centre, Shahrah-e-Faisal,
Karachi.
Website: www.modarabas.com.pk

Pakistan Microfinance Network Secretariat
132, Street 40,
F-10/4, Islamabad
Tel.: +92-51-229 2270 / 229 2231
Fax: +92-51-229 2230
E-mail: info@pmn.org.pk

Insurance Association of Pakistan
1713 - 1715, 17th Floor Saima Trade Tower - A
I.I. Chundrigar Road,
Karachi
Website: www.iap.net.pk

House Building Finance Corporation Limited
3rd Floor, Finance and Trade Cente,
Main Shahra-e- Faisal,
Karachi
Website: www.hbfc.com.pk

Leasing Association of Pakistan
602, 6th Floor, Progressive Centre,
30-A, Block 6, PECHS, Shahrah-e-Faisal,
Karachi-75400.

12. SWITZERLAND - PAKISTAN BILATERAL RELATIONS:

Pakistan is an important economic partner for Switzerland in Asia and a number of bilateral economic agreements have facilitated business activity. Switzerland ranks among the top ten foreign investors in Pakistan. During the past 7 years, Swiss based multinational companies have invested over 1.2 billion US$ in areas like food processing, pharmaceuticals, chemicals, engineering as well as banking and other service sectors. Many of the leading Swiss multinational companies like ABB, Clariant, Nestlè, Novartis, Roche, SGS, Syngenta, SICPA and Sika etc. are successfully operating in Pakistan. Besides that, there are over 200 strategic alliances between Swiss and Pakistani companies, many of the leading Swiss manufacturers of machines, chemicals, watches etc. have long lasting agent agreement with local firms. The trade volume between Pakistan and Switzerland which reached about 500 Mio CHF in 2008 has gradually come down to about 360 Mio CHF in 2010. However, in view of the existing market potential, the figures can be improved.

With regards to the development and cooperation, Switzerland maintains a longstanding cooperation with Pakistan. In 1966 the Government of Switzerland signed an agreement on technical and scientific cooperation with the Government of Pakistan. In 1977 an office of the Swiss Agency for Development and Cooperation (SDC) was opened in Islamabad.

13. SWISS BANKS IN PAKISTAN:

Currently, there is only one Swiss bank namely Habib Bank AG Zurich operating in Pakistan through its subsidiary Habib Metropolitan Bank (HMB).

Habib Metropolitan Bank (HMB): Habib Metropolitan Bank was incorporated in Pakistan as a Public Listed Company in 1992 under the name, Metropolitan Bank Limited. The Bank commenced, duly licensed, full scheduled commercial-banking operations in October 1992. Metropolitan Bank, from October 1992 to September 2006, remained a highly rated bank and, vide its nationwide 51-branch on-line network, established as a distinguished provider of trade finance services.

On October 26, 2006, The Pakistan Operation of Habib Bank AG Zurich merged into Metropolitan Bank Limited and the merged entity was named Habib Metropolitan Bank Limited (HMB).

HMB operates in all major cities of the country. The Bank ranks within Top 10 in Pakistan. HMB has its primary focus on retail banking and trade finance and also offers highly innovative e-Banking solutions and Consumer Banking to its customers. The Bank's Islamic Banking Division is fully capable of catering to customers seeking Shariah compliant products.

Habib Bank AG Zurich, the principal shareholder of HMB has a representative office in Pakistan. It is a Swiss incorporated bank, founded in 1967 by the Habib Banking Family of Pakistan, the same family who had founded and owned Habib Bank (Overseas) Ltd. and Habib Bank Limited, the largest bank of Pakistan till it's nationalization in 1974.

At the time of its incorporation, Habib Bank AG Zurich had a modest capital of Swiss Francs 2 million, with only one branch in Zurich, Switzerland. After nationalization of all the banks in Pakistan, the family decided to grow and expand the operation of Habib Bank AG Zurich.

14. OPPORTUNITIES FOR SWISS FINANCIAL INSTITUTIONS:

Large Un-served Agriculture Sector - Pakistan, being an agrarian economy, agriculture is strategically an important sector for the economy, having above 20% share of GDP and a major source of livelihood for 65% of the country's population living in rural areas. The sector is largely un-served/under-served by banks; less than 20% of about 7 million farm households in the country have access to bank credit.

The SME sector is another under-served area. Presently only 0.2 million SMEs have access to bank financing out of 3.1 million SMEs across the country. The low presence of banking services in SMEs is attributable to the high risk perception about SMEs, over conservatism of banks in underwriting the risks in serving the non-traditional sectors like SMEs and agriculture. On the contrary, banks place their surplus funds in risk free government securities.

Similarly, **Housing finance** is another attractive avenue. Despite a deficit of more than six million housing units in the country - that is increasing due to supply shortage - the housing finance market is largely under developed; mortgage loans are approximately 1 percent of GDP, which suggests that a huge un-tapped market awaits banks to exploit.

Consumer banking: A large portion of 170 million people in Pakistan are potential consumer loan customers. However, banks need to developing sound lending strategies to manage their risk.

Islamic banking, and generally Islamic Financial Services are a growing phenomenon, which came into existence to meet the needs of the devout Muslims around the world, who have the main wish to observe the Koran and Sunne. Pakistan with 97% Muslim population presents a huge market for Islamic Financial Service.

Microfinance is another sector which provides a lot of opportunities. Commercial banks and other financial institutes may have an opportunity to invest there funds in this sector.

Setting-up a new bank or acquiring a bank on sale: Swiss Banks interested to enter in the banking sector of Pakistan can setup a new bank in Pakistan or acquire a locally incorporated bank as several small banks are consolidating with other banks or exiting the market by selling-off.

15. CONCLUSION:

The banking in Pakistan - a highly regulated industry - has witnessed a rapid progress in recent years and has been characterized by an increasing sophisticated provision of banking services. However, a large portion of the 180 million population of Pakistan is still un-banked or underserved by the formal financial system which is attributable to, among others, low penetration of the banking system particularly in rural/semi rural areas and general dislike for interest income (un-Islamic banking system). A World Bank study on access to finance published in 2008 estimated that only 14 % of the population in Pakistan is banked and has access to the formal financial system. Thus a huge un-tapped market is available for financial services.

Today, the biggest challenge for Banks in Pakistan is increase in non-performing loans (NPLs) and low private sector credit demand as high lending rates and weak economy is adversely affecting the borrowers' payment capacity. Furthermore, heavy flooding in Pakistan during August 2010 caused humanitarian disaster and altered the macroeconomic outlook. These adverse developments create a difficult operating environment for banks. However, some experts are of the opinion that the weak economic growth is for a short run.

Due to the said challenges, Pakistan's banking industry has been undergoing risk consolidation since 2009 by rebalancing its assets from advances to investment. The banks' efforts to contain the element of credit risks are clearly visible from their inclination to invest in government securities and their preference to meet financing needs of the government rather than the private sector.

Notwithstanding the difficult operating environment, the Banks' numbers show that the banking sector in Pakistan has been performing well - though dominated by five large commercial banks.

Compiled by :

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Consulate General of Switzerland in Karachi

Main sources:
- State Bank of Pakistan
- Interviews of some Bankers