Performance of the Banking Sector

Research Paper

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INTRODUCTION TO THE BANKING SECTOR AND PAKISTAN'S ECONOMY

Pakistan's Economy is agrarian and its contribution to the GDP of the country is very significant. Pakistan has transformed its economy from low skilled agrarian to semi-industrialized economy. A lot of developments have taken place in its economy. Some of them are:

- Liberalization of markets
- Establishments of money and security markets
- Development of banking sector and enhancing its role in the economic growth of the country.

Due to these developments, the financial sector of Pakistan has become strong which supports the economic growth of the country. Pakistan consists of variety of financial institutions that include commercials banks, insurance companies, investments banks, stock exchanges etc. Bank are financial intermediaries that have deposits and they use these deposits for lending activities either through capital markets or through direct lending and in return of it banks earn interest that is its income (Consulate General of Switzerland 2011).

The banking sector is an essential part of financial service industry of Pakistan and it has come across a lot of challenges over the period of 63 years. Now a days this sector is playing a very significant role in the growth of Pakistan's economy. The banking system of Pakistan consists of two tier systems according to the State Bank of Pakistan Act that includes SBP, commercial banks, specialized banks, Islamic banks, Microfinance banks, Development finance institution (DFI). There were 36 commercial banks operating in Pakistan in 2010 that include 25 private banks, 7 foreign banks and 4 public sector banks. There was extraordinary growth in this sector during 2001-2003 and its deposits almost doubled during that period (Consulate General of Switzerland 2011)

State Bank of Pakistan is the central bank that monitors and regulates all the financial institutions and is also responsible to ensure the interests of shareholders and investors.

LITERATURE REVIEW

(Akram, Rafique and Alam 2011) This study examines the growth and development phases as well as prospects of Islamic banking in Pakistan. Awareness in public also has been growing and people are moving towards Islamic banking system. In this paper growth and performance of Islamic banking is discussed and compared among the financial years from 2003 to 2010 in terms of growth parameters like assets, deposits, sources and uses of funds. The performance indicators are also discussed to evaluate the growth and performance of Islamic banking system.. The efforts made by the central bank in Pakistan (SBP) are also remarkable in growth of Islamic banking. By seeing the present growth of Islamic banking, it is anticipated that in near future, Islamic banking with get major share in banking industry in Pakistan.

(Akhtar 2010)The banking sector constitutes the major part of the financial sector in Pakistan. The growth in banking system has been mainly due to the rise in deposits to Rs4.1 trillion and advances to Rs3.3 trillion. Banks as profitable ventures have attracted close to over $4 billion of foreign direct investment during 2006-2008. The banking sector has gained dynamism, profitability, respectability and strength. While these achievements are impressive, many challenges remain, including the need for greater financial access, availability of financial safety nets, and supervisory challenges for a dynamic financial infrastructure etc.

(Consulate General of Switzerland 2011) The banking sector in Pakistan has developed and changed over time with various policy reforms and regulations by the SBP . The banking sector has been affected by the interest rates and the credit risk has increased due to the conditions of the local economy and consequently the NPLs have increased in the recent past. Also the profitability has been depressed as a result of the revised MCR requirements by the SBP in the light of the ensuing economic scenario. This has affected their dividend paying ability and affected their share prices adversely.

(Hussain n.d.)The reforms in the banking sector in the 1990s have bought about major changes in the sector. It has been privatized; the banks have cleared up their balance a sheet, removing the nonperforming loans, the quality of new assets has improved and the human resource and the technology has been upgraded. All in the entire sector has become more efficient.

METHODOLOGY

The research conducted is secondary in nature where different published sources and online articles by renowned authors have been consulted.

FINDINGS

Pakistan's economy in its initial phases was largely agrarian in nature but now it has come a long way. The contribution of the services sector to the GDP in FY09-FYIO has been 53%. The Banking sector of Pakistan is now playing a very important role in the growth of the country's economy.

The array of product and service offerings by the banking sector has widened since the sector reforms in the 1990s to make it more market based. Despite the mergers and acquisitions in the banking sector in the recent past due to the effect of the economic conditions, there is a healthy number of banks in the economy. As of June 2010 the banking sector consisted of 36 commercial banks (25 local private banks, 4 public sector commercial banks and 7 foreign banks) and 4 specialized banks with a total number of 9087 branches throughout the country.

A brief summary of the services provided by the banks to the population includes; settlement and cash services, domestic and cross border remittance services, depository services for accounting and safekeeping of securities. The banks have also increased the services rendered to households. In addition to these services the banks have also introduced new forms and channels of making payments.

The banks have played an important role in the economy in the recent past, as can be seen from the fact that the government was the dominant borrower of the banking sector in FY09.

1990S BANKING SECTOR REFORMS

Major policies that have been changed in the banking sector in recent years that have created a great impact are:

- Most of the national banks have been privatized due to which a more professional and service oriented culture has emerged and has overcome the culture of bureaucracy. Most of the banks are privatized due to which 80 percent of banking assets are held by private sector. (Hussain n.d.)
- The human capital of banks has been highly upgraded due to the acceptance of the principles of merit and performance. Due to highly competitive recruitment process now there are more chartered accountants and MBAs in banking sector due to which this sector has become the preferred choice for the young individuals. (Hussain n.d.)

- Due to advancement in technology the banking sector has also adopted it by introducing online banking, ATM, mobile phone banking, credit cards etc that reduced the transaction costs for the banks (Hussain n.d.). Currently SBP has upgraded its policy by removing the barriers of branchless banking in which they will provide the customer an upgraded access to the financial services without relying on the bank branches. Banks will be providing other modes like mobile phones, third part outlets etc through which services can be provided to the customers. (Bold 2011)
- One major change that occurred was that foreign investors can now easily take back their capital and remit profits through their banks. (Hussain n.d.)

POLICES OF STATE BANK OF PAKISTAN

There are some policies of SBP that had great impact on the health of financial institutions.

In 1998 SBP introduced the concept of capital adequacy which was risk based in order to protect the interest of shareholders. At that time each bank had to maintain 8% capital to risk weighted assets (CRWA) ratio and currently it is 14% [1]. Banks have to maintain the minimum paid up capital of one billion from 2003 which was 500 million initially. Now the banks have to maintain more capital amount and if the banks don't follow these policies then they have to face penalty. After 1998 there was decline in the reserve ratio due to change in the SBP policy related to the investment in securities. (Commercial Banks in Pakistan n.d.)

The liquid assets to total assets ratio declined in 1999 as a result of which SBP changed the monetary policy due to which cash reserve requirement and statutory liquidity requirement were reduced. Also the SBP discount rate and T-Bills yields were fallen during this period that

[1] The Nation- 12th April 2011. http://www.nation.com.pk/pakistan-news-newspaper-daily-english-online/Business/12-Apr-2011/SBP-says-banks-to-meet-requirements-comfortably

assisted the banks to meet their credit requirements. Due to easing of SBP policy for credit extension the banks extended bulk of advances which increased the liquidity of the banks. (Commercial Banks in Pakistan n.d.)

ISLAMIC BANKING IN PAKISTAN

At the global front, Islamic Finance Industry (IFI) has emerged as one of the fastest growing industry in the past thirty years. In the last decade IFI has seen significant growth with the growth rate of around 15-20 % on annual basis.(SBP 2007) . This growth has lead to development of dedicated regulatory, legal and academic institutions at the international level that are helping the growth of the industry. The increased growth is driven by multiple factors, one being its faith base appeal from the Muslim community, the other being the potential of IFI to supplement finance with social and ethical standards, and its potential to attract cross border oil revenue surpluses. As of the year 2007, the reports published by The Banker, The Shariah compliant assets have grown by 30%, to almost $500.5 billion globally, which is a remarkable performance as the Commercial banks globally have seen a major slump in their assets.(Robinson 2007).

In Pakistan IFI has gained momentum too, since year 2001 IFI has been integrated in Pakistan's commercial banking sector. The State Bank of Pakistan plays a vital role in framing all the rules and regulations. The State Bank of Pakistan has formed a separate department so as to make the Islamic Banking grow efficiently; it has introduced 12 Islamic modes of financing so as to make the transition smooth and easy. (SBP Report 2002).

The growth of Islamic Banking is analyzed taking parameters like assets, deposits, sources and uses of funds. Islamic Banking has significantly grown in these four parameters in comparison to commercial banking in Pakistan.(Akram, Rafique and Alam 2011)

TRACKING THE PERFORMANCE OF BANKING SECTOR FROM 2000 TO 2010

A growing and dynamic banking sector acts as a backbone for the economic growth of a country, and growth in banking sector and real economic growth acts as pillar to each other strengthen the overall economy of a country (Akhtar 2010). In Pakistan , during the past decade there have been significant changes in terms of consolidation and diversification, more than 40 transactions of mergers and acquisitions have taken place (inter and intra bank). Banks have diversified into other sectors like asset management, leasing and other non-banking finance services. According to Financial Development Report 2009, Pakistan has been ranked 49 out of 55 countries in World Economics' Forum. (Switzerland 2011).

In the past decade the Banking sector in Pakistan ups and down owing to different policy and environmental factors. The Banking sector increased its efficiency due to privatization, as they became stronger and competitive. The extraordinary performance has lead to an inflow of USD 4.2 billion as Foreign Direct Investment over the past seven years that has given a major boast to the economy, but there is still a need to improve the financial infrastructure and investment to induce further investments from non-resident Pakistani. The Banks and NBFI's have been pursuing the conglomerate structure that has helped in achieving synergy and cross selling of financial products.

Despite successful expansion in recent years, the banking sector has seen some problems that hinder its growth in Pakistan. First being the lack of consumer protection and low level of financial literacy which contribute to financial sector underdevelopment. Also the recent turmoil that has hit the financial markets around the world has had a profound effect on the banking sector, and calls for a safety net to deal with contagion and systematic risks.

The Financial Markets see a need of new issues of shares which are very limited, private corporate (listed) issues of Term Finance Certificates (TFCs) and sukuk are still of only marginal importance. The growing financing requirements of private and public infrastructure investment, particularly in the transportation and energy sectors, are likely to remain unmet unless new long-term financing sources are developed outside the banking sector.(Akhtar 2010)

MAJOR CHALLENGES FACED BY THE SECTOR IN THE RECENT YEARS

The major challenges faced by the sector due to the prevailing economic scenario in the country are as follows:

- **Credit Risk (Rise in the Non-Performing loans on the banks balance sheets):**

Since late 2007 Pakistan's macroeconomic conditions have been deteriorating at record levels affecting the performance of all the sectors in the economy. Among some of the major factors are power supply shortage causing industrial capacity underutilization and increasing the level of production costs, inter-corporate circular debt, high inflation rate, decline in FDI and the mounting fiscal deficit.

All the above stated factors have affected the local industries and businesses adversely, thus affecting their ability to pay back bank loans; this increased credit risk has in turn caused a rise in the non performing loans on the bank's balance sheets. The increase in NPLs has doubled over two years by the end of FY09

- **Equity Base (Decrease in profitability and reserve accumulation):**

The equity base increased by 17.3% during the FY09 in contrast to the previous year's 3.4%. This increase in equity has been a consequence of the SBPs regulations which were given out in the light of the increase in the credit risk. The banks were required by the SBP to increase their capital to a minimum level of Rs. 6.0 Billion by the end of FY09 and hence the increase. This reduced the profitability of the banking sector and affected its reserve accumulation. The state bank further increased the minimum capital requirement (MCR) TO Rs. 10.0 Billion at the end of FY10, Rs. 15.0 Billion at the end of FY11 and Rs. 23.0 Billion by the end of FY13. This was done by the SBP to prevent financial instability which could result from the financially weak banks. The Micro finance banks were left exempt from these obligations.

These requirements have caused a drastic increase in the number of merger and acquisitions seen by the banking industry each year and some banks have been forced to exit the market altogether.

- **Share Prices:**

The increase in non-performing loans has forced the banks to build contingency reserves and provide for the infected assets (in this case NPLs), which has affected their ability to pay out dividends; this has in turn has affected their share prices adversely.

INTEREST RATE CHANGES AND PERFORMANCE OF THE SECTOR

The interest rate structure plays an important role in the performance of a banking sector in an economy, being one of the major determinant s of credit risk. Between 1992 and 2010 Pakistan's official interest rate on an average was 12.78%. In this period it reached a high level of 20% in October, 1996 and a low level of 7.25 % in Nov, 2002. The official interest rate on November 2010 was 14.0%. The reasons for these double digit interest rates are high level of government borrowing, fiscal deficits and the resulting high level of inflation.

The fluctuation in interest rates and their persistent pattern of double digit levels has affected the cost of borrowing which in turn has affected the paying back capacity of the borrowers, causing a rise in NPLs (not withstanding other factors contributing to NPLs, as mentioned above)[2]

RECOMMEDATIONS

The Banking Sector in Pakistan has seen robust growth over the last decade, with certain macro environment factors slowing down the growth since the year 2008. The Banking sector in Pakistan needs to develop the financial infrastructure so that the potential that the Banking sector has in Pakistan can be fully utilized.

Also as Muslim population in Pakistan is in majority, Islamic Banking can be readily accepted, hence the need to grow people's confidence and acceptance in this sector. Islamic Banking has a lot of potential to connect globally; hence this can be easily integrated.

The Financial Markets see a need of new issues of shares which are very limited, private corporate (listed) issues of Term Finance Certificates (TFCs) and sukuk are still of only marginal importance, hence a need to make these investments more liquid for the investors.

[2] Appendix I

Also the recent turmoil that has hit the financial markets around the world has had a profound effect on the banking sector, and calls for a safety net to deal with contagion and systematic risks.

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APPENDICES

Appendix-I

Official interest/Discount rates in Pakistan (2006-2010):

Years	Jan	Feb	March	April	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2006	-	-	-	-	-	-	9.5	-	-	-	-	-
2007	-	-	-	-	-	-	-	7.0	-	-	-	-
2008	10.0	10.5	-	-	-	-	13.0	-	-	-	15.0	-
2009	-	-	-	14.0	12.0	-	-	13.0	13.0	-	12.5	-
2010	-	12.5	-	-	12.5	-	13.0	-	13.5	-	14.0	-

Source: report by consulate general of Switzerland. Karachi, 25th February 2011.

Pakistan's Banking Sector
Current Situation and Critical Issues

ISHRAT HUSAIN

Pakistan's banking sector reforms which were initiated in the early 1990s have transformed the sector into an efficient, sound and strong banking system. The most recent comprehensive assessment carried out jointly by the World Bank and the IMF in 2004 came to the following conclusion:

> "Far reaching reforms have resulted in a more 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."

The major changes that have occurred in the banking sector during the last decade or so can be summarized as follows:

(a) 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.

(b) The banks that were losing money due to inefficiencies, waste and limited product range have become highly profitable business. These profits are, however, being used to strengthen the capital base of the banks rather than paying out to the shareholders. The minimum capital requirements have been raised from Rs. 500 million to Rs. 6 billion over an extended period in a phased manner. The consolidation of the banking sector into fewer but stronger banks will lead to better management of risk.

(c) The banks that were burdened with the non-performing and defaulted loans have cleared up their balance sheets in an open transparent, across-the-board manner. Contrary to the popular myth the main beneficiaries of the wirite-offs of the old outstanding and unrecoverable loans have been from almost 25 percent to 6.7 percent by Dec. 2005. Small individual borrowers the ratio of non-performing loans of the Commercial Banks to total advances has declined.

(d) The quality of new assets has improved as stringent measures are taken to appraise new loans, and assure the underlying securities. Online Credit Information Bureau reports provide updated information to the banks about the credit history and track record of the borrowers. Loan approvals on political considerations have become passé. Non-performing loans account for less than 3 percent of all new loans disbursed since 1997.

(e) The human resources base of the banks has been substantially upgraded by the adoption of the principles of merit and performance throughout the industry. Recruitment is done through a highly competitive process and promotions and compensation are linked to training, skills and high performance. The banks now routinely employ MBAs, M.Coms, Chartered Accountants, IT graduates, economists and other highly educated persons rather than Clerical and Non Clerical Workers. The banking industry has become the preferred choice of profession among the young graduates.

(f) Banking Technology that was almost non-existent in Pakistan until a few years ago is revolutionizing the customer services and access on-line banking, Internet banking, ATMs, mobile phone banking and other modes of delivery have made it possible to provide convenience to the customers while reducing the transaction costs to the banks. Credit Cards, Debit Cards, Smart Cards etc. are a thriving and expanding business in Pakistan. Once the RTGS is put in place the payment system in Pakistan. Would enter a new phase of modernization.

(g) Competition among the banks has forced 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 has expanded four fold in the last six years as the banks have diversified into agriculture, SMEs, Consumers financing, mortgages, etc. The middle class that could not afford to buy cars or apartments as they did not have the financial strength for cash purchases are the biggest beneficiaries of these new products and services.

(h) Along with strong regulation, supervision and enforcement capacity of the State Bank of Pakistan a number of measures have been taken to put best corporate governance practices in the banking system. ‘Fit and proper’ criteria have been prescribed for the Chief Executives, members of the Boards of

Directors, and top management positions. Accounting and audit standards have been brought to the International Accounting Standards (IAS) and the International Audit Codes. External audit firms are rated according to their performance and track record and those falling short of the acceptable standards are debarred from auditing the banks. These practices were put in place in Pakistan long before the scandals of Enercon, World Call and Pramalat had shaken the corporate world.

(i) 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. Foreign investors can now bring in and take back their capital, remit profits, dividends and fees without any prior removal and directly through their banks. Similarly, foreign portfolio investors can also enter and exit the market at their own discretion.

The main lesson learnt from the last decade suggest that financial sector functions effectively and efficiently only if the macroeconomics situation is favorable and stable. The need to maintain macroeconomic stability will thus remain paramount in the years to come.

The agenda for further reforms in the financial sector is still quite formidable and the challenges to spread the benefits of financial liberalization among the middle and low income households and small and medium farms and enterprises are still enormous.

There are several areas of dissatisfaction with the banking sector that need to be addressed.

The most serious complaint against the banking system in Pakistan today is that the depositors are not getting adequate return on their bank deposits. The difference between the monthly weighted average rates of lending and deposits is taken as an indicator of the spreads earned by the banks. It is true that these spreads have widened in the recent months land this phenomenon has caused resentment among those whose only source of income is their returns from bank deposits. But it is important to examine the facts and their form judgments

The monthly comparisons are meaningless because PLS deposit rates are changed every six months, while the lending rates are continuously adjusting because they are automatically linked to T-bills or KIBOR rates.

During the last eight months the weighted average deposit rate has risen from 1.6 percent in July – Feb, 2005 to 3.9 percent in July – Feb, 2006. This trend reflects that the return on the new deposits mobilized is much higher than what the average rate indicates. The old deposits are earning much lower rate because they were lodged at the time when the overall structure of interest rates had come down significantly. This lag is adjustment between the deposit and lending rates is due to the costs incurred by the depositor in shifting deposits from one bank to the other.

The additional deposits mobilized in the last twelve months amounted to Rs. 382 billion i.e. a growth rate of 16.8 percent. This growth rate took place despite deceleration in the volume of Resident Foreign deposit accounts. So if the deposit rates were unattractive then this high growth rate in deposits mobilized by the banks appears to be puzzling. The reason for this high growth is that the fresh deposits were fetching an average return of 6.2 percent in March, 2006 compared to 3.5 percent in July, 2005 – rise of 270 basis points in nine months. In the coming months the average rate is likely to move further upwards bringing them to positive real interest rates.

Why have the profits of the banks risen so sharply in the last few years? There are several reasons that need to be understood:

First, the drag of non-performing loans has been eased considerably reducing the need for setting aside the provisions for loan losses. As these provisions were made at the expense of the profits the banks are now reaping the benefits of building up substantial provisions and taking the hit on their profits in the past.

Second, the corporate income tax rate on banks' profits has gradually come down from 58 percent to 38 percent saving on their tax deductions. These savings not only get translated in to higher profits but also act as incentives for better performance because the tax rate no longer acts as a penalty.

Third, the diversification of the banks assets into new and so far underserved segments such as agriculture, mortgage, auto, SMEs, Consumer and Credit Cards have raised their net interest margins. As competition has become quite tough in the corporate segment the margins on corporate loans have been squeezed considerably. But the spreads earned in these new segments are quite attractive. Thus a large part of the profits originate from lending to these underserved segments of the population. This is a Win- Win situation as small farmers, small businesses and middle class consumers, who had so far been denied access to bank credit, are able to get financing the banks are able to earn higher spreads.

Fourth, there has been a shift in the maturing profile of both the banks' deposits and banks' loans. Half of the total deposits are now placed for short term duration earning negligible rates of return compared to the past where the distribution of deposits were concentrated in medium to long duration earning much higher returns.

On the assets side, more of the bank loans are being disbursed for fixed investment purposes. These have long maturity structure and pay higher interest rates in double digits.

This shift in the composition of deposits and advances has helped earn the banks a higher spread boosting their profitability.

As the majority of the banks are operating in the private sector they will remain guided by the bottom line considerations i.e. the profits. Consolidation and market competition will act as a deterrent on abnormal profits but it is the responsibility of the regulator to ensure that these profits are not made by taking excessive risk with the depositors' money or by banks indulging in collusive practices. The regulator has to ensure that the access to credit is further broadened and small farming households, small and medium businesses and middle classes are able to meet their legitimate credit needs. At the same time the regulator has to take stringent action against those banks found guilty of anti-competitive or collusive practices.

Another popular indictment against the banking sector is that they are financing speculative activities such as stock market trading, real estate, commodities, auto etc. The facts do not support this indictment. Direct and indirect exposure by banks in stock market equities has been limited to 20 percent of their capital i.e. the maximum amount all the banks can collectively provide for this activity is only 40 billion. The outstanding stock of bank advances in March, 2006 stood at Rs. 2063 billion. Thus the bank credit allocated for stock market equity trading is less than 2 percent of the total advances of the banking system. If we further assume that some amounts are diverted from consumer loans or corporate loans also the exposure of the banks may double to as much as 4 percent but the securities and collaterals against the diverted loans may not necessarily be the scrips themselves.

Real estate financing by banks is restricted to mortgage loans only and the purchase of plots cannot be financed by the banks. Mortgage loans can be disbursed in installments after physical verification of the various phases of construction. The total disbursements of loans for mortgage amounted to Rs. 11.4 billion in FY 05.

Commodity financing and its prevailing rates are not attractive for the borrowers as there has been net retirement of commodity loans in the first nine months of the current fiscal year.

The regulatory environment for the banks to indulge in lending for speculative purposes is not very propitious. The State Bank of Pakistan supervisors are not only vigilant in their on-site inspection but they monitor the banks on a continuous basis and can detect irregularities and violations fairly quickly. The more deterrent effect of strong oversight by the supervisors is enough to discourage such activities. The penalties imposed by the supervisors on recalcitrant banks are quite severe.

http://www.scribd.com/doc/18676156/Pakistan-Banking-Sector

INTRODUCTION

Financial Sector

Financial Sector in Pakistan possesses a wide spectrum 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. Financial deepening has intensified during the last several years but the commercial banks are by far the predominant players accounting for 90 percent of the total financial assets of the system.

Among the commercial banks, 12 foreign and 20 domestic banks together hold 80 Percent of the banking system assets - a feat that is unparalleled among developing countries. Foreign banks enjoy the same facilities and same access as the domestic banks and there is no preferential treatment for domestic institutions. Unlike many countries, foreign banks can have 100 percent ownership, can open their branches or establish local subsidiary with full ownership. Foreign companies are also provided level playing fields as they can raise finances of all types and tenures from the domestic banking system.

Banks

Banks are financial intermediaries. The role of a financial intermediary is to sell its own obligations and to buy the obligations of others. By endowing its obligations with attractive features, an intermediary can sell its obligations at a higher price than it has to pay for the obligations it buys. Or to say the same thing in a different fashion, it can market its obligations at a lower interest rate than it can command the obligations it buys. The spread between the interest rate it pays on its own obligations and the one it receives on the obligations of other expenses of doing business must then be deducted. The net profit after these other deductions represents the return to the shareholders for their participation in the activity of a financial intermediary.

'Bank is an institution transacting the business of accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft order or otherwise and includes any post office saving bank.'

There are different kinds of banks, i.e. central bank, commercial banks, exchange banks, industrial banks, etc. but for our purpose it will suffice to consider only central and commercial banks.

Central Banking

A central bank is responsible for the monetary policy of the country in which it operates. 'Central bank is an institution which is responsible for safeguarding the financial stability of the country. It holds the ultimate reserves of the nation, controls the flow of purchasing power, whether in form of credit or currency and it acts as bankers to the state.

PAKISTAN BANKING OVERVIEW PAKISTAN BANKING SECTOR-PAKISTAN FINANCIAL HUB

The Banking sector is an integral part of the country's financial services industry. The sector witnessed a phenomenal growth in 2001-03 where deposits rose by almost 100%. There are 39 scheduled banks (including 11 foreign banks) operating in Pakistan. Competition is relatively high, especially after the challenging capital adequacy benchmarks set by the State Bank of Pakistan to nourish a stable banking system. Attracting foreign investment and winning profitable customers are the only options left to banks for survival.

Opportunities for foreign banks, especially in consumer and retail banking, are greater than ever before. In the financial year of 2004-05, the banking sector experienced growth rates of 21% and 36% in its deposit and advances portfolio respectively, which in turn, has increased the banks' stability as compared to the preceding year.

A significant shift of focus from industrial lending to consumer products has allowed the banks to enjoy enormous spreads. However, the manufacturing sector is still enjoying the highest share in credit facilities extended by the banking industry.

The industry is passing through a transitional period from long established patterrns and norms to the unknown land of threats and opportunities. And what will demarcate the banking organizations that will turn every change into an opportunity, taking the bull by the horns using the art of change management successfully from the losers. These are some of the daunting questions which will pose a challenge to the potential future banking brains but flowing are a few areas of banking industy where the wind of change is presently quite visible.

1. Increasing diversity within the commercial banking industry

Diversity is making the head way at a rapid speed pattern of operations, market focus, advertising emphasis and use of information technology. Now the banks are inclined to build their organizations to look different from their market competitors by pursuing divergent and distinctive strategies and by introducing novel products and services through product differentiation.

2. Intensifying pressure of competition

Competition is scaling new heights in the banking industry and it will gain further force. A number of factors are expanding the frontiers of competition in both funding and asset use. Competition for all kinds of savings will continue to deepen and broaden but constant consumer awareness about different markets; situations and alternatives will surely block the capacity of banks to collect savings at lower rates than said by their aggressive market competitors. On the other hand, market pressures will compel the banks to make loans in unknown areas loosening the rope of risk management

3. Profit trends in banking industry

Current key ratios indicate a striking upward trend in the banking industry with huge banking spreads, particularly during the last half decade.

4. Soaring loan losses

Provision for loan losses is on the rise over the years. Troubled loans or non performing advances are regarded as a cancer for banking industry. It can be said that quality loans is the ultimate goal for bankers today.

5. Merger mania

Merger game is going to take front seat in the world. A craze for giant banks is developing to benefit effectively from the future market openings and to tame ever increasing competition. But there are inherent constraints in this mania. The economies of scale vanish automatically after a certain level of expansion in the banking industry.

Structure of the Banking Sector

Pakistan being a developing country and having a relatively low level of income, is required growth rate is low as there is hardly any savings. The standard of living along with the quality of life is the newer concept in Pakistan which emphasizes on individual aspects of human nature. These have led to foreign aids which have been the holding force to bridge the gap for us between our savings and investments. Nevertheless, these aids have become the drowning force for our country. By virtue of being a member of the most western aid consortium, the famous IMF occupies a pivotal role in our economies sphere by influencing our international financial transactions and creates the pace of our development policies. IMF's main objective for Pakistan is to maintain stable exchange rates, multi lateral credit system and international liquidity so as to recover the country from its worst economic crisis. But Pakistan's economic problem can mainly be aspired by internal development and avoidance of any major international role.

Structure of the Pakistani banking sector has substantially changed in the last decade, particularly following the privatization of the state-owned banks. In 1990, the banking system was dominated by five commercial banks which were all state-owned. The 1990 amendments to the Banking Companies Ordinance launched the process of financial sector reforms by allowing privatization of the state-owned banks. During the first round of reform, two of the state-owned banks, Muslim Commercial Bank (MCB) and Allied Bank (ABL), were privatized between 1991 and 1993. The reforms process was subsequently delayed for several years and resumed significantly only in the early 2000s. With the privatization of the third large bank, United Bank (UBL), in 2002, the domination of the state-owned banks was ended. As of September 2003, the asset share of local private banks and public sector commercial banks was 47 percent and 41 percent respectively (Tables 1, 2, and 3). Another large state-owned bank, Habib Bank (HBL), completed its privatization n process in February 2004. As a result of this privatization, the share of banking system assets held by public sector commercial banks decreased to less than 25 percent. The largest bank in the country, National Bank of Pakistan (NBP), with a market share of approximately 20 percent, remains state-owned and its privatization prospects are uncertain at this stage, although the government divested approximately 25 percent of its capital in 2001-03.

The privatization of state-owned banks has been accompanied by the liberalization in the financial system and the openness to domestic and foreign competition. The number of commercial banks and various nonblank financial institutions grew rapidly in the early 1990s (the number of commercial banks increased to more than 40 by the year 1995). Worried by the health and soundness of the newly entering smaller banks, the authorities imposed a moratorium on the establishment of new banks in 1995, which still remains in force. In addition, the authorities sought to consolidate the banking sector by increasing the minimum capital requirement from PRs 500 million to PRs 750 million from end-December 2001 and to PRs 1 billion (around US$17 million) from end December 2002.

Efforts have been made in recent years to promote Islamic banking services. In particular, the State Bank of Pakistan (SBP) exempted Islamic commercial banks from the moratorium on the establishment of new banks, and the first full-fledged

Islamic bank, Meezan Bank, was licensed in 2002. Several conventional banks have also opened branches that provide only Islamic financial services. The size of these Islamic banking institutions

Analysis of Banking Sector in the Present Decade

The Banking sector, which was fully dominated by Nationalized Commercial Banks (NCBs) until a few years ago, has been opened up to the private sector. Four of out five largest NCBs have been privatized. While the ownership and management of the banks by private sector is one pillar of the reforms, the other pillar is a strong regulatory environment. Private banks are prone to taking excessive risks in their lending as their own capital is much lower in relation to the depositors' money. They can realize the large upside potential from high-risk assets while the defaults and losses in event of downside scenario are borne disproportionately by the depositors. It is the responsibility of the central bank as a regulator to be extremely vigilant and take prompt timely action to prevent the bank managers and owners from assuming excessive risks. The Central Bank in Pakistan has strengthened its capacity by acquiring new skills, upgrading the quality of the existing human resources base, adopting technology and re-engineering business processes. The banking regulation and supervision are risk-based and are fully compliant with the international standards and codes prescribed by Basle Committee. The risk management practices are being modified to conform to Basle II rules. The financial soundness indicators show a healthy and sound banking system with high degree of financial stability.

Along with strong regulation, supervision and enforcement, a number of measures have been taken to put best corporate governance practices in the system by prescribing 'fit and proper' criteria for Chief Executives, members of the Boards of Directors and top management positions. Accounting and audit standards have been brought to the International Accounting Standards (IAS) and the International Audit Codes. External audit firms are rated according to their performance and track record and those falling short of the acceptable standards are blacklisted. These practices were put in place in Pakistan long before the scandals of Enron, World Call and Pramalat had shaken the corporate world.

The banking sector has now diversified its product base and carried out a lot of innovation. They have expanded their out reach to agriculture, SMEs, mortgage financing and consumer financing. Not only that this diversified lending portfolio mitigates risks but it also raises the purchasing power of a large segment of population that was completely shut out from credit markets. Pakistan's auto industry has expanded its car production by a multiple of five times in the last four years as auto financing enabled a vast number of middle class income earners to purchase the cars on monthly installments.

The affordability of these new products by the middle class became possible as the prudent fiscal and monetary policies pursued by the Government left a lot of liquidity in the banking system. The healthy competition among banks, lower taxation and reduction in non-performing loans brought about a lowering of average interest rate from 14 percent to 5 percent. The Government, by reducing its fiscal deficit and public sector enterprises by making cash profits, freed up loan-able funds for the use of the private sector. The Central Bank by pursuing an accommodating monetary policy did not mop up excess liquidity and helped the businesses and consumers to access funds at historically record low levels.

Pricing and remuneration for most of the financial services are now determined by banks on a competitive basis. There are no directions or interventions by the State Bank of Pakistan or the Government. Prior to the reforms, there were subsidized lending rates for priority sectors and the rate paid by the Government on its borrowing through banking system was artificially pegged at below market rates. Banks and other financial institutions are free to set their own lending and deposit rates. Government and public sector enterprises have to pay market based interest rates on debt raised through the banking system. The Government has, however, extended the yield curve by raising funds for longer maturity i.e. up to 20 years. These bonds, called Pakistan Investment Bonds, act as the benchmark for corporate debt market. Insurance companies, Benevolent Funds, Pensions Funds, Provident Funds that have strong appetite for investment in these long dated instruments can now find avenues to match their liabilities. At the same time well reputed corporate with long gestation projects can now issue bonds to raise funds of preferred duration. These bonds are not redeemable before maturity but are allowed to be traded freely in the secondary market. A number of multinational companies have raised long-term funds through corporate bonds.

Anatomy of Banking Sector

(Classification of Pakistan's Banking Sector)

Pakistan’s Banking Sector can be classified under the following broad categories

Category	Description
State Bank of Pakistan	Central Bank and the Autonomous and Governing Body for all banking operations in the country
Nationalized Scheduled Banks	These deal primarily in industries of banking and capital markets. They offer a host of unique policies, banking training, services and products which include loans, credit cards, savings and consumer banking
Private Scheduled Banks	Banks engage in channeling funds from depositors to lenders against the primary objective of acquiring profit i.e. Bank Spread
Foreign Banks	These concentrate primarily on International Trade Finance, Innovative Credit Orientation and Plastic Money
Development/ Cooperative/ Investment Banks	Investment Banks act as underwriter or agent serving as intermediary between an issuer of securities and the investing public
Specialized Banks	These banks are created with specific interest thus specializing and catering to a particular sector industry.

Categorical Listing of Operating Banks

Central Bank	State Bank of Pakistan
Nationalized Scheduled Banks	First Woman Bank Ltd. National Bank of Pakistan
Specialized Banks	Zari Taraqiati Bank (ZTBL) Industrial Development Bank of Pakistan Punjab Provincial Cooperative Bank Ltd
Private Scheduled Banks	Askari Commercial Bank Limited Bank Al-Falah Limited Bolan Bank Limited Faysal Bank Limited Bank Al-Habib Limited Metropolitan Bank Limited KASB Commercial Bank Limited Prime Commercial Bank Limited PICIC Commercial Bank Limited Soneri Bank Limited Union Bank Limited Meezan Bank Limited Saudi-Pak Commercial Bank Limited Crescent Commercial Bank Limited Dawood Bank Limited NDLC-IFIC Bank Limited (NIB) Allied Bank of Pakistan Limited United Bank Limited Habib Bank Limited SME Banks
Foreign Banks	ABN Amro Bank N.V Albaraka Islamic Bank BSC (EC) American Expresss Bank Limited Bank of Tokyo Mitsubishi Limited Citibank N.A Deutsche Bank A.G. Habib Bank A.G. Zurich Hongkong & Shanghai Banking Corp Limited Oman International Bank S.O.A.G Rupali Bank Limited Standard Chartered Bank Limited
Investment Banks	Crescent Investment Bank Limited First International Investment Bank Limited Atlas Investment Bank Limited Security Investment Bank Limited Fidelity Investment Bank Limited Prudential Investment Bank Limited Islamic Investment Bank Limited Asset Investment Bank Limited

Al-Towfeek Investment Bank Limited
Jahangir Siddiqui Investment Bank Limited
Franklin Investment Bank Limited
Orix Investment Bank (Pak) Limited

State Bank of Pakistan

Core Functions of State Bank of Pakistan

State Bank of Pakistan is the Central Bank of the country. While its constitution, as originally laid down in the State Bank of Pakistan Order 1948, remained basically unchanged until 1st January 1974 when the Bank was nationalized, the scope of its functions was considerably enlarged. The State Bank of Pakistan Act 1956, with subsequent amendments, forms the basis of its operations today .
Under the State Bank of Pakistan Order 1948, the Bank was charged with the duty to "regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in Pakistan and generally to operate the currency and credit system of the country to its advantage". The scope of the Bank's operations was considerably widened in the State Bank of Pakistan Act 1956, which required the Bank to "regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest with a view to securing monetary stability and fuller utilization of the country's productive resources". Under financial sector reforms, the State Bank of Pakistan was granted autonomy in February 1994. On 21st January, 1997, this autonomy was further strengthened by issuing three Amendment Ordinances (which were approved by the Parliament in May, 1997) namely, State Bank of Pakistan Act, 1956, Banking Companies Ordinance, 1962 and Banks Nationalization Act, 1974. The changes in the State Bank Act gave full and exclusive authority to the State Bank to regulate the banking sector, to conduct an independent monetary policy and to set limit on government borrowings from the State Bank of Pakistan. The amendments in Banks Nationalisation Act abolished the Pakistan Banking Council (an institution established to look after the affairs of NCBs) and institutionalised the process of appointment of the Chief Executives and Boards of the nationalised commercial banks (NCBs) and development finance institutions (DFIs), with the Sate Bank having a role in their appointment and removal. The amendments also increased the autonomy and accountability of the Chief Executives and the Boards of Directors of banks and DFIs.

Like a Central Bank in any developing country, State Bank of Pakistan performs both the traditional and developmental functions to achieve macro-economic goals. The traditional functions, which are generally performed by central banks almost all over the world, may be classified into two groups: (a) the primary functions including issue of notes, regulation and supervision of the financial system, bankers' bank, lender of the last resort, banker to Government, and conduct of monetary policy, and (b) the secondary functions including the agency functions like management of public debt, management of foreign exchange, etc., and other functions like advising the government on policy matters and maintaining close relationships with international financial institutions. The non-traditional or promotional functions, performed by the State Bank include development of financial framework, institutionalisation of savings and investment, provision of training facilities to bankers, and provision of credit to priority sectors. The State Bank also has been playing an active part in the process of islamization of the banking system. The main functions and responsibilities of the State Bank can be broadly categorised as under.

REGULATION OF LIQUIDITY

Being the Central Bank of the country, State Bank of Pakistan has been entrusted with the responsibility to formulate and conduct monetary and credit policy in a manner consistent with the Government's targets for growth and inflation and the recommendations of the Monetary and Fiscal Policies Co-ordination Board with respect to macro-economic policy objectives. The basic objective underlying its functions is two-fold i.e. the maintenance of monetary stability, thereby leading towards the stability in the domestic prices, as well as the promotion of economic growth.

To regulate the volume and the direction of flow of credit to different uses and sectors, the Bank makes use of both direct and indirect instruments of monetary management. Until recently, the monetary and credit scenario was characterised by acute segmentation of credit markets with all the attendant distortions. Pakistan embarked upon a program of financial sector reforms in the late 1980s. A number of fundamental changes have since been made in the conduct of monetary management which essentially marked a departure from administrative controls and quantitative restrictions to market-based monetary management. A reserve money management programme has been developed. In terms of the programme, the intermediate target of M2 would be achieved by observing the desired path of reserve money - the operating target. While use in now being made of such indirect instruments of control as cash reserve ratio and liquidity ratio, the program's reliance is mainly on open market operations .

ENSURING THE SOUNDNESS OF FINANCIAL SYSTEM :

REGULATION AND SUPERVISION

One of the fundamental responsibilities of the State Bank is regulation and supervision of the financial system to ensure its soundness and stability as well as to protect the interests of depositors. The rapid advancement in information technology, together with growing complexities of modern banking operations, has made the supervisory role more difficult and challenging. The institutional complexity is increasing, technical sophistication is improving and technical base of banking activities is expanding. All this requires the State Bank for endeavoring hard to keep pace with the fast-changing financial landscape of the country. Accordingly, the out dated inspection techniques have been replaced with the new ones to have better inspection and supervision of the financial institutions. The banking activities are now being monitored through a system of 'off-site' surveillance and 'on-site' inspection and supervision. Off-site surveillance is conducted by the State Bank through regular checking of various returns regularly received from the different banks. On other hand, on-site inspection is undertaken by the State Bank in the premises of the concerned banks when required.

To deepen and broaden financial markets as also to diversify the sources of credit, a number of non-bank financial institutions (NBFIs) were allowed to increase substantially. The State Bank has also been charged with the responsibilities of regulating and supervising of such institutions. To regulate and supervise the activities of these institutions, a new Department namely, NBFIs Regulation and Supervision Department was set up. Moreover, in order to safeguard the interest of ultimate users of the financial services, and to ensure the viability of institutions providing these services, the State Bank has issued a comprehensive set of Prudential Regulations (for commercial banks) and Rules of Business (for NBFIs.(

The "Prudential Regulations" for banks, besides providing for credit and risk exposure limits, prescribe guide lines relating to classification of short-term and long-term loan facilities, set criteria for management, prohibit criminal use of banking channels for the purpose of money laundering and other unlawful activities, lay down rules for the payment of dividends, direct banks to refrain from window dressing and prohibit them to extend fresh laon to defaulters of old loans. The existing format of balance sheet and profit-and-loss account has been changed to conform to international standards, ensuring adequate transparency of operations. Revised capital requirements, envisaging minimum paid up capital of Rs.500 million have been enforced. Effective December,1997, every bank was required to maintain capital and unencumbered general reserves equivalent to 8 per cent of its risk weighted assets.

The "Rules of Business" for NBFIs became effective since the day NBFIs came under State Bank's jurisdiction. As from January, 1997, modarbas and leasing companies, which are also specialized type of NBFIs, are being regulated/supervised by the Securities and Exchange Commission (SECP), rather than the State Bank of Pakistan.

EXCHANGE RATE MANAGEMENT AND BALANCE OF PAYMENTS

One of the major responsibilities of the State Bank is the maintenance of external value of the currency. In this regard, the Bank is required, among other measures taken by it, to regulate foreign exchange reserves of the country in line with the stipulations of the Foreign Exchange Act 1947. As an agent to the Government, the Bank has been authorised to purchase and sale gold, silver or approved foreign exchange and transactions of Special Drawing Rights with the International Monetary Fund under sub-sections 13(a) and 13(f) of Section 17 of the State Bank of Pakistan Act, 1956.

The Bank is responsible to keep the exchange rate of the rupee at an appropriate level and prevent it from wide fluctuations in order to maintain competitiveness of our exports and maintain stability in the foreign exchange market. To achieve the objective, various exchange policies have been adopted from time to time keeping in view the prevailing circumstances. Pak-rupee remained linked to Pound Sterling till September, 1971 and subsequently to U.S. Dollar. However, it was decided to adopt the managed floating exchange rate system w.e.f. January 8, 1982 under which the value of the rupee was determined on daily basis, with reference to a basket of currencies of Pakistan's major trading partners and competitors. Adjustments were made in its value as and when the circumstances so warranted. During the course of time, an important development took place when Pakistan accepted obligations of Article-VIII, Section 2, 3 and 4 of the IMF Articles of Agreement, thereby making the Pak-rupee convertible for current international transactions with effect from July 1, 1994.

After nuclear detonation by Pakistan in 1998, a two-tier exchange rate system was introduced w.e.f. 22nd July 1998, with a view to reduce the pressure on official reserves and prevent the economy to some extent from adverse implications of sanctions imposed on Pakistan. However, effective 19th May 1999, the exchange rate has been unified, with the introduction of market-based floating exchange rate system, under which the exchange rate is determined by the demand and supply positions in the foreign exchange market. The surrender requirement of foreign exchange receipts on account of exports and services, previously required to be made to State Bank through authorized dealers, has now been done away with and the commercial banks and other authorised dealers have been made free to hold and undertake transaction in foreign currencies.

As the custodian of country's external reserves, the State Bank is also responsible for the management of the foreign exchange reserves. The task is being performed by an Investment Committee which, after taking into consideration the overall level of reserves, maturities and payment obligations, takes decision to make investment of surplus funds in such a manner that ensures liquidity of funds as well as maximises the earnings. These reserves are also being used for intervention in the foreign exchange market. For this purpose, a Foreign Exchange Dealing Room has been set up at the Central Directorate of State Bank of Pakistan and services of a 'Forex Expert' have been acquired .

DEVELOPMENTAL ROLE OF STATE BANK

The responsibility of a Central Bank in a developing country goes well beyond the regulatory duties of managing the monetary policy in order to achieve the macro-economic goals. This role covers not only the development of important components of monetary and capital markets but also to assist the process of economic growth and promote the fuller utilisation of a country's resources .

Ever since its establishment, the State Bank of Pakistan, besides discharging its traditional functions of regulating money and credit, has played an active developmental role to promote the realisation of macro-economic goals. The explicit recognition of the promotional role of the Central Bank evidently stems from a desire to re-orientate all policies towards the goal of rapid economic growth. Accordingly, the orthodox central banking functions have been combined by the State Bank with a well-recognised developmental role.

The scope of Bank's operations has been widened considerably by including the economic growth objective in its statute under the State Bank of Pakistan Act 1956. The Bank's participation in the development process has been in the form of rehabilitation of banking system in Pakistan, development of new financial institutions and debt instruments in order to promote financial intermediation, establishment of Development Financial Institutions (DFIs), directing the use of credit according to selected development priorities, providing subsidised credit, and development of the capital market.

Market Share-Pakistan Banks (as of September 2006)

PRs mn

#	Name of Bank	Assets	Deposits	Equity
1	National Bank of Pakistan	625,592	483,232	92,623
2	Habib Bank Limited	513,876	411,246	47,699
3	United Bank Limited	388,177	308,065	27,070
4	MCB Bank Limited	317,608	251,092	30,541
5	Bank Alfalah Limited	261,499	214,843	10,753
6	Allied Bank Limited	232,178	198,030	16,691
7	Askari Commercial Bank Limited	152,484	122,701	10,475
8	Bank of Punjab	139,223	114,898	15,779
9	Standard Chartered Bank	133,132	100,107	8,128
10	Faysal Bank Limited	116,847	78,229	13,369
11	Union Bank Limited	113,556	73,385	5,262
12	Bank AL Habib Limited	108,205	88,003	6,078
13	Metropolitan Bank Limited	94,298	60,377	6,973
14	Citibank	89,088	61,905	5,915
15	Zarai Taraqiati Bank Limited	85,479	2,645	12,471
16	ABN Amro Bank	68,984	53,077	5,397
17	Soneri Bank Limited	67,014	50,931	4,840
18	PICIC Commercial Bank Limited	65,349	53,150	4,081
19	Prime Commercial Bank Limited	54,458	42,659	3,609
20	SaudiPak Commercial Bank Limited	49,480	40,692	3,736
21	Habib Bank AG Zurich	45,186	33,191	3,324
22	NIB Bank Limited	40,258	21,709	4,232
23	Meezan Bank Limited	38,831	29,447	3,453
24	Bank of Khyber	26,522	19,440	3,057
25	KASB Bank Limited	23,461	19,051	2,070
26	Mybank Limited	22,129	16,212	3,940
27	Punjab Provincial Cooperative Bank	17,379	1,441	3,284
28	Atlas Bank Limited	16,938	8,453	3,014
29	HongKong & Shanghai Banking Corp.	15,544	10,753	2,351
30	Albaraka Islamic Bank	14,992	10,727	2,104
31	Industrial Development Bank of Pakistan	9,217	7,117	-28,189
32	SME Bank	8,677	1,361	2,270
33	First Women Bank Limited	8,232	6,385	831
34	Crescent Commercial Bank Limited	7,689	4,169	1,842
35	Deutche Bank Limited	7,581	2,649	2,368
36	American Express Bank	6,660	5,581	678
37	Bank of Tokyo	6,097	1,209	2,369
38	Dubai Islamic Bank Pakistan Limited	4,631	2,305	2,147
39	Arif Habib Rupali Bank Limited	4,372	1,040	3,040
40	Bank Islami Pakistan Limited	2,758	614	2,003
41	Oman International Bank	1,810	718	1,014
	Total	4,005,491	3,012,839	352,692

ANALYSIS OF THE MARKET SHARE OF PAKISTAN BANKS AS OF SEPTEMBER 2006

National bank of Pakistan is the largest bank in terms of asset, deposits and equity. High proportion of low cost deposits as given rise to favorable funding costs and high net interest margin.

Habib Bank Ltd (HBL) has a dominant domestic presence being the largest bank in the country in terms of advances and branch network. In terms of deposits, assets and equity, it stands second only to National Bank of Pakistan (NBP). In an industry where size does matter, HBL’s size is expected to be a big advantage. Low costs deposit base due to extensive branch network is a key advantage.

United Bank Limited (UBL) is Pakistan’s third largest bank in terms of assets as well as deposits. Post privatization in 2002, the bank has revamped its strategy and emerged as a strong market player in both corporate and consumer segments.

MCB Bank (MCB) is the fourth largest bank in terms of assets as well as deposits. It is one of the fastest growing banks in the industry with a strong backing of Nishat Group. Post privatization, MCB’s focus has been on aggressive cost reduction.

Bank Alfalah Limited (BAFL) is Pakistan’s fifth largest bank in terms of assets as well as deposits. It has been the fastest growth story in the industry. BAFL has shown excellent asset quality, sufficient capital levels and good profitability.

FABL is a small sized private bank, with a share of 2.7% in the assets of total banking system in 2006. FABL has one of the most consistent dividend payout streams in the banking sector.

Bank of Punjab (BOP) is a public sector bank with extensive branch network and favorable funding mix. The low cost deposits form more than 55% of total deposits. The Government of Punjab holds the majority stake in the bank.

Mybank (MYBL) is a small sized private bank with total assets less than 1% of the total banking system. MYBL operates a network of 60 branches in all major cities of Pakistan.

Comparing the foreign banks, Standard Chartered Bank stands out at 1st with its highest assets, deposits and equity.

COMPARISON & CLASSIFICATION OF BANKS OPERATING IN PAKISTAN ON THE BASIS OF

ASSETS, DEPOSITS & EQUITY

Banks under study:

Comparison & Classification of Banks Operating in Pakistan
On the basis of
Assets, Deposits & Equity

Name of Bank	Assets PRs mn	Deposits PRs mn	Equity PRs mn
National Bank of Pakistan Number of Branches Nation Wide: 1458	625,592	483,232	92,623
Habib Bank Limited Number of Branches Nation Wide: 1400	513,876	411,246	47,699
United Bank Limited Number of Branches Nation Wide: 1056	388,177	308,065	27,070
Muslim Commercial Bank Number of Branches Nation Wide: 954	317,608	251,092	30,541
Bank Alfalah Limited Number of Branches Nation Wide: 210	261,499	214,843	10,753
Faysal Bank Limited Number of Branches Nation Wide: 87	133,132	100,107	8,128

Market Share as of September 2006
Source: SBP

NATIONAL BANK OF PAKISTAN (NBP)

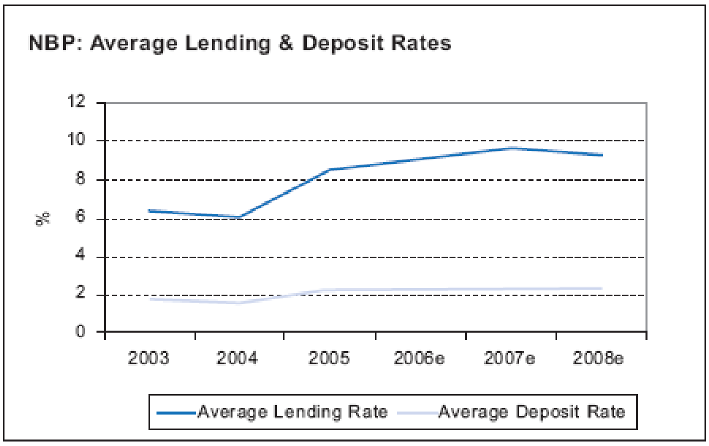
National Bank of Pakistan is the largest bank in terms of assets as well as deposits. High proportion of low cost deposits has given rise to favorable funding costs and high net interest margin. NBP's market position is unique in the sense that it's a government bank.

It is the default bank for all government servants' salaries and government transactions. Its deposit base is backed and guaranteed by the government To date, its majority shareholder is Government of Pakistan (76%) and it has a free float of approximately 20.3%

Deposits

NBP had 16% of sector's total deposits as of September 2006, the composition of deposits stood as follows:

- 39% Current Deposits
- 44% Saving Deposits
- 17% Fixed Deposits



Over the year NBP has consistently reduced its reliance on fixed deposits and increased he portion of current and saving deposits. Like most other banks with large deposit franchises such as MCB and UBL, this concentration of current and saving deposits is primarily responsible for bank's low funding costs.

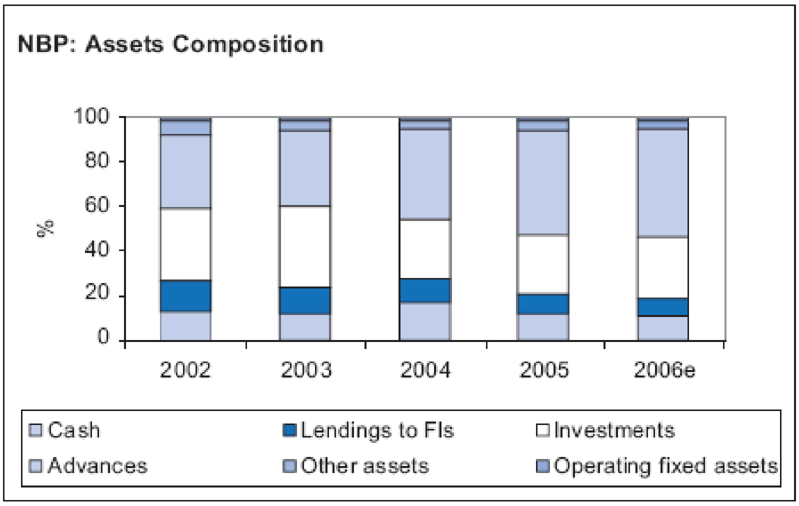
Assets

NBP had 15.6% of total assets share in the sector as of September 2006. The composition of assets stood as follows:

- 12% Cash
- 8% Lending to FIs
- 27% Investments
- 47% Advances
- 4% Other Assets
- 2% Operating Fixed Assets

NBP: Assets Composition

Exposure to advances is low and there exists ability to take on more risk



Business Mix, Strategy and Management

Like most other Pakistani banks NPB is focused towards corporate lending. Being a public sector bank it has the largest portion of (17.71%) of government and public sector advances.

The bank is reasonably well diversified with only a slight domination of loans to the textile sector at 18.87%. Loans to oil, gas and petroleum sector form 8.06% of total loans. Other than these, advances are distributed quite evenly among the other sectors.

The exposure to public sector lending has made the bank prone to greater defaults. Non Performing Loans (NPLs) form 13% of bank's total loans.

NBP over the years has experienced strong growth in revenues backed by high reliance on NIR (Net Interest Revenue)

NBP Bank Deposit Growth

Our concern is the growth in balance sheet particularly deposits. Deposits over the period have shown a compound annual growth rate of only 5%.

NBP Bank Deposit Growth

%

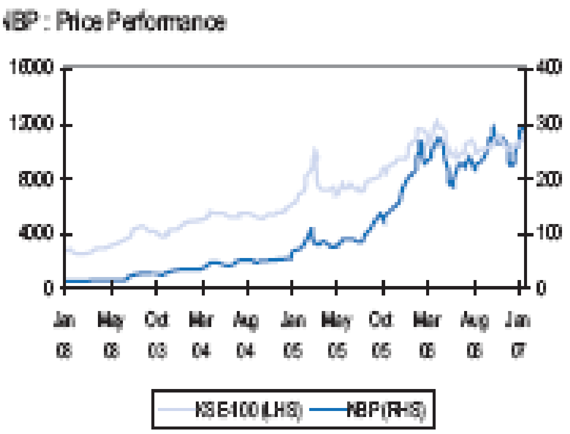
	2003	2004	2005	2006e	2007e	2008e
Number of branches	986	946	952	988	1,028	1,068
Deposit per branch (PRs mn)	401	492	487	506	527	548
Total Deposits (PRs mn)	395,492	465,572	463,427	500,189	541,257	584,811

Financial Analysis

Operating Profit has shown consistent increase during the past two years after a steep decline in 2003. The bank's Return on Equity (ROE) was 22% slightly lower than the average 29%.

	Net Income PRs mn	EPS PRs	Dividend PRs	PE Rating x	NAV PRs	Price-to-Book x
2005	12,709	21.51	2.50	12.5	125.81	2.14
2006e	17,104	24.12	3.13	11.2	134.10	2.01
2007e	20,921	29.50	3.00	9.1	166.86	1.61
2008e	23,592	33.27	2.80	8.1	197.55	1.36

Bloomberg Code	*NBP PA*
Current Price (PRs per share)	*248.8*
Average daily Volume (shares)	*10,906,544*
Market Capitalization (PRs mn)	*200,596.3*
Market Capitalization (US$ mn)	*3,276*
Paidup Capital (PRs mn)	*8,154.32*
Shares Outstanding (mn)	*815.432*
Weightage in KSE100 (%)	*5.283*
Free Float (%)	*20.30*
Average Price Per Share (PRs per share)	*244.06*



HABIB BANK LIMITED

(HBL)

Habib Bank has a dominant domestic presence being the largest bank in the country in terms of advances and branch network. In terms of deposits it stands second only to the National Bank of Pakistan (NBP). In an industry where size does matter, HBL is expected to be a big advantage.

Low cost deposit base due to extensive branch network is a key advantage to HBL, along with other Tier I banks continues to enjoy favorable interest rate spreads. Strong international presence and aspirations of becoming a universal bank provide the bank a focus towards trade finance.

High advances exposure to the textile sector may prove risky for the bank. The dismal performance of the textile exports may result in default and advances lending to declining asset quality.

Deposits

HBL had about 11% of sector's total deposits as of September 2006, the composition of deposits stood as follows:

- 45% Current Deposits
- 31% Saving Deposits
- 24% Fixed Deposits

Similar to NBP, over the year HBL has consistently reduced its reliance on fixed deposits and increased the portion of current and saving deposits.

Assets

HBL's total composition of assets stood as follows:

- 13% Cash
- 9% Lending to FIs
- 21% Investments
- 53% Advances
- 2% Other Assets
- 2% Operating Fixed Assets

Business Mix, Strategy and Management

Like most other Pakistani banks HBL over the years has focused towards corporate lending. A major chunk of its advances are directed to the Textile Sector. The deteriorating situation and reduced efficiency levels of the sector is likely to cause problems for HBL in the near future.

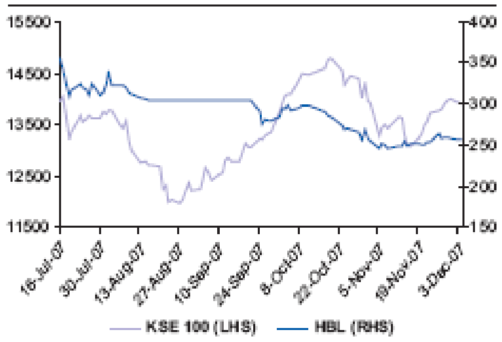
The intense exposure to public sector lending and the textile has made the bank prone to greater defaults. Non Performing Loans (NPLs) form 8% of bank's total loans which is comparatively much less than that of National Bank.

Financial Analysis

	Net income (PRs mn)	EPS (PRs)	Dividend (PRs)	PE Rating (x)	NAV (PRs)	Price/Book (x)
2005A	8,916	12.92	0.00	20.2	57.58	4.54
2006A	14,276	20.69	1.00	12.6	76.97	3.40
2007F	12,296	17.82	2.00	14.7	93.96	2.78
2008E	18,176	26.34	2.00	9.9	119.57	2.19
2009E	21,458	31.10	2.50	8.4	149.55	1.75

Bloomberg Code	*HBL PA*
Current Price (PRs per share)	*261.50*
Average daily Volume (shares)	*2,152,007*
Market Capitalization (PRs mn)	*180,952.5*
Market Capitalization (US$ mn)	*2,955.7*
Paidup Capital (PRs mn)	*6,900*
Shares Outstanding (mn)	*690*
Weightage in KSE100 (%)	*0*
Free Float (%)	*7.5*
Average Price Per Share (PRs per share)	*289.27*

Chart 24: HBL: Price Performance



UNITED BANK LIMITED
(UBL)

United Bank Limited (UBL) is Pakistan's third largest bank in terms of assets as well as deposits. It was privatized in 2002 and since then it has grown rapidly. The major shareholders include Government of Pakistan (44.7%), Bestway Group (25.5%) and Abu Dhabi Group (25.5%). The free float is lowest at 3.37%.

UBL is the only privatized bank that has a dual focus on consumer as well as corporate banking. Share of total consumer segment is about 12% High proportion of low cost deposits (79%) has given rise to favorable funding costs and high net interest margins.

Unlike other banks UBL has not curtailed deposits growth to preserve low cost funding and the deposit growth has been at around 25% in the last 3 years. Healthy coverage ratio is prudent and suggests ability to withstand future losses. High Capital Levels with Capital Adequacy Ration of 16.8% as of September 2006.

Deposits

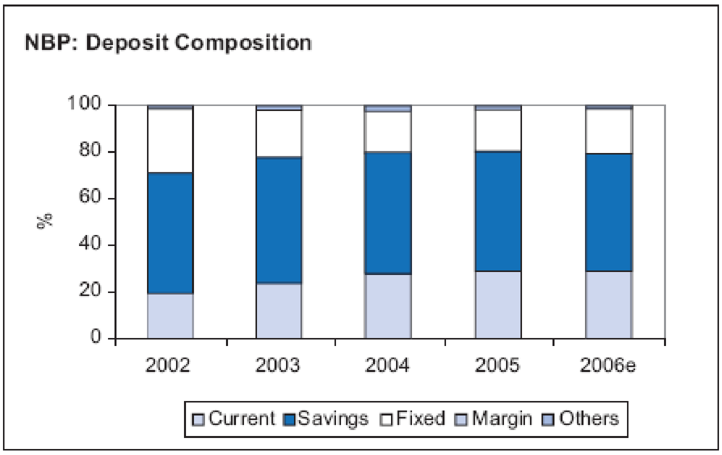
NBP had 10.2% of sector's total deposits as of September 2006, the composition of deposits stood as follows:

- 29% Current Deposits
- 50% Saving Deposits
- 19% Fixed Deposits
- 1% Margin Deposits
- 1% Others

Over the year NBP has consistently reduced its reliance on fixed deposits and increased the portion of current and saving deposits. This is primarily responsible for bank's low funding costs. The average deposit rate was 1.76% in 2005 and the growth in average deposit rates is expected to rise by 2007.

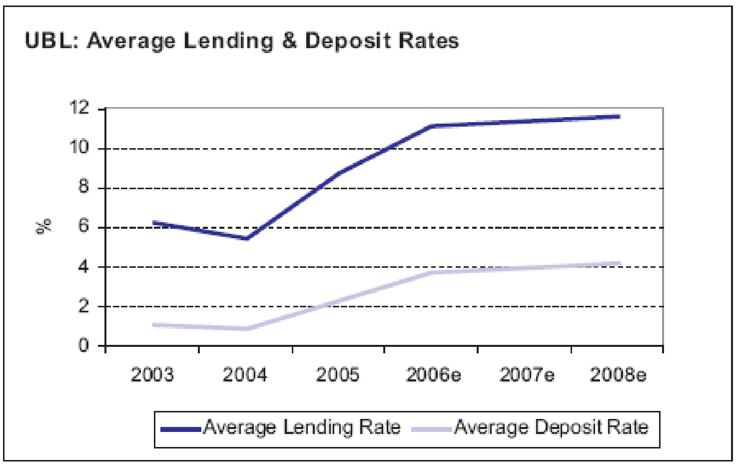
UBL: Deposit Composition

Proportion of fixed deposits is low while that of current & savings is high



UBL: Average Lending & Deposit Rates

Deposit rates have risen sharply as deposit growth has been through higher cost deposits



Source: Company Reports & IGI Research

- **Assets**

UBL has 10% of the

UBL had 9.7% of the total assets share in the sector as of September 2006. The

Business Mix, Strategy and Management

UBL made a kick start in being a dual focused bank specializing in both corporate and consumer banking. Its consumer loan portfolio amounted to PKR 30 billion in 2005. This represents a market share of 11.87%.

The bank has a slightly high proportion of loans to the Textile Sector which forms 25.23% of its total loans in 2006. Other than that the bank is reasonably well diversified.

Post privatization UBL has vastly improved its management, the top management team now comprises of people with plenty of global banking experience. It has been reasonably successful in changing UBL's culture from that of a state run bank.

Financial Analysis

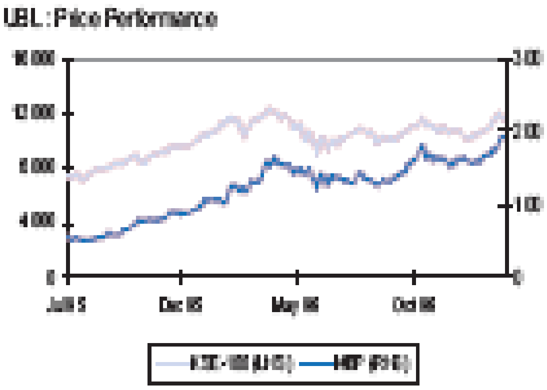
Operating Profit in 2004 had been negative but in 2005 operating profit grew by a remarkable figure of 116%, the year 2005 was a good one for most banks. The bank's Return on Equity was 29% in 2005 and has been increasing steadily.

Return on Assets has been lower than average in the past few years and suggests some problems in the pricing of loans. Net Interest Revenue and Profits are expected to grow in the coming years of operations.

	Net Income PRs mn	EPS PRs	Dividend PRs	PE Rating x	NAV PRs	Price-to-Book x
2005	6,168	11.91	1.50	15.6	46.86	3.97
2006e	9,115	14.08	3.00	13.2	49.39	3.76
2007e	11,648	17.99	2.50	10.3	65.54	2.84
2008e	14,754	22.79	2.50	8.2	86.54	2.15

UBL is the only privatized bank that has not restricted itself to benefit from its huge deposits base only. It has also focused on non interest based revenue and consumer banking, which will provide cushion to its profitability as the favorable funding costs disappear.

KATS Code	UBL
Bloomberg Code	UBL PA
Reuters Code	UBL.KA
Current Price (PRs per share)	186.00
Average Daily Volume (mn shares)	0.55
Market Capitalization (PRs mn)	120,370
Paid-up Capital (PRs mn)	6,475
Shares Outstanding (mn)	648
Free Float (%)	3.37
Weightage in KSE-100 (%)	4.36
Average Price (PRs per share)	143.77



MUSLIM COMMERCIAL BANK LIMITED
(MCB)

Muslim Commercial Bank (MCB) is Pakistan's fourth largest bank in terms of assets as well as deposits. It was the first to be previously nationalized bank to be privatized in 1991 and it has come a long way since then. It has the majority shareholding of the Nishat Group of 35.3% and 44% of Free Float.

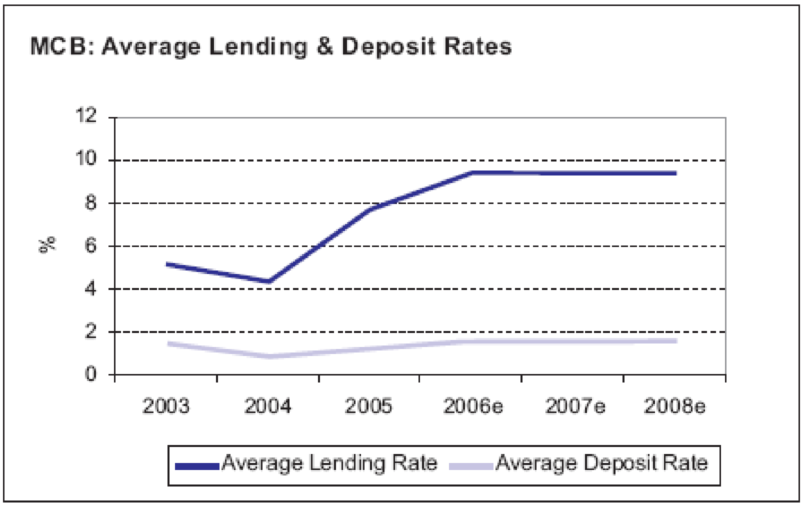
Deposits

NBP had 8.33% of sector's total deposits as of September 2006, the composition of deposits stood as follows:

- 33% Current Deposits
- 60% Saving Deposits
- 06% Fixed Deposits
- 01% Margin Deposits

MCB: Average Lending & Deposit Rates

Enjoys the widest spread in our selection with the lowest average deposit rates



Over the year NBP has consistently reduced its reliance on fixed deposits and increased the portion of current and saving deposits. This is primarily responsible for bank's low funding costs. The average deposit rate was 1.24% in 2005 which is expected to rise in 2006 as MCB's deposit composition shifts towards higher cost deposits. Further expansion through low cost deposits seems very difficult.

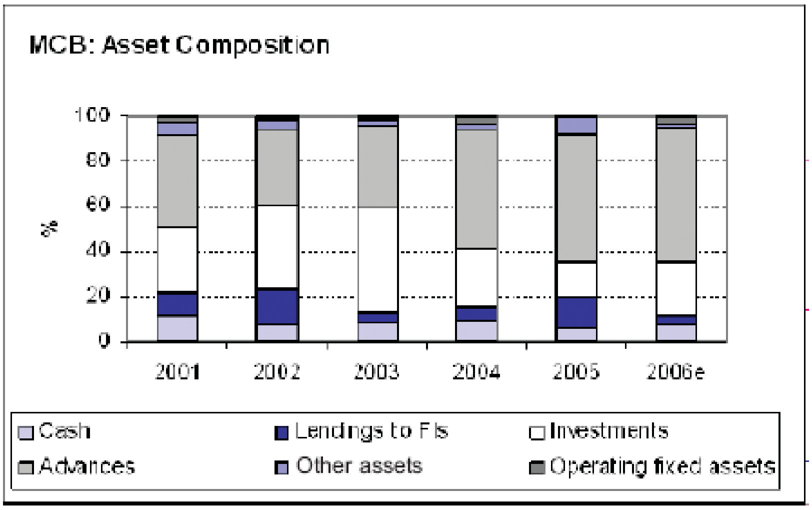
Assets

NBP had 7.93% of total assets share in the sector as of September 2006. The composition of assets stood as follows:

- 06% Cash
- 14% Lending to FIs
- 15% Investments
- 57% Advances
- 08% Other Assets

MCB: Assets Composition

Further increase in proportion of advances would be risky



Over the years, the bank has increased focus on advances and any further increase in reliance on advances may prove to be risky. Analysts expect MCB to maintain the portion of advances below 60% in future.

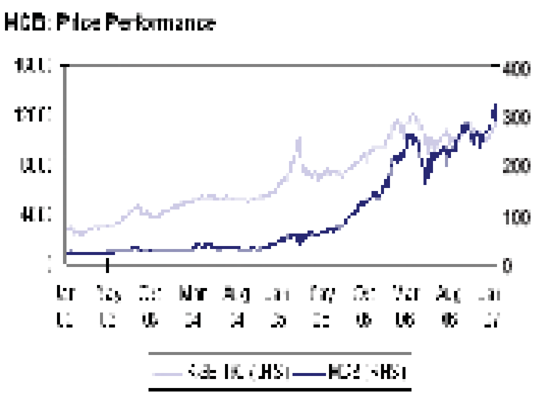
Business Mix, Strategy and Management

Traditionally MCB has been focused towards Corporate Lending and more recently it has shifted towards consumer lending. The share of individual loan is only 8.9% of the total loans. The bank is reasonably well diversified and not heavily dominated by a particular type of loan. Loans to textile sector form 13.78%of the total loans, while loans to sugar industry form 4.34% of the total.

The other big chunks lie with the communication sector which is 13.24% of total loans. MCB boasts a high quality management with plenty of international banking experience. The top management seems committed to investments in technology with a recent shift towards expansion in consumer financing.

Financial Analysis

Like most banks in Pakistan, MCB has preponderance of Net Interest Revenue (NIR) with 73% of total revenues. MCB has the highest proportion of low cost deposits which include current and savings deposits but the proportion is now decreasing.



KATS Code	MCB
Bloomberg Code	MCB PA
Reuters Code	MCB.KA
Current Price (PRs per share)	293.00
Average Daily Volume (mn shares)	11.40
Market Capitalization (PRs mn)	149,969
Paid-up Capital (PRs mn)	5,118
Shares Outstanding (mn)	512
Free Float (%)	44.00
Weightage in KSE-100 (%)	5.44
Average Price (PRs per share)	237.83

MCB has only recently launched credit card and shifted its focus towards consumer lending. However the interesting fact is that presently, MCB's non interest revenues are not dominated by trading gains unlike other banks.

The overall risk profile of the bank has vastly improved with non performing loans coming down from 11% to 5% between 2003 and 2006. Coverage ratio is 93% which is very healthy and indicative of the fact that the bank is adequately covered against possible loan losses. This is due to the regulatory pressures across the board to provide heavily against loan losses. This is MCB's strength versus the smaller private banks which are not adequately covered and run the risk of possible equity erosion from loan losses.

	Net Income	EPS	Dividend	PE Rating	NAV	Price-to-Book
	PRs mn	PRs	PRs	x	PRs	x
2005	8,922	20.92	4.25	14.0	54.64	5.36
2006e	12,148	22.24	7.00	13.2	80.44	3.64
2007e	13,872	25.39	7.00	11.5	98.82	2.96
2008e	16,812	30.77	7.00	9.5	122.59	2.39

Operating profit growth had been marginal till 2005. the year 2005 saw huge increase in operating income by 81% and the bank's return on equity was 47%.

BANK ALFALAH LIMITED
(BAFL)

Bank Alfalah (BAFL) started operations in 1997and since then it has grown manifolds. The bank operates 194 branches across Pakistan including 23 Islamic Banking Branches and 5 overseas branches.

Its major shareholding lies with H. E. Nahayan Mabarak Al Nahayan (16.74%) and H. E. Shaikh Hamdan Bin Mabarak Al Nahayan (10.03%) of the royal family of Abu Dhabi.

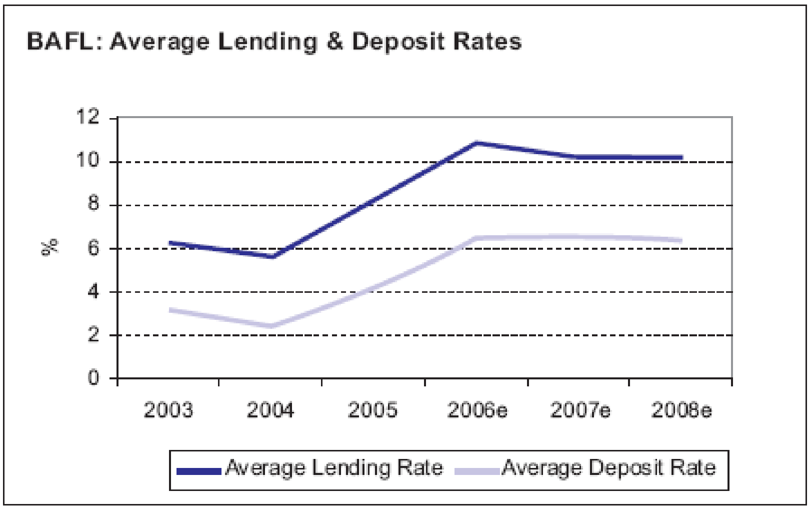
Deposits

NBP had 7.1% of sector's total deposits as of September 2006, the composition of deposits stood as follows:

- 20% Current Deposits
- 42% Saving Deposits
- 36% Fixed Deposits
- 02% Margin Deposits

BAFL: Average Lending & Deposit Rates

Funding cost has gone up as a result of the bank's deposit growth through high cost deposits



Over the years BAFL has consistently increased it reliance on fixed deposits and deduced the proportion of current and saving deposits. This is primarily responsible for bank's higher funding costs. The average deposit rate was 6.05% in 2006 which is expected to rise in the coming years.

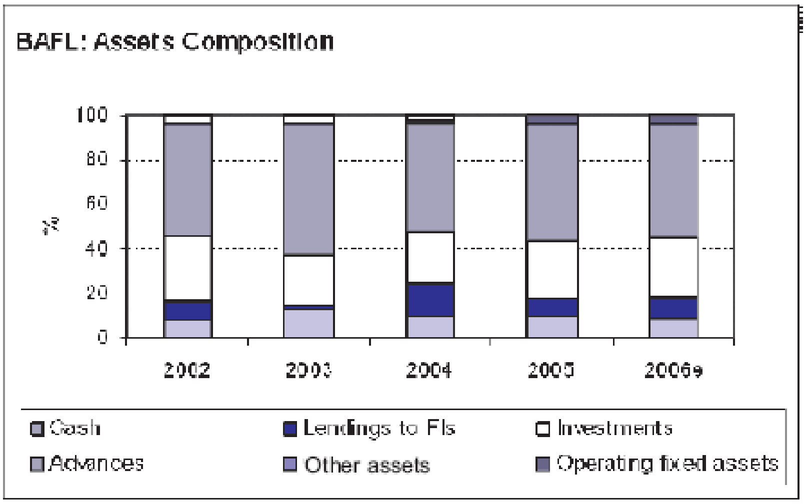
Assets

BAFL had 6.5% of the total assets share in the sector as of September 2006. The composition of assets stood as follows::

- 10% Cash
- 08% Lending to FIs
- 26% Investments
- 51% Advances
- 02% Other Assets
- 03% Operating Fixed Assets

BAFL: Assets Composition

Exposure to advances is not excessively high



Over the years BAFL has reduced its focus on Advances, which is generally an indication of lower risk weighting. Risk Weighted Assets were 65% of total assets in 2003 and 52% in 2005. However as loan growth progresses we expect risk weight to rise.

Business Mix, Strategy and Management

BAFL's product mix comprises of corporate, consumer and international banking. Individual loans contribute 24% of the loan book while 20% are the loans to the textile sector. When questioned about the likely negative repercussions of current crisis in Pakistan's Textile Industry, the management reports that the BAFL's exposure in textile is high only on the spinning side that is 9.8% which is so far not been hit by the crisis. BAFL is more than adequately covered against potential loan losses with 147% coverage ratio. Moreover, so far the incident of fresh Non-Performing Loans has not been showing of much concern.

Investments in technology also seem to be underway as the bank had finalized an agreement to install core banking system with the help of international consultants.

Financial Analysis

The contribution of Net Interest Revenues (NIR) to the bank's total revenues is 69% which is in line with the average for the banks under our study. Growth in NIR has been consistent.

The bank has the lowest Net Interest Margin at 2.5% in 2006 which suggests a few problems on the pricing side. Funding costs for the bank are not as favorable as its competitors. Due to its limited reach across the country the bank has sought higher cost deposits to fuel its deposits growth.

The overall profit growth has been erratic being 153% in 2003, -13% in 2004 and 55% in 2004. The profits in the year 2006 have been approximately 32%. Similarly returns have also been volatile. The banks ROE was 50.5% in 2003, 21.8% in 2004, 26.75% in 2005 and about 25% in 2006.

	Net Income PRs mn	EPS PRs	Dividend PRs	PE Rating x	NAV PRs	Price-to-Book x
2005	1,702	5.67	1.20	9.1	24.88	2.08
2006e	2,406	4.81	1.00	10.7	22.72	2.28
2007e	3,510	7.02	1.50	7.4	27.99	1.85
2008e	4,498	9.00	1.50	5.7	34.78	1.49

Return on assets have been much lower than average as the banks assets have expanded at rate higher than growth in profits.

KATS Code	BAFL
Bloomberg Code	BAFL PA
Reuters Code	BAFL.KA
Current Price (PRs per share)	52.00
Average Daily Volume (mn shares)	3.90
Market Capitalization (PRs mn)	25,850
Paid-up Capital (PRs mn)	5,000
Shares Outstanding (mn)	500
Free Float (%)	30.00
Weightage in KSE-100 (%)	0.94
Average Price (PRs per share)	47.45

FAYSAL BANK LIMITED
(FABL)

Faysal Bank (FABL) is one of the smaller banks under our study. In terms of assets size its ranked as the 9th largest bank in Pakistan. Its majority shareholding of Dar Al-Maal Al Islami (DMI Trust) of 42% and 30.4% of free float. FABL is a small sized private bank that has exposures to both interest and non interest revenue. It has a relatively low coverage ratio of 42% which is not very prudent and creates concerns of future loan losses.

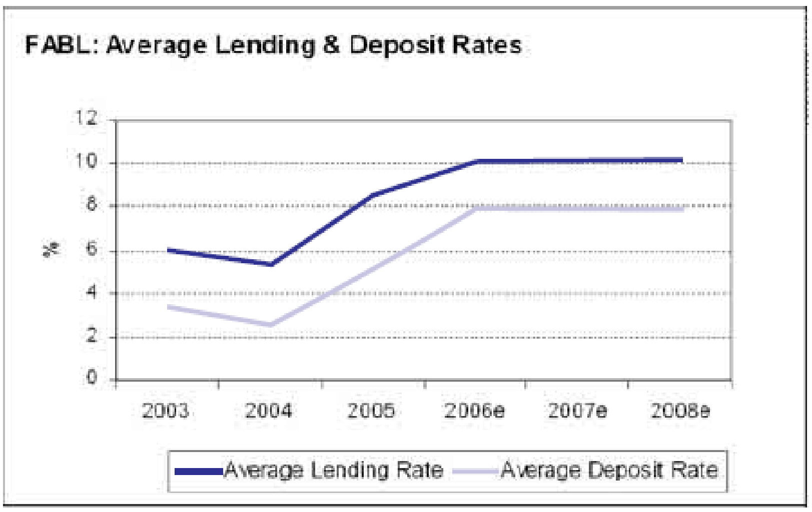
Deposits

NBP had 2.6% of sector's total deposits as of September 2006, the composition of deposits stood as follows:

- 15% Current Deposits
- 39% Saving Deposits
- 44% Fixed Deposits
- 02% Margin Deposits

FABL: Average Lending & Deposit Rates

Funding costs are the highest in our selection



Unlike other banks, FABL has consistently increased its reliance on fixed deposits over the years. The bank does not have a very large network of branches and therefore has resorted to high cost deposits for deposits mobilization. FABL had 75 branches nationwide as of September 2006. The bank's funding costs are on the higher side. The average deposit rate was 5.05% in 2005 and is expected to rise in the future.

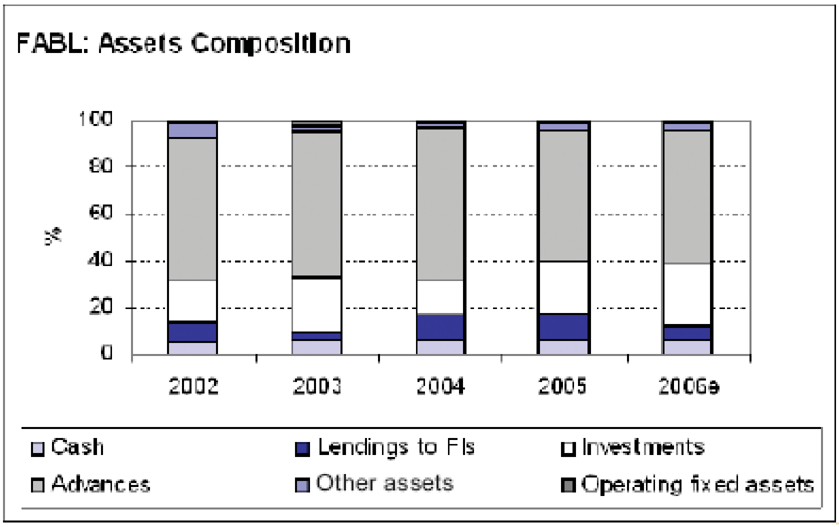
Assets

NBP had 2.9% of total assets share in the sector as of September 2006. The composition of assets stood as follows:

- 06% Cash
- 12% Lending to FIs
- 22% Investments
- 56% Advances
- 02% Other Assets
- 02% Operating Fixed Assets

FABL: Assets Composition

High exposure to advances



Over the year bank has decreased its proportion of advances in total assets and proportion of investment had remained somewhat stable

Business Mix, Strategy and Management

FABL is focused towards corporate and consumer banking. Although FABL does not have an Islamic Banking License or a license to open Islamic Banking Branches, yet it does provide Islamic Financing Products like Morahaba and Ijara. It therefore refers to its loans as financing. Morahaba Financing contributes 74% of total financing provided by the bank where as Ijara forms 17%.

Financial Analysis

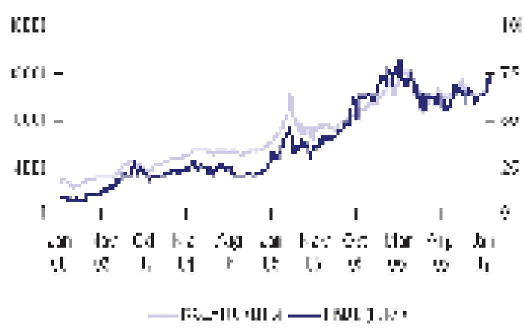
FABL is the exception in the sector in terms of its revenue make up. Its Net Interest Revenue (NIR) forms 59% of its total revenue which is much lower than the average of 70%. It might not be a cause for concern as the rate for NIR growth has been higher than the average. It is the smallest bank under our study in terms of branch network and it does not have the luxury low cost deposits enjoyed by other banks. Consequently, it hosts the highest deposits cost in our selection.

Average deposit rate was 5% in 2005 while the proportion of low cost deposits was 54%. Although we do not view gains on equity investments as sustainable form of revenue source, yet FABL's investment in NIT is of a strategic nature. It is one of the three holders of Letter of Comfort (LOC) from Government of Pakistan.

	Net Income	EPS	Dividend	PE Rating	NAV	Price-to-Book
	PRs mn	PRs	PRs	x	PRs	x
2005	3,070	8.33	3.50	7.7	33.01	1.95
2006e	2,894	6.83	3.50	9.4	32.91	1.96
2007e	3,427	8.09	3.50	8.0	37.32	1.73
2008e	3,948	9.32	3.50	6.9	50.70	1.27

Operating Profit showed a sharp rise of 47% in 2005 on the back of 85% increase in NIR. Due to general slow down in the sector operating profit growth in 2006 was much lower. The Bank's return on equity was 25% in 2005 which was lower than the average for our selection. Return on asset on the other hand has historically been much higher than the average.

FABL: Price Performance



KATS Code	FABL
Bloomberg Code	FABL PA
Reuters Code	FYBL.KA
Current Price (PRs per share)	64.00
Average Daily Volume (mn shares)	3.75
Market Capitalization (PRs mn)	27,330
Paid-up Capital (PRs mn)	4,237
Shares Outstanding (mn)	424
Free Float (%)	30.40
Weightage in KSE-100 (%)	0.99
Average Price (PRs per share)	66.16

FABL has problems of small deposit base, poor coverage ratio and low ROE as compared to its peers. The bank does not show signs of any dramatic increase in returns in the future.

ANALYSIS - Sector-wise lending

Pakistan Banks-Loan Portfolio

%

	2002	2003	2004	2005
Government	12.5	6.7	4.4	5.3
Corporate:				
Agriculture	1.9	2.3	3.4	3.1
Manufacturing	43.7	46.1	48.9	45.4
Construction	0.7	0.9	1.5	1.8
Commerce & Trade	7.3	7.3	8.5	7.8
Communications	1.7	1.7	2.1	3.2
Real estate	0.0	0.0	1.7	2.9
Others	22.6	22.6	15.9	14.4
Personal	9.6	12.3	13.6	16.0

Source: State Bank of Pakistan

Analysis

REFORMS RESULTED IN A SEGMENTED MARKET-READY TO CONSOLIDATE AGAIN

Recent reforms in the banking sector have been aimed at liberalization and increasing competition. The greatest changes in the type of services offered by banks occurred due to the emergence of greater competition in the sector. Although significant changes have occurred, banks still have to seek regulatory approval if they want to expand into new businesses.

The regulatory constraints have the result that the number of services directly provided by banks is relatively limited. Ultimately most banks are engaged in making simple loans and taking deposits with few banks having established presence in other segments of the financial services industry. Banks get around this by having affiliates and subsidiaries that provide specialist services (such as asset management and stock-broking).

The relatively under-developed nature of the sector can be judged by the fact that corporate banking remains the predominant business for banks. Competition has forced banks to diversify and banks have started expansion into other businesses most notably consumer banking.

Poor availability of information regarding the break-up of businesses forces us to consider lending as the principal measure of assessing the importance of a particular type of business in the analysis below.

Corporate Banking

Pakistan Banks-Loan Portfolio

%

	2002	2003	2004	2005
Government	12.5	6.7	4.4	5.3
Corporate:				
Agriculture	1.9	2.3	3.4	3.1
Manufacturing	43.7	46.1	48.9	45.4
Construction	0.7	0.9	1.5	1.8
Commerce & Trade	7.3	7.3	8.5	7.8
Communications	1.7	1.7	2.1	3.2
Real estate	0.0	0.0	1.7	2.9
Others	22.6	22.6	15.9	14.4
Personal	9.6	12.3	13.6	16.0

Source: State Bank of Pakistan

Corporate banking remains the core activity for most banks in Pakistan. The principal sector for most banks remains manufacturing especially textiles. This high exposure may be viewed as an advantage because it suggests that banks are less reliant on the volatile property sector. However, the proportion of loans to textile is still too high.

The share of personal or retail lending is rising which is also a positive factor. Not many banks have carved out niches for themselves in terms of the type of customers they lend to. One exception is BOP which has created a niche in agricultural as well as SME lending. Most other banks typically favor large corporate clients because it provides greater opportunity to cross-sell other services to them and generate fee income and also because it is viewed as safer.

Growth in Corporate Financing

PRs bn

Years	Growth in Corporate Financing
2002	543
2003	606
2004	873
2005	1,076

Source: State Bank of Pakistan

LARGE CORPORATES DOMINATE BANK LOANS

Large corporate lending accounts for 52% of all banks loan portfolio as of 2005. This is mainly concentrated in the manufacturing sector. Favorable upturn in economic conditions has boosted the corporate sector. Textile and automobile sector in particular have undertaken capacity expansion and restructuring programs. These programs have been fueled through internal capital as well as bank borrowing.

However, we do not believe this segment offers an attractive outlook in the medium term due to rising competition. This high dominance has survived thus far mainly because corporate preferred not to access the bond or capital markets for raising capital. The situation is changing as far as the capital market is concerned. PRs48.75bn amount of fresh capital (both IPO's and right shares) was raised through the Karachi Stock Exchange in 2006 alone.

SME lending

SME LENDING IS GAINING SHARE AND PROMISES POTENTIAL

SME sector has received a lot of attention from the government's side lately and the central bank has established a separate set of regulations governing SME financing. Resultantly, its share in the banks total loans portfolio has been increasing. As of 2005, SME lending formed 18% of banks' total loans.

In most banking markets SME lending generates far better returns than other types of corporate lending. This is also true for Pakistan, as BOP and NBP are the banks with high exposure to such lending and both have quite high margins. Other banks have less exposure to this type of lending mostly because it requires a large distribution network and historically this sector has had weaker than average asset quality.

Retail banking

RETAIL BANKING RELATIVELY UNDERDEVELOPED BUT GAINING IMPORTANCE.

Retail lending is gaining importance in the Pakistan market although its share is still quite small. As of 2005, retail (or household as the central bank likes to call it) lending comprised 12% of the banks' total loans portfolio. Most banks in Pakistan want to expand their exposure to this segment and we expect this segment to grow in importance in the future. The continued strong performance of the domestic economy is helping to increase consumer affluence which will significantly increase demand for retail lending. Already rising consumer affluence has attracted key foreign players to expand in the Pakistan market. Examples include Standard Chartered Bank's acquisition of Local Union Bank in 2006 and SAMBA's acquisition of local Crescent Commercial Bank. Rumors about others foreign banks' interest in the sector have also been floating.

AUTO FINANCING THE MOST DEVELOPED PRODUCT IN THIS SEGMENT

This segment is largely dominated by auto and personal loans. This is unlike developed markets where mortgage loans form the largest part in retail lending. This also suggests the largely untapped potential in this segment which is just waiting to be explored. More than half the population of the country does not own a house and there is a shortage of housing units. In 2005 alone the growth in mortgage loans was 103%.

Share in Household Financing

Household Items (%)	2004	2005	Sep-06
Consumer durables	1	1.0	0.4
Mortgage loans	11	13.0	15.8
Credit cards	9	11.0	11.5
Auto loans	33	33.0	32.0
Other personal loans	46	43.0	40.2
Amount outstanding (PRs bn)	153	253	318

Source: State Bank of Pakistan

Generally, it is feared that the rising interest rate scenario and soaring inflation reduces the debt servicing capacity of average consumers. However, we have not seen any significant increase in the default rates for this segment to cause alarm. The overall NPL-to-total loans ratio has been low in all categories except consumer durables.

NPLs and Loans in Household Sector (2005)

	Amount Outstanding (PRs bn)	NPLs (PRs bn)	NPLs-to-loans (%)
Credit cards	27.2	0.2	0.8
Auto loans	82.1	0.7	0.9
Consumer durable	1.7	0.1	7.8
Mortgage loan	34.2	0.2	0.6
Other	108	1.8	1.7
Overall consumer finance	252.8	3.1	1.2

Source: State Bank of Pakistan

DEFAULTS HAVE BEEN LOW-CONSUMER APPETITE FOR DEBT IS STILL HIGH

Concerns looming about debt servicing capacity of consumers must be viewed in tandem with the usage of consumer credit in the economy. In Pakistan's case the household debt-to-GDP ratio at 3.86% is low and this presents great potential for further expansion in this segment.

Household Debt-to-GDP

%

	Household Debt-to-GDP Ratio
2002	0.51
2003	1.36
2004	2.8
2005	3.86

Source: State Bank of Pakistan

We believe that this segment offers very attractive returns in the future. Banks which already have established presence in this segment stand to reap rich rewards. These include UBL, BAFL and to some extent FABL

Mortgage Lending

MORTGAGE FINANCE OFFERS THE GREATEST UNTAPPED POTENTIAL

Mortgage loans present a high likelihood of increase. The demand for housing finance in the country is large and there is a backlog of housing units. The outreach of financial services to the underserved segments of population is yet to increase.

Restrictions on commercial banks to lend for housing and other consumer durables have been minimized. The upper limits on mortgage loans have been raised and foreclosure laws have been revised so that banks can repossess properties without recourse to courts; this has enewed the confidence of banks.

Credit cards

Credit Card Statistics

	No. of Cardholders '000	Outstanding Amount PRs mn
2001	292	-
2002	369	6,102
2003	397	,938
2004	808	14,123
2005	1,257	27,099
2006*	1,512	33,529

* June

Source: State Bank of Pakistan

THE FASTEST GROWING PRODUCT IN THIS SEGMENT IS CREDIT CARDS

In recent years, credit cards have emerged as the fastest growing portion of the consumer segment. Since 2004, the outstanding credit card amounts have almost doubled. The card-per-person ratio of 0.01 suggests a large untapped potential in this segment. The latest entrant in this segment was MCB. The growing demand despite the rising lending rates indicates the growing demand for credit cards.

The availability of information about credit cards is limited. Banks are extremely reluctant to share information such as interest income from cards, merchant fees, rollover rates etc. The central bank too does not provide the desired detail.

◦ Auto loans

THE MOST DEVELOPED PRODUCT IN THE CONSUMER SEGMENT

Auto loans comprise the second largest category of the consumer segment. This segment saw an upsurge in 2005 as demand for transport in the country picked up. The low rates at that time significantly helped create this demand spurt because it made cars suddenly more affordable. Although the growth rate reduced in 2006, auto loans remained the largest contributor in terms of absolute growth. A number of new players have entered this field. FABL, UBL, MCB and BAFL are some of the players in this field. We consider this an attractive segment for future, although it may not be as profitable as the credit card business.

◦ Personal loans

PERSONAL LOANS ARE RELATIVELY UNDER DEVELOPED

Personal loans category has the largest share in the overall consumer segment. This is a result of the absence of a(her customized products, which forces consumers to resort to personal loans. In future, we expect this category to be broken down further into specialized consumer products.

° Consumer durables

CONSUMER DURABLES HAVE SPORTED THE POOREST ASSET QUALITY

Consumer durables have been the poorest performer of this segment, having the highest level of NPLs. According to the central bank these small sized NPLs contained in consumer durable category are emanating from only a small number of banks primarily due to relatively lax credit appraisal and monitoring standards.

Internet Banking

This mode of distribution is not very well received in Pakistan. Most banks have websites but few have proper internet banking operations.

Electronic Banking Statistics

	2001	2002	2003	2004	2005	2006*
No. of ATMs	450	777	1,581	2,475	3,265	3,555
No. of online branches	259	399	552	786	1,217	1,612
No. of card holders (000)	415	736	1,257	1,874	4,257	4,999
No. of transactions (mn)	6	10	15	24	37	29
Transaction value (PRs bn)	22	39	69	120	143	139

* June

Source: State Bank of Pakistan

International Banking

TRADE FINANCE IS THE LARGEST PART OF INTERNATIONAL BANKING

The recent economic reforms and especially free trade agreements with the World Trade Organization (WTO) have resulted in a sharp increase in Pakistan's foreign trade. Though the country remains a net importer, both types of businesses (import/export) have exhibited considerable growth in the past few years. Most banks in our coverage have been trying to expand their branch network internationally yet investors cannot regard these banks as global by any standards. Essentially the banks in our coverage remain players in the domestic market.

A number of banks have international operations with NBP being the clear leader in terms of its international branch network and its prominence in activities such as trade finance and foreign exchange.

MCB has clearly stated its interest in broadening its operations through foreign acquisition. MCB also has the necessary capital position to make such an acquisition and we believe that such an acquisition would be a significant boost to this segment.

Most foreign operations are concentrated in the Middle East Asia because that is where Pakistan's major trading partners lie.

Activities undertaken by these banks are primarily limited to traditional commercial banking businesses such as trade finance, remittance activities and foreign exchange.

BREAKUP OF INTERNATIONAL REVENUES NOT AVAILABLE

Most banks do not provide much detail in terms of their involvement in these activities and therefore, it is difficult to make comparisons across individual banks. Overall we can compare the overseas branch network size.

Overseas Subsidiaries/Branches

	Country
National Bank of Pakistan	USA (2), France (1), Germany (1), Bahrain (1), Turkmenistan (1), Pakistan EPZ (1), Afghanistan (2), Bangladesh (2), Korea (1), Kyrgystan (1), Japan (2), Hong Kong (2), Azerbaijan (1), UK (1)
United Bank Limited	USA(1), Qatar (1), UAE (8), Bahrain (3), Yemen (2), UK (1), Switzerland (1), Oman (2)
MCB Bank Limited	Sri Lanka (3), Bahrain (1), Pakistan EPZ (1)
Bank Alfalah Limited	Bangladesh (3), Afghanistan (1)
Bank of Punjab	None
Faysal Bank Limited	None

Source: Company Reports

Investment Banking

INVESTMENT BANKING IS IN ITS DEVELOPING STAGES

Investment banking activities are generally limited in Pakistan. The focus is generally underwriting of TFC issues and trading of government bonds. Stock-broking activities cannot be undertaken by banks as per regulation. These activities are carried out through subsidiaries and associates.

Some banks also have subsidiary asset management companies. This has special significance for the three banks that have investment in National Investment Trust (NIT) units and are holders of the government's Letter of Comfort (LoC). These three banks are: NBP, BOP and FABL. In the event of NIT's privatization, management rights of the units will pass on to the banks and they will in turn sell the units to their asset management subsidiaries realizing a capital gain. Out of the three banks NBP and FABL have got such associates lsubsidiaries but BOP does not. BOP's management is trying to devise alternative arrangements but so far nothing has been finalized.

LOAN GROWTH

LOAN GROWTH OF ENTIRE SECTOR IS ON THE RISE

Before 2003, Pakistan's banks showed very small loan growth of 2%. However, after the loan growth took off and reached as high as 39% in 2005. in the three years from 2002 to 2005 the cumulative growth in loans has been 29%.

Sectorial Loan Growth

%

	2001	2002	2003	2004	2005
I. Government	(12)	25	(40)	(10)	65
II. Non-Financial Public Sector Enterprises	23	(16)	(10)	24	1
III. Non-Bank Financial Institutions	(31)	639	5	133	55
IV. Private Sector Enterprises	7	(1)	18	39	35
A. Agriculture, Hunting and Forestry	(7)	20	33	101	26
B. Manufacturing	10	1	17	44	29
C. Construction	8	(22)	50	127	73
D. Commercial Trade	(2)	(25)	11	58	28
E. Transport, Storage & Communication	(8)	25	5	73	113
V. Trust Funds & Non-Profit Organizations	(12)	3	57	(11)	1
VI. Personal	7	3	42	50	64
VII. Others	56	1	(21)	0	211
Total Growth	7	2	11	36	39
Average Growth	3	55	14	52	58

Source: State Bank of Pakistan

HIGH EXPOSURE TO TEXTILE LAONS ACROSS THE BOARD

Over a number of sectors have seen dramatic rates of growth, in recent years. Although in the case of Transport & Communication and Construction these are only a small proportion of the total loan book. Lending to manufacturing especially in textiles forms a large part (45%) of the total loan book. Most plants in Pakistan have high exposure to this sector. However, going forward we expect a decline in this exposure since textile sector is already heavily leveraged. This is encouraging for the banking sector in that it reduces concentration of their risk. Other emerging sectors offer potential for growth especially in the telecommunications industry which has formed a large proportion of fresh loans written in recent years.

PERSONAL LENDING INCREASING IN IMPORTNACE

Personal lending is another emerging area which offers huge potential as the consumer market in Pakistan is largely untapped. Most banks are shifting their focus to strengthen their consumer business so that they can continue to increase profits even as the current high margins get squeezed eventually.

Lending to the government had been slowing down until in 2005 when it made a u-turn. We expect that twith the renewal in issuance of Pakistan investment bonds (PIB's) that started towards the year end 2006 the government will have an alternative form of borrowing available and its reliance on bank borrowing will decrease.

LOAN GROWTH EXPECTED TO SLOW DOWN A LITTLE AFTER A PERIOD OF EXTRAORDINARY ECONOMIC GROWTH.

For an alternative indication of the potential loan growth in the future, it is useful to look at the past relationships between nominal GDP or the money supply and the loan growth. This relationship can be highly volatile although it is to be expected that banks reduce their rates of loan growth relative to GDP growth as the economy turns down so the multiples fall sharply (and can in fact go below 1 suggesting a period of de-gearing). In arriving at our figures for loan growth in 2006 and 2007 we have averaged the two loan growths based on the two approaches (i.e. we have assigned a multiple based on nominal GDP growth and money supply growth, and used this to forecast our loan growth and then taken an average of these two figures). The multiples we have assigned are lower than the recent past reflecting the fact that we believe that the recent extraordinary growth in loans cannot be sustained and must come down. This is only an indicative measure since the relationship between loan growth and these economic measures can be highly volatile. The estimates that the banks we are covering provide to us are close to 22%. The evidence to date in 2006 has also been encouraging with market loan growth of 22% in September 2006.

Loan Growth

%

	2002	2003	2004	2005	2006	2007E
National Bank of Pakistan	15	38	21	17	11	13
United Bank Limited	33	49	42	15	15	16
MCB Bank Limited	23	41	31	15	15	12
Bank Alfalah Limited	74	81	34	19	8	13
Bank of Punjab	177	115	6	52	47	40
Faysal Bank Limited	34	75	21	8	8	16
Average	36	57	35	21	17	18
Market	21	41	26	22	N/A	N/A

Source: Company Reports & IGI Research

ANALYSIS OF REVENUES

ANALYSIS OF REVENUES IN BANKING SECTOR

NET INTEREST REVENUES

Net Interest Revenues-to-Total Revenues

%

	2003	2004	2005	2006E	2007E	2008E
National Bank of Pakistan	64	63	71	70	69	64
United Bank Limited	60	62	73	74	71	67
MCB Bank Limited	62	65	73	77	75	72
Bank Alfalah Limited	37	68	69	68	65	62
Bank of Punjab	59	63	72	52	52	51
Faysal Bank Limited	29	47	59	57	57	53
Average	52	61	70	66	65	61

Source: Company Reports & IGI Research

INCREASING RELIANCE ON NIR ALONG WITH HIGH MARGINS

Pakistan's banks have been experiencing increasing trends in terms of their reliance on Net Interest Revenues (NIR). This has occurred in line with the increase in margins. This is also reflective of weak fee generation in this market and the effects of improving asset quality. However, we do not expect this increasing trend to continue to rise to higher levels. The favorable funding costs are already beginning to disappear and the recent tight monetary stance of the central bank will eventually start hitting the banks' margins. Also, increased fee income will decrease reliance on NIR.

MCB HAS SHOWN THE MOST IMPRESSIVE GROWTH IN NIR

Looking at the individual bank's above, the banks with better margins (NBP, UBL AND MCB) generally gave a higher exposure to this type of revenue source helped by relatively lower funding costs and captive deposits. The only exception to the average of our selected banks in FABL. In this case it reflects a high proportion of both trading and fee income in its revenue mix as well as reliance on gains from securities and equity investments to boost its revenues. BAFL has recently caught up with the average but in 2003 it was also an exception.

As detailed below, the recent growth rates in NIR have been impressive although the average figures mask a considerable difference in terms of individual banks. MCB has clearly out performed all others by more than doubling its NIR in 2005. coupled with the facts that the MCB's NIR growth of 105% was on a health base PRs. 7.29 bn in 2004 and that MCB has decreasing NIR for the past couple of years, this is indeed outstanding. This growth was more of a result of better margins than volume or loan growth which increased by only 31% in 2004 for MCB. The rising interest rate scenario in 2005 helped banks with cheap deposit bases to boost their margins. This was particularly true for MCB, NBP and UBL. In 2005, NBP and BAFL showed NIR growth less than the average. The reason in NBP's case was t he already huge base of PRs.14.39 bn in 2004. Given NBS's better than average margin of 4.14% this growth is no a cause of concern. In case of BAFL, the lower than average margin (2.5% in 2005) is responsible for this slow growth. For BAFL, the previous years' impressive growth in NIR was backed by high loan growth (81% in 2004), but in 2005 the loan growth of only 34% occurred which is the second factor responsible for the slow growth in NIR.

Net Interest Revenue Growth

%

	2003	2004	2005	2006E	2007E	2008E
National Bank of Pakistan	2	13	62	32	24	5
United Bank Limited	24	7	85	42	15	16
MCB Bank Limited	(20)	(2)	105	40	14	15
Bank Alfalah Limited	39	59	58	29	21	27
Bank of Punjab	10	56	88	22	61	49
Faysal Bank Limited	5	45	85	8	18	10
Average	10	24	81	29	25	20

Source: Company Reports & IGI Research

The outlook for NIR is driven by two factors, volume of loan growth and the outlook for margins.

MARGINS

FURTHER INCREASE IN MARGINS UNLIKELY

The past few years have seen an increasing trend in margins. Generally our view is that margins will stabilize at these levels and then begin a more gradual decline in the medium term since the funding costs are likely to increase. Furthermore, the remaining players after consolidation may very well drive out the existing favourable margins through price wars. (By margins we mean Net Interest Margin defined as Net Interest Revenue divided by average earning assets).

Pakistan has a history of high interest rates and high inflation and most countries with such records also see high margins. This reflects the fact that the higher are the interest rate environment the easier it is for banks to mould changes in interest rates to serve their margin purposes.

In the future we believe the impetus to consolidate will result in a number of banks with large networks. Secondly the increased importance of local private banks and foreign banks will boost the focus on profitability rather than absolute measures of growth. Also we expect higher margin lending such as consumer loans to form a greater proportion of total lending. Mortgage lending is also likely to form greater proportion of lending portfolio owing to the rising real estate prices.

LARGE DEPOSIT FRANCHISE BANKS ENJOY THE HIGHEST MARGINS

Looking at the individual banks below illustrates that the highest margins are enjoyed by the public sector i.e. NBP and BOP, as well as the largest market shareholders i.e. MCB and UBL. The reason is that these banks have access to cheapest types of funding owing to their branch networks. MCB has the highest margins in 2005 as it increased its NIR by 105%.

Margins %

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	2.81	2.82	4.14	5.00	5.55	5.29
United Bank Limited	3.52	3.10	4.54	5.37	5.42	5.56
MCB Bank Limited	2.93	2.74	5.37	6.42	6.29	6.24
Bank Alfalah Limited	2.44	2.51	2.50	2.48	2.71	3.09
Bank of Punjab	3.23	3.34	3.90	3.17	3.64	3.88
Faysal Bank Limited	2.68	2.59	3.21	2.86	3.12	3.10
Average	2.88	2.85	3.94	4.22	4.45	4.53

Source: Company Reports & IGI Research

We believe high margins in this sector are more a result of favourable funding costs rather than high lending rates. This becomes apparent when we take a look at the banks' spreads. Banks with largest deposit rates on loans enjoy the widest spreads.

FAVOURABLE FUNDING COSTS HAVE RESULTED IN WIE SPREADS

Public sector banks have enjoyed the largest spreads in recent years, but the average deposit rates have begun to rise gradually. Historically, spreads of private domestic banks were lower than both public sector as well as foreign banks. Although the deposit rates offered by foreign banks are higher, they have effectively managed to get higher rates on loans, to result in a wider spread.

Spreads

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	4.59	4.52	6.27	6.83	7.41	6.96
United Bank Limited	5.17	4.60	6.45	7.39	7.38	7.38
MCB Bank Limited	3.78	3.39	6.58	7.77	7.78	7.79
Bank Alfalah Limited	3.00	3.19	4.07	4.31	3.66	3.86
Bank of Punjab	5.79	4.38	5.19	4.13	4.14	4.28
Faysal Bank Limited	2.57	2.76	3.42	2.16	2.14	2.16
Average	4.15	3.81	5.33	5.43	5.42	5.40

Source: Company Reports & IGI Research

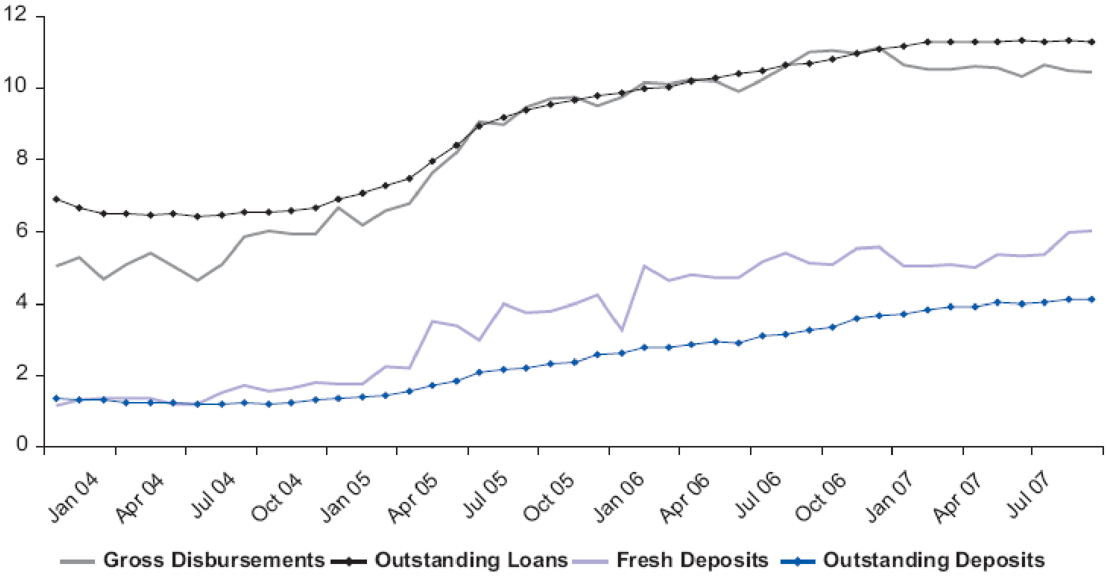
Spreads: Foreign Banks vs. Domestic Banks

%

(June end)	2003	2004	2005	2006
Public sector banks				
Average deposit rate	1.01	1.30	2.45	2.51
Average loan rate	7.42	6.88	8.54	10.91
Spread	6.41	5.58	6.09	8.40
Private domestic banks				
Average deposit rate	1.24	1.22	2.43	2.94
Average loan rate	6.80	6.17	8.01	10.18
Spread	5.56	4.95	5.58	7.24
Foreign banks				
Average deposit rate	0.75	1.63	3.45	3.22
Average loan rate	6.72	6.70	9.57	8.26
Spread	5.97	5.07	6.12	5.04

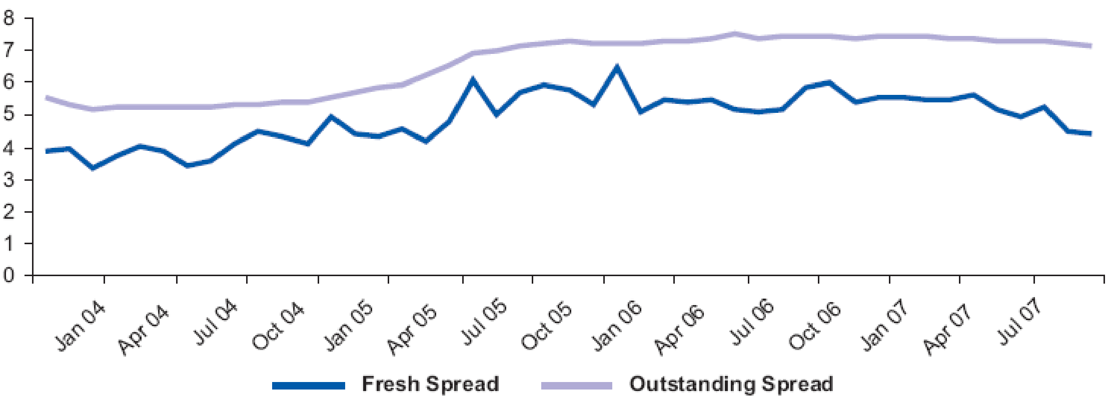
Source: State Bank of Pakistan

Chart 6: Banks Lending & Deposit Rates (%)



Source: FBS & IGI Research

Chart 7: Banks Spreads (%)



Source: FBS & IGI Research

ANALYSIS OF COSTS

Cost-to-Income

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	39	39	34	36	35	34
United Bank Limited	59	58	44	41	40	38
MCB Bank Limited	55	62	32	34	34	33
Bank Alfalah Limited	33	57	59	54	50	45
Bank of Punjab	50	38	27	25	25	26
Faysal Bank Limited	22	33	28	26	27	28
Average	42	48	37	36	35	34

Source: Company Reports & IGI Research

PAKISTAN BANKS SHOW SURPRISING COST EFFICIENCY

When using the cost-to-income ratio Pakistan banks surprisingly appear to be fairly efficient. We would like emphasize that a possible explanation for the decreasing cost-to-income ratios may be that income is increasing at apace much greater the rate of increase in costs. Moreover, the expenses necessary for technology related expenses on their agenda for the coming years. Therefore, we can certainly expect these ratios to increase.

DECLINING COST RATIOS

The ratio has generally been on a decline which is encouraging. Post privatization large banks like UBL and MCB cut back on their expenses and have aggressively sought to improve this ratio. However, our view is that there is certainly scope for further improvement.

BAFL’S COSTS HIGHEST DUE TO BRANCH EXPANSION

Looking at individual banks, we find that BAFL’s ratio has been increasing over the years and in 2005, it sported the highest cost-to-income ratio in our selection. This is because of its aggressive branch expansion from 59 branches in 2003 to 147 in 2005.
As margins get squeezed in this sector, we will see further pressure on these ratios. An alternative measure is to use cost-to-assets ratio, and in this regard, the Pakistan sector generally looks attractive. The average has been declining consistently and in 2005 stands at 1.76%. this reduction may also be attributed to the banks’ asset base expansion. We expect this ratio to further decline as banks continue their asset expansion plans.

BOP MOST EFFICIENT IN TERMS OF COSTS

Looking at individual banks, we see the impressive performance of BOP. Its cost-to-assets ratio stands at 1.15% in 2005 which is the lowest in the industry. It has also shown the most impressive improvement in our selection decreasing from 1.68% in 2004 to 1.15% in 2005.

Cost-to-Assets

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	1.65	1.62	1.94	2.42	2.64	2.68
United Bank Limited	3.19	2.59	2.45	2.77	2.87	3.01
MCB Bank Limited	2.42	2.70	2.16	2.60	2.61	2.66
Bank Alfalah Limited	1.82	1.73	1.74	1.90	2.00	2.15
Bank of Punjab	0.90	1.68	1.15	1.33	1.52	1.68
Faysal Bank Limited	1.75	1.44	1.30	1.28	1.41	1.52
Average	2.17	1.96	1.79	2.05	2.18	2.29

Source: Company Reports & IGI Research

STAFF COSTS FROM THE LARGEST PART OF BANK COSTS

The largest portion of banks' costs is staff cost. The tables below show some detail relating staff numbers to various ratios. The large banks (MCB, NBP and UBL) have been maintaining a tight control on their staff costs with minimal increases in the number of employees in the past couple of years. MCB has in fact reduced its number of employees from 10,164 in 2003 to 9,377 in 2005. The ratios, such as revenue per employees and deposits per employees have generally exhibited a rising trend suggesting a productive workforce. BAFL's performance has not been impressive looking at its revenue per employees which deteriorated in 2004 from 2.53 to 1.40% and did not show any change in 2005. Comparing it to the deposit per employee ratios it seems that BAFL's workforce has been instrumental in mobilizing deposits but not necessarily profitable ones. A more plausible reason may be that it has aggressively increased the size of its workforce by 145% in two years, the benefits of which are yet to be realized. FABL's performance has been the most impressive as it continues to improve its deposits mobilization. However it must be kept in mind that FABL has lower than average reliance on NIR.

Number of Employees

	2003	2004	2005	% change
National Bank of Pakistan	13,272	13,745	13,824	4
United Bank Limited	8,815	9,206	9,354	6
MCB Bank Limited	10,164	9,889	9,377	(8)
Bank Alfalah Limited	2,133	3,352	5,218	145
Bank of Punjab	3,019	3,144	3,430	14
Faysal Bank Limited	722	899	1,068	48

Source: Company Reports & IGI Research

Revenue per Employee

PRs mn

	2003	2004	2005
National Bank of Pakistan	1.50	1.65	2.37
United Bank Limited	1.32	1.29	2.04
MCB Bank Limited	1.18	1.14	2.17
Bank Alfalah Limited	2.53	1.40	1.40
Bank of Punjab	0.67	0.93	1.40
Faysal Bank Limited	5.32	3.86	4.77

Source: Company Reports & IGI Research

Deposits per Employee

PRs mn

	2003	2004	2005
National Bank of Pakistan	29.80	33.87	33.52
United Bank Limited	21.00	25.01	30.92
MCB Bank Limited	20.81	22.24	24.46
Bank Alfalah Limited	35.96	38.70	42.61
Bank of Punjab	11.57	17.41	25.79
Faysal Bank Limited	43.40	62.80	69.98

Source: Company Reports & IGI Research

BRANCHES OF SMALLER BANKS APPEAR MORE PRODUCTIVE:

Alternatively we can focus on branch network as a possible driver of costs going forward. The next tables details the growth in branch networks in recent years and generally highlights the facts that Pakistan's large banks have been restraining branch network expansion while the smaller banks have done just the opposite. UBL and MCB have actually been closing down branches (see tables below) .This has had the effect of very low deposits growth for MCB but UBL has been impressive because its deposits growth outstripped the industry even when it was effectively reducing the number of branches. These figures do mask the fact that UBL not only closed down problem branches but also opened new ones and the net result was a decline.

Overall, the revenue and deposits per branch figures have been on a rise. This shows improved productivity and better selection of branch locations. Even though most banks are trying to bring more and more branches online, the physical location of a branch still plays a vital role to Pakistan. FABL appears to be the best performing player on both these measures although BAFL seems better in terms of deposits per branch but its revenues are lower.

MCB HAS THE LARGEST ATM NETWORK:

If we were assess exactly why FABL has managed to generate more revenue and deposits from its existing branch network we should say that it is because of its aggressive deposits mobilization and automation of branch network. The bank is one of the pioneers in the industry to adopt a core banking solution i.e. SYMBOLS. MCB has only recently followed suit while both UBL and NBP lack this. FABL's deposits growth, however, has come at a higher funding cost which has resulted in its low margins of 3.21% in 2005.
MCB has the largest ATM network in the country (262 ATMs as of September 2006). Inspite of that its revenue per branch has not been impressive, especially at a time when the volume of transactions going through these networks has been rising dramatically. Overall the view is that remote banking (online banking) is still in its infancy and branch distribution will remain the primary means available to banks in the next five years, although online banking is growing in importance and will help banks improve their levels of efficiency in the future.
In the table below we provide our projections regarding cost growth in addition to the recent track record of these banks. The rate of cost growth has varied for large and small banks. The large banks', namely NBP, MCB and UBL, cost growth by been relatively low. This is accompanied by relatively stagnant branch growth by these banks. However, UBL has been different and impressive in that its deposit growth has not been dulled by cost control. BAFL seems to be in trouble when it comes to controlling its cost base.
In the next few years we expect cost growth to accelerate as banks try to expand and particularly pressure from technology spending begins to rise.

OVERALL TAX RATES ARE HIGH BUT SMALLER BANKS HAVE LOWER RATES:

The tax rate imposed by regulation has decreased to 35% from 50% earlier. This is also one of the reasons for rising profitability of banks. However, the effective tax rate differs in accordance with provisions and exemptions. In the next table we have detailed the effective tax rates that these banks have been paying in recent years. The overall tax rate is high and does affect the ROEs from these banks. ROEs have been high inspite of these high rates which is impressive.
Looking at individual banks shows considerable volatility in terms of tax rates with no one bank having a clear trend of tax rates. FABL's is an exception and clearly has been able to produce tax deductible income resulting in consistently low tax rates. In our forecasts we have generally assumed the banks to average a normalized tax level of 30/35%.

ANALYSIS OF EXPOSURE TO ASSETS

ASSET MIX:

Exposure to loans is not too high-pricing seems attractive:
In terms of the bank loan-to-assets ratios these banks are low although their margins are decidedly high suggesting that they are pricing their loans well. The fact that the country's loan-to-GDP ratio is on the lower side, may suggest that Pakistan banks seem to have very attractive pricing is the factor responsible for the high margins. In terms of outlook we expect that loan-to-assets ratios will rise further from current levels reflecting an improved economic environment and increased appetite on the part of banks to lend in a more stable economic outlook.

Loan-to-Assets

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	34	40	47	48	49	50
United Bank Limited	44	53	59	59	60	61
MCB Bank Limited	36	53	60	59	58	56
Bank Alfalah Limited	50	57	48	52	50	51
Bank of Punjab	42	59	57	63	66	66
Faysal Bank Limited	62	65	57	57	57	59
Average	45	55	55	56	57	57

Source: Company Reports & IGI Research

NBP AND BAFL HAVE ROOM FOR FURTHER LEVERAGE:

Looking at the individual banks we find that MCB has the highest loan-to-assets ratio closely followed by UBL. This also helps to explain why this bank has the highest margins in the sector. Generally we do not believe that loan-to-assets ratio of any of the selected banks I high enough to be a cause for alarm. NBP has the lowest loan-to-assets ratio yet it still has high margins which suggest that its strength must be on the funding side in the form of cheap deposits. Both NBP and BAFL have the potential to gear up their balance sheets further ion the years ahead. Concerns should be focused on MCB which already has a high level of loan-to-assets.

MIXED TREND IN EXPOSURE TO LOANS:

The trend of this ratio has been mixed. It has increased for NBP, UBL and MCB i.e. all the banks with huge deposit bases, and has decreased for the other three banks. This reinforces our view that the recent improvement in margins is largely due to favorable funding costs rather than any change in asset mix.

SMALL BANKS HAVE GREATER EXPOSURE TO INTER-BANK MARKET:

Other than loans the table below details the asset breakdown of these banks with the smaller banks having high exposure to the inter-bank market as well as in securities. The higher exposure in securities may be due to the fact that they have lower reserve requirements due to their deposit structure.

Asset Breakdown %

	Loans	Interbank /Cash	Securities	Fixed Assets	Other	Total
National Bank of Pakistan	46.5	20.2	27.2	1.6	4.1	100.0
United Bank Limited	58.7	19.7	17.2	1.5	2.9	100.0
MCB Bank Limited	60.4	11.8	23.3	2.7	1.9	100.0
Bank Alfalah Limited	47.9	24.8	23.1	2.7	1.6	100.0
Bank of Punjab	57.2	23.2	16.2	1.5	1.8	100.0
Faysal Bank Limited	56.5	17.7	22.1	1.6	2.1	100.0
Average	54.5	19.6	21.5	1.9	2.4	100.0

Source: Company Reports & IGI Research

Breakdown of Funding Sources %

	Equity	Deposits	Inter -bank	Long-term	Other	Total
National Bank of Pakistan	12.9	80.2	1.8	0.0	5.1	100.0
United Bank Limited	6.8	82.8	7.5	1.1	1.8	100.0
MCB Bank Limited	7.8	76.8	12.0	0.5	2.9	100.0
Bank Alfalah Limited	3.0	89.5	3.9	1.3	2.3	100.0
Bank of Punjab	12.3	79.6	6.5	0.0	1.5	100.0
Faysal Bank Limited	12.9	67.8	15.0	0.0	4.3	100.0
Average	9.3	79.4	7.8	0.5	3.0	100.0

Source: Company Reports & IGI Research

DEPOSITS ARE THE PRIMARY MEANS OF FINANCE FOLLOWED BY EQUITY AND INTER-BANK FUNDING:

Pakistan banks rely to a great extent on deposit for their funding, as is illustrated above. The pricing on these deposits is a key driver in terms of overall cost of funding for these banks. The levels of capital are also healthy and by no means low. Pakistan banks have very limited amounts of long term funding due to the relatively undeveloped bind market. More recently banks have opted to raise Tier 2 capital through Term Finance Certificates (TFCs) in the market and we can expect the long term funding proportion to rise in the future. This will strengthen the banks' Tier

2/supplementary capital and allow banks to grow without diluting shareholders' earnings.

LOW EQUITY FUNDING MAY PROVE PROBLEMATIC FOR BAFL:

Looking at individual banks shows that capital levels are substantially high for some banks while others, particularly BAFL , drag down the average. MCB and UBL both have increased their equity is essential for BAFL if it is to grow.

INTER-BANK MARKET SERVES A TRANSACTIONARY PURPOSE MORE THAN FUNDING:

Most banks have a low reliance on interbank funding. The inter-bank market is used more for short term transactionary purposes rather than meeting actual funding requirements. The inter-bank market is dominated by large banks like NBP, UBL, MCB and Habib Bank Limited (not in our coverage) as well as foreign banks like Standard Chartered and ABN Amro.

Three banks in our coverage (NBP, MCB and UBL) have Primary Dealer (PD) licenses from the central bank. BAFL used to have a license but it was cancelled by the central bank in 2006. Having a PD license means that the bank must be a market maker in Treasury instruments. Since the debt and fixed income market is still in its developing stage in Pakistan the activities of these PDs are relatively restricted. The non-PDs show even less activity, which is why the inter-bank market is dominated by PD's. Consequently, they have a higher exposure to inter-bank funding. We admit that year end figures can be misleading because they only show a snapshot of the positions taken by the bank at year end. The activity during the year is masked.

FABL is an exception which shows high activity in inter-bank market even though it is not a PD. We believe that FABL has an active treasury department to explain for it and we view this favorably in its valuation.

Deposits-to-Total Liabilities %

	2003	2004	2005
National Bank of Pakistan	89	92	92
United Bank Limited	91	90	89
MCB Bank Limited	81	90	83
Bank Alfalah Limited	81	87	92
Bank of Punjab	91	94	91
Faysal Bank Limited	78	83	78
Average	85	89	88

Source: Company Reports & IGI Research

LARGE BANKS ARE NET LENDERS DUE TO EXCESSIVE AVAILABILITY OF FUNDS:

The table below details the net inter-bank position of the banks in our coverage showing that many of them have positive positions. The reason for UBL and NBP's positive position is party because they are retail banks with sizeable branch networks and so can gather deposits. MCB is one large retail bank with a net negative position. The reason behind is one that we reiterate: MCB's deposit growth has been slow. It must place greater emphasis on deposit growth if they want to keep the asset growth momentum. Alternatively their funding cost will become reliant on volatility in inter-bank interest rates. BAFL's inter-bank position has recovered from a large negative in 2004 to positive in 2005. Same is the case for FABL. Both banks have shown impressive deposit growth to justify it.

Net Interbank Funding

PRs mn

	2003	2004	2005
National Bank of Pakistan	19,167	5,733	11,505
United Bank Limited	20,415	13,187	5,406
MCB Bank Limited	9,801	10,336	(9,934)
Bank Alfalah Limited	(117)	(5,575)	26,850
Bank of Punjab	3,562	(3,436)	5,494
Faysal Bank Limited	(2,285)	(5,590)	6,443

Source: Company Reports & IGI Research

The mix of deposits is critical in terms of overall cost of funding. The cost of funding is driven primarily by the deposits mix and reserve requirements. Both of these are detailed in the next tables. Banks with a high proportion of current and call (demand) enjoy the lowest interest costs, although these also have higher reserve requirements.

RESERVE REQUIREMENTS ENCOURAGE FIXED DEPOSITS

Until 2006, the central bank did not differentiate between demand and time liabilities and the reserve requirements were imposed on total Demand and Time Liabilities (DTL). The current reserve requirements comprise of 2 components: Cash Reserve Requirements (CRR) and Statutory Liquidity Requirement (SLR). CRR is the proportion of DTL that a band must deposit with the central bank on which it earns zero interest. SLR is the proportion of DTL that a bank must invest in treasury instruments on which it earns the prevailing treasury rate.

RISING RESERVE REQUIREMENTS ARE A THREAT TO THE MARGINS

Reserve requirements have been on an increase in recent years and we except that this would eventually hurt the high margins in the sector. This is an anomaly is this sector as globally most regulators are reducing reserve requirements as they are regarded as poor tools for bank regulation.

Reserve Requirements

%

	Current	2000
(weekly average)		
Cash Reserve Requirements		
Total Demand & Liabilities	7 Demand & 3 Time	7
Statutory Liquidity Requirements		
Total Demand & Time Liabilities	18	15

Source: State Bank of Pakistan

Breakdown of Individual & Corporate Deposits

%

	Current	Call	Other	Saving	Fixed	Total
2000	15.7	1.7	4.3	52.8	25.6	100.0
2001	18.0	1.4	3.2	54.0	23.4	100.0
2002	20.0	1.4	2.2	54.2	22.3	100.0
2003	21.5	1.5	2.0	57.8	17.3	100.0
2004	24.9	2.2	1.4	56.3	15.1	100.0
2005	27.0	1.7	1.5	52.0	17.8	100.0

Source: State Bank of Pakistan

LOW COST DEPOSITS ON A RISE FOR THE ENTIRE SECTOR:

As illustrated above, the sector overall has seen increasing proportion of demand deposits (current and call) and a declining proportion of time deposits. Savings deposits showed increase till 2003, but have been declining since. The rising proportion of demand deposits is reflective of the low propensity to save in the country and the desire to keep money in checking accounts. PLS savings accounts are for all practical purposes very close to checking accounts. Therefore, the terminology is deceptive. We believe that this trend is very close to running its course. As competition for deposits rises, banks which do not have large deposit franchises will resort to attracting more savings and fixed deposits which cost more. Going forward this rise in deposit costs will reduce margins in the sector.

LARGE DEPOSIT FRANCHISES HELP TO GAIN LOW COST DEPOSITS:

Looking at individual banks' breakdown of deposits, we fid that the banks with large deposit franchises, namely NBP and MCB, have a large proportion of current and savings deposits. The exception is UBL. NBP and MCB have been able to maintain this high proportion because their deposit growth has been low. UBL on the other hand chose to continue its deposit growth even if that meant going for higher cost deposits.

MCB SPORTS THE STRONGEST FUNDING STRUCTURE:

Overall the strongest funding structure appears to be with MCB and its high margins are reflective of this. However, we believe that MCB has paid the price through very low deposit growth when the overall industry was showing substantial growth. With the exception of NBP and MCB all the banks in our coverage have seen a rising proportion of their deposits in the form of fixed deposits.

Breakdown of Deposits

%

	Current	Call	Other	Saving	Fixed	Total
National Bank of Pakistan	38.6	44.0	17.5	0.0	0.0	100.0
United Bank Limited	28.3	41.8	27.7	0.8	1.4	100.0
MCB Bank Limited	33.2	59.8	5.8	1.1	0.0	100.0
Bank Alfalah Limited	20.6	41.7	36.1	1.6	0.0	100.0
Bank of Punjab	17.9	40.5	40.5	1.1	0.0	100.0
Faysal Bank Limited	14.6	39.3	44.5	1.6	0.0	100.0

Source: Company Reports & IGI Research

Fixed Deposits-to-Total Deposits

%

	2003	2004	2005
National Bank of Pakistan	19	17	17
United Bank Limited	20	19	28
MCB Bank Limited	10	6	6
Bank Alfalah Limited	14	17	36
Bank of Punjab	24	17	40
Faysal Bank Limited	11	16	32

Source: Company Reports & IGI Research

INDIVIDUAL'S SHARE OF DEPOSITS HAS INCREASED AT THE EXPENSE OF CORPORATE DEPOSITS:

Finally in the table below we have detailed the source of deposits in Pakistan. Recent years have seen a decline in the proportion of deposits from corporates. We expect this proportion to stabilize in the future. The recent decline is reflective of the fact that other avenues, such as mutual funds, have developed in the sector that provide an attractive alternative to corporate depositors. The government's recent decision to allow corporations to invest in the government's unfunded debt instruments (National Savings Scheme) will also restrict increase in corporate deposits.

LOANS-TO-DEPOSITS NOT EXCESSIVELY HIGH FURTHER GEARING LIKELY ESPECIALLY FOR NBP AND BAFL:

Focusing below on the loan-to-deposit ratio shows that Pakistan banks have generally increased their loan-to-deposit ratios. These banks still have an appetite to further increase the level of gearing i.e. to raise the proportion of lending on their balance sheet without experiencing pressure on their funding. Equally it suggests that proportion of funding from deposits is also high. We believe that the increasing loan-to deposit ratio suggests that the risk profile of the banks is rising. However, lower levels of NPLs mitigate that fear. Going forward, banks must exercise stricter asset quality standards as we do expect margins to decline.

The situation varies among individual banks. NBP and BAFL have significantly low level of gearing and they can take up more, whereas FABL and MCB have reached high levels. Thus NBP and BAFL are in a strong position to expand their loan books without placing pressure on their deposit bases. This remains their key advantage relative to FABL and MCB. The situation is different for MCB as it suggests constraints on its balance sheet growth in the future unless it can raise deposits. This remains the principal negative factor when focusing on this stock.

Loans-to-Deposits

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	41	48	58	63	65	68
United Bank Limited	52	63	71	75	77	80
MCB Bank Limited	46	62	79	80	80	78
Bank Alfalah Limited	64	69	53	63	65	70
Bank of Punjab	53	72	72	78	82	85
Faysal Bank Limited	94	91	83	85	85	90
Average	58	67	69	74	76	79

Source: Company Reports & IGI Research

Investors should be aware of a significant maturity mismatch on banks balance sheets. These banks have low access to longer term funding to fuel their long term loans. As debt markets develop and long term funding for banks becomes available this mismatch will get reduced.

ANALYSIS OF NON PERFORMING LOANS

Non-performing loans

LEVEL OF NON NPLS ON A DECLINE –IMPROVED ASSET QUALITY

The level of non-performing loans (NPLs) ultimately remains the best measure of assessing assets of quality.NPLs as a percentage of total loans have been decreasing consistently and are very low at current levels. More encouragingly is the fact that the NPLs on an absolute level have actually been decreasing which means that they are either recovered or written off. Judging from the levels of write offs the latter option does not seem very likely .Overall, all these indicators suggests that asset quality is undergoing structural improvement .This improvement in a asset quality has come in line with improving margins in the sector which alleviates the fear of that the improving of asset quality maybe due to weaker price. Generally we are of the view that the increasing competition may drive banks to aggressively price loans and some compromise in asset quality is inevitable. Going forward we do not view NPLs to decline any further and they will keep on growing as the loans grow.

BAFL HOSTS THE LOWEST LEVEL OF NPLS AS WELL AS THE BEST COVERAGE

As is clearly illustrated in the next table, in the recent years there has been a sharp reduction in the level of NPLs as a percentage of total loans, amongst the banks in our coverage. We attribute this fact not only to improved asset quality but also to rapid grow in total loans. large banks have higher NPLs which are not at worrying levels .smaller banks have very marginal levels of NPLs not only because of strict credit control but also because these bank loan books have only seen recently a dramatic rise in and loans need longer to turn sour . The best figures have have consistently come from BAFL, which practices very strict credit control policies and believe in 100% collateralized lending . it also has a generous provisioning policy that create loan loss reserves in excess of specific regulatory requirement.

SLOWER GROWTH IN LOANS EXPECTED IN THE FUTURE

We also believed in recent spurt in bank loans growth has stabilized and we will not see spectacular growth to continue any longer , however the generally improving condition indicates that level of NPLs are not going to deteriorate too much.

LEVELS OF DEFECTION IN CONSUMER SEGMENT HAS BEEN LOW TO DATE

One possible source of concern is the recent popularity of consumer banking products. These products are believed to be the most vulnerable to deterioration..However,to date the incidence of NPLs in this category has been small(more on this in the section on business streams) . Banks have been very careful in assessing the retail borrower's quality and most NPLs in the sector continue to be dominated by the corporate sector.

NPLs-to-Total Loans

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	25	16	13	12	12	12
United Bank Limited	19	14	8	8	8	8
MCB Bank Limited	11	6	5	6	6	6
Bank Alfalah Limited	6	3	1	1	2	2
Bank of Punjab	7	3	2	2	2	2
Faysal Bank Limited	11	5	4	5	5	5
Average	13	8	5	6	6	6

Source: Company Reports & IGI Research

Growth in NPLs

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	(9)	(9)	(7)	12	11	13
United Bank Limited	(34)	6	(15)	12	15	16
MCB Bank Limited	(9)	(20)	(5)	48	15	12
Bank Alfalah Limited	85	3	(64)	33	63	13
Bank of Punjab	(9)	(4)	17	42	47	40
Faysal Bank Limited	(6)	(25)	4	35	8	16
Average	3	(8)	(12)	30	27	18

Source: Company Reports & IGI Research

The low level of NPLs is even more commendable when viewed in tandem with the stricter level of NPL classification introduced by the central bank effective from 2005.A loan is classified as non-performing after being over due for 90 days.

LOAN LOSS PROVISIONING

COVERAGE RATIO HIGH FOR MOST PAKISTAN BANKS

The picture in terms of provisioning levels of NPLs with most banks having coverage ratios(loan loss-reserves-to-NPLs) in excess of 50%.In this regard Pakistan would certainly rank among better –provisioned sectors in the region .Therefore, in the event of a sudden deterioration in the asset quality these banks have a reasonable cushion in the form of provisioning to rely on which will save the equity to erosion .

Loan Loss Reserves-to-Total Loans

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	17	13	11	11	11	11
United Bank Limited	16	11	7	6	6	6
MCB Bank Limited	7	5	4	5	5	5
Bank Alfalah Limited	2	2	1	1	2	2
Bank of Punjab	3	1	1	1	1	1
Faysal Bank Limited	5	3	2	2	2	2
Average	8	6	5	5	5	5

Source: Company Reports & IGI Research

Coverage Ratio: Loan Loss Reserves-to-NPLs

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	70	80	91	90	90	90
United Bank Limited	81	79	85	80	80	80
MCB Bank Limited	62	76	93	90	90	90
Bank Alfalah Limited	41	46	147	120	120	120
Bank of Punjab	40	44	61	60	60	60
Faysal Bank Limited	46	59	42	40	40	40
Average	57	64	86	80	80	80

Source: Company Reports & IGI Research

DISCLOSURE OF COLLATERAL VALUES IS POOR

Generally, coverage ratio is regarded as the most useful measure to assess adequacy of provisions. We believe, as a bench mark , banks should have a courage ratio at least 50% , with a level of 50%-70% being prudent . Investors should relate coverage ratio to the level of collateral that these banks have but level of disclosure for collateral values values is generally poor.

Pakistan banks have generally had a low exposure to unsecured lending .Consequently , their collateral values are high .Even then regulatory directives force the banks to provide the heavily resulting in high coverage ratios .With the improving asset quality in the form of declining NPLs , coverage ratio has also seen improvement .In the future we expect Pakistan to maintain these coverage levels while the ones short of the average will struggle in trying to catch up.

FABL AND BOP HAVE WEAK LEVELS OF COVERAGE

In the next table we have a detailed , as a percentage of equity , the extent of under provisioning of these banks assuming they were forced to reach three different levels of coverage ratio (50%, 70% and 100%).This highlights the weak position of FABL and to some extent BOP , as well as the very strong position of BAPL .In the subsequent table we have also highlighted the coverage making assumptions of the value of collateral backing NPLs .We have assumed that the level of NPLs that are secured is similar to to that of the overall loan book and the value of the security is 60% of the value of the loan . In this regard , all banks even FABL look reasonably well reserved .Ultimately this result is based on a simplistic assumption but in the absence of better disclosure this a reasonable measure.

Shortfall in Provisions-to-Equity (2005)

%

Coverage	50%	75%	100%
National Bank of Pakistan	0.0	0.0	4.2
United Bank Limited	0.0	0.0	10.8
MCB Bank Limited	0.0	0.0	2.5
Bank Alfalah Limited	0.0	0.0	0.0
Bank of Punjab	0.0	1.4	3.9
Faysal Bank Limited	1.4	5.7	10.1

Source: Company Reports & IGI Research

Provisions and Collateral Values (% of 2005 Equity)

%

	Coverage	Value of collateral *	Total
National Bank of Pakistan	91	57	148
United Bank Limited	85	57	142
MCB Bank Limited	93	57	150
Bank Alfalah Limited	147	57	204
Bank of Punjab	61	57	118
Faysal Bank Limited	42	57	99
Average	86	57	143

* Assumptions: Unsecured loans are 5% of total loans & unsecured NPLs are also 5% of total NPLs. Value of collateral is 60% of loan amount

Source: Company Reports & IGI Research

BAFL'S POSITION IS STRONGEST IN TERMS OF COVERAGE

In the next table , we have recorded the recent records in terms of annual provisions, showing that these banks have reduced their level of provisioning in recent years with BOP and FABL actually realizing reversals of earlier provided for loans. Since these banks have been seeing in an improvement in an asset quality their annual provisions are unlikely to be high .

The greater prudence of banks such as BAFL, MCB and NBP is clearly highlighted below. NBP's high levels of NPLs trigger higher than average levels of provisioning .

We believe that it will continue its high provisions at least for a couple more years . BAFL and MCB have a clear advantage because they will be able to reduce provisioning at a faster pace than the rest of the sector, a favorable factors in terms of earning outlook .

Loan Loss Provisions-to-Total Loans %

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	1.05	0.68	0.91	0.53	1.11	1.24
United Bank Limited	0.45	0.31	0.61	1.09	0.83	0.90
MCB Bank Limited	0.73	0.32	0.69	0.29	0.55	0.55
Bank Alfalah Limited	0.18	0.42	0.34	0.48	0.50	0.50
Bank of Punjab	0.04	0.12	(0.01)	0.43	0.43	0.43
Faysal Bank Limited	0.71	0.10	(0.03)	0.49	0.49	0.49
Average	0.53	0.32	0.42	0.55	0.65	0.69

Source: Company Reports & IGI Research

LOAN LOSS PROVISIONS TO- TOTAL- LOANS

The level of disclosure in terms of movements in loan loss reserves is of reasonable detail to provide an indication of the level of write offs and recoveries .In any assessment of asset quality it is critical to look at the banks policy towards write offs since a low level of NPL ratio may simply be a result of an aggressive write off policy although this usually goes hand in hand with a low level of loan less reserves as these are used up to make the necessary write offs. The most favorable combination is a low level of NPLs and high level of loan loss reserves. And only MCB offers this to some extent.

Generally, banks do not write off loans easily. Consequently the level of write offs have remained fairly low historically.

Write-offs-to-Total Loans

%

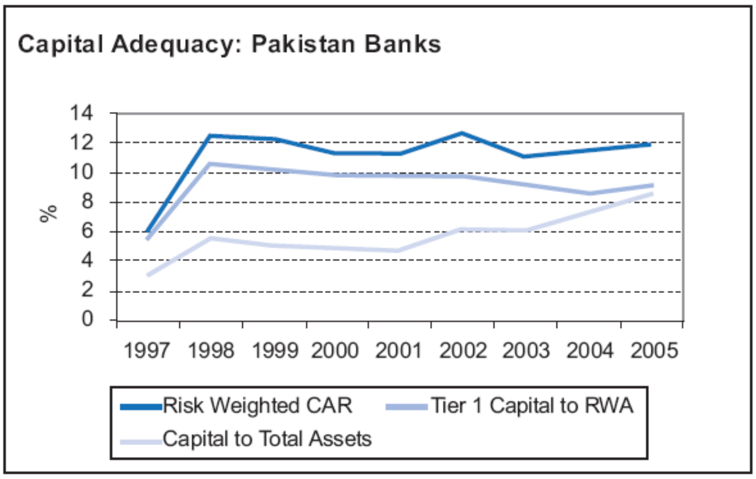
	2003	2004	2005
National Bank of Pakistan	0.18	0.36	0.34
United Bank Limited	0.70	0.36	1.30
MCB Bank Limited	0.33	0.44	0.07
Bank Alfalah Limited	0.10	0.19	0.21
Bank of Punjab	0.06	0.04	0.03
Faysal Bank Limited	0.06	0.25	0.00
Average	0.24	0.27	0.32

Source: Company Reports & IGI Research

ANALYSIS OF CAPITAL ADEQUACY

Capital Adequacy: Pakistan Banks

Capital ratios are on a rise



Source: State Bank of Pakistan

Total Capital Ratio

%

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	11.7	12.8	14.8	17.5	20.0	24.8
United Bank Limited	N/A	N/A	9.3	16.8	19.3	22.0
MCB Bank Limited	11.6	9.7	12.8	20.9	22.8	20.4
Bank Alfalah Limited	8.5	8.2	8.7	10.0	12.0	15.1
Bank of Punjab	15.5	12.8	11.5	10.5	12.1	13.7
Faysal Bank Limited	15.6	12.2	14.6	12.7	14.7	19.2
Average	12.6	11.1	12.5	14.3	16.3	18.7

Source: Company Reports & IGI Research

CAPITAL RATIOS ARE GENERALLY HIGH

Generally capital to ratios are higher in Asian markets than most European markets .Capital ratios of Pakistan banks have generally been on a rise mostly due to regulatory pressures . Fund requirements have been on a rise on account of the rapid loan growth in recent years . These banks do not generate enough internal capital to fund their growth and consequently capital raising exercise have been common in 2005 as well as 2006 . The central bank requires banks to meet the minimum capital requirement (MCR) of PRs6bn by the year 2009 . this means that more capitalizing activities will occur till then . Banks, which already meet this requirement include NBP , MCB and UBL . MCR of PRs6bn has to be achieved in a phased manner .MCR of PRs3bn has to be achieved by December 2006. The requirement increases by PRs1bn in each subsequent year till 2009 .

MCB AND NBP HAVE SHOWN THE HIGHEST RATIOS HISTORICALLY

Looking at the individual banks show that MCB and FABL have been the most impressive in terms of their overall capital ratios. However, FABL still has to raise additional capital to meet the MCR (more on this on FABL valuation). MCB on the other hand has excess capital (more on this in MCB valuation)

It is interesting to know while the CAR has steadily been on the rise , the capital to-total assets ratio has been rising at a faster pace and the gap between them two is decreasing . This suggests that a greater proportion of total assets fall under the risk – weighted category on the outset it may appear that the banks are taking more risk however, that this is also explained by the stricter risk weighting criteria imposed by the central bank.

STRICTER RISK WEIGHTING EXPECTED IN THE FUTURE DUE TO BASE1 IMPLEMENTATION

Earlier assets were only assigned credit risk weighting but with the faced transition towards the base 1 2 risk management frame work banks are required to take into account marking and operational risks in addition to credit risks . Going forward we expect that the ratio of risk weighted assets to-total assets will increase and the gap between CAR and the capital-to -assets ratio will further decrease.

VARIABLE CAR TO BE MAINTAINED FROM 2006 ONWARD

In terms of regulatory minimum capital requirements, Pakistan until 2005 followed the bank for international settlement (BIS) standard of an 8% minimum capital ratio . As of 2006 the requirement has changed to a variable capital ratio (8-14%) depending on the rating of the central bank's rating for that bank . The rating mechanism is called the IRAF.

It is fair to say that Pakistan banks capital is primarily made up of Tier 1 capital .Recently banks have been allowed to raise Tier 2 capital in the form of subordinated loans and this will no doubt increase Tier 2 capital ratios. However, the limit to Tier 2 capital is 50% of Tier 1 capital .

UBL is one bank that is determined to fund its growth through Tier 2 capital Through management and discussion we have learnt that they intend to fully utilize 50% of Tier 1 capital limit on Tier 2 capital .

Since there is limited disclosure on Tier 1 capital ratios we have used equity to- assets ratio below proxy .the domination of of Tier 1 capital in total capital is clearly a positive factor since we should perceive the quality of Tier 1 capital as higher than capital Tier 2 .This also suggests that these banks have room to issue Tier 2 capital in the years ahead and so the potential dilution to shareholders going forward from capital requirements may be low .

BAFL'S CAPITAL RATIO RAISES CONCERNS

Looking at individual banks , we find that historically NBP , BOP and FABL had the healthiest capital ratios and MCB Joined them in 2006 .Ultimately our greatest concerns are focused on BAFL in terms of capital but this concern is mitigated as it also has the greatest levels for provisioning for NPLs .Generally we believe that investors should expect a series of Tier 2 capital raising activities going forward , with UBLs management particularly showing interest in this route .

Equity-to-Assets %

	2003	2004	2005	2006	2007E	2008E
National Bank of Pakistan	6	8	13	14	16	17
United Bank Limited	7	7	7	7	9	10
MCB Bank Limited	4	6	8	10	13	14
Bank Alfalah Limited	4	3	3	4	4	5
Bank of Punjab	0	12	12	12	11	11
Faysal Bank Limited	16	13	13	13	15	19
Average	6.0	8.3	9.8	10.4	11.7	13.3

Source: Company Reports & IGI Research

FABL AND BOP UNDER-PROVISIONED AND REQUIRE ADJUSTMENT TO CAPITAL

Banks with the largest Tier 2 capital bases have high level of revaluation reserves . It is fair to say that investors should make some assessment of the potential gains that banks could make were they to sell both those assets which have already been revalued and also those assets which are yet not revalued and so are essentially 'hidden reserves' .Hidden reserves are primarily in the form of property / real estate and long term investments , banks are not willing to provide disclosure for these . The figures should be treated as a buffer to their equity bases in the context that the banks were to experience severe problems.

Our analysis suggests that even though under – provisioning is a source of concern for FABL and BOP , in terms of capital (since any serious losses in terms of problem loans would have to be borne by capital), in reality most of these losses will be borne by collateral.

Adjusted Capital Positions

%

	Under Provisioning	as a % of 2005 Equity
Coverage	**50%**	**75%**
National Bank of Pakistan	0.00	0.00
United Bank Limited	0.00	0.00
MCB Bank Limited	0.00	0.00
Bank Alfalah Limited	0.00	0.00
Bank of Punjab	0.00	1.39
Faysal Bank Limited	1.35	5.71

Source: Company Reports & IGI Research

ANALYSIS OF PROFITABILITY

Operating Profit Growth

%

	2003	2004	2005	2006E	2007E	2008E
National Bank of Pakistan	43	14	56	30	29	14
United Bank Limited	45	6	107	47	23	27
MCB Bank Limited	24	(20)	225	29	18	21
Bank Alfalah Limited	278	(44)	47	47	37	46
Bank of Punjab	108	80	93	71	61	52
Faysal Bank Limited	143	(22)	57	14	18	15
Average	107	2	98	40	31	29

Source: Company Reports & IGI Research

OPERATING PROFIT GROWTH SUPERB IN 2005 SLOW DOWN IN 2006

We believe operating profit growth i.e. before loan loss provisions (LLP) Is a far better measure for growth than other alternatives based on a balance sheet number .Operating profit growth has been spectacular in the past few years albeit a brief down turn in 2004 .In 2006 , operating profit growth is expected to be lower than the growth in 2005 . This is justified by the high GDP growth and somewhat developing state of the sector .The previous high growth is mainly attributed to strong margins and high loan growth.

BOP SHOWS CONSISTENT GROWTH IN PROFITS

BOP is one bank that has seen a consistent operating profit growth even when other banks were experiencing a downturn in 2004. The reason it has been a spectacular loan growth (61%,in 2005, highest selection) . Its loan growth going forward is expected to slow down to a more stable level. NBP too has been able to show a positive growth for 3 years (2003-2005).MCB and UBL showed impressive growth in 2005 on their cheap deposit bases.

Return on Equity

%

	2003	2004	2005	2006E	2007E	2008E
National Bank of Pakistan	16	18	22	21	20	19
United Bank Limited	20	22	28	32	31	30
MCB Bank Limited	20	20	47	36	28	28
Bank Alfalah Limited	43	23	27	24	26	29
Bank of Punjab	16	21	22	26	33	35
Faysal Bank Limited	34	20	25	19	22	20
Average	25	20	28	26	27	27

Source: Company Reports & IGI Research

ROE MEASURE FOR THE SECTOR IS ON THE RISE

Profitability measures have also been attractive to Pakistan banks in addition to underlying growth. Return on equity (ROE) has been on a rise at a very healthy level of 29% .this is even more impressive when viewed with the levels of rising levels of capitals in the banking system .strong margins in the industry are the primary reason behind the rising profitability .

The highest ROE in the sector came from MCB in 2005. This is even more commendable when we take into an account the higher than the average levels of capital of the bank. The other bank are more or less converging while there was a considerate difference in ROE's in 2003. We expect a gradual rise in equity- to assets of most banks and consequently a slight depression in ROE's but by no means to low levels UBL and BAFL have also provided consistently good returns in the past 3 years. UBL's rising ROE is also attributed to its high margins and growing trading income .

ROA'S HIGH IN SPITE OF HIGH ASSET GROWTH

An alternative measure is to use Return on assets (ROA) and again Pakistan banks have shown consistently high ROA over the past few years .Compared with the fact that asset growth had also been accelerated in this period, the ROA is indeed impressive. With the industry asset growth stabilizing in the future we expect even further improvement in this measure.

MCB SHOWS THE MOST IMPRESSIVE RETURNS

Looking at individual banks we can see that MCB has shown the highest ROA in 2005 while it figured below average in the past few years, the reason being its enormous profit growth in the year 2005. Profit After Tax (PAT) increased by 3.5 times in 2005 from PRs2.5bn to PRs8.9bn.FABL on the other hand has shown consistent above average returns on the back of its relatively smaller asset base. This shows that it has one of the highest yielding assets in the sector and attractive pricing mechanism.

BAFL'S RETURNS LOWEST IN OUR SELECTION

BOP too has seen consistently high returns. BAFL's low ROA when compared with its rapidly expanding book size suggests that it has preferred to show volume growth rather than higher yielding assets.

Return on Assets

%

	2003	2004	2005	2006E	2007E	2008E
National Bank of Pakistan	0.93	1.22	2.25	2.87	3.14	3.22
United Bank Limited	1.35	1.51	1.93	2.33	2.65	2.95
MCB Bank Limited	0.88	0.96	3.20	3.73	3.65	3.81
Bank Alfalah Limited	2.59	0.86	0.84	0.87	1.13	1.55
Bank of Punjab	1.88	2.49	2.65	3.05	3.60	3.96
Faysal Bank Limited	5.11	2.78	3.25	2.41	2.67	2.80
Average	2.12	1.64	2.35	2.54	2.81	3.05

Source: Company Reports & IGI Research

MERGERS AND ACQUISITIONS

Mergers and Acquisitions
Mergers and acquisitions (M&A) in the banking sector have implications for four stakeholders, namely:

- Regulator
- Customer
- Sponsors
- Minority Shareholder

In the compliance with the Basel II framework, SBP has raised the Minimum Capital Requirement (MCR) for commercial banks to Rs6bn to be achieved in a phased manner till December 2009. MCR of Rs2bn had to be achieved by December 2005. Subsequently, MCR rises by RS1bn each year.

Out of all scheduled banks, only 22 are listed on the local bourses. Among the listed commercial banks, 8 banks donot meet the Rs3bn MCR as of December 2006. These are:

Potential Acquisition Targets^

PRs mn

	Paid-up Capital
Askari Commercial Bank	2,004
Bank Al Habib	2,629
Bank of Khyber	2,002
Bank of Punjab	2,902
Crescent Commercial Bank	2,770
KASB Bank	2,293
PICIC Commercial Bank	2,735
Prime Commercial Bank	2,739

Source: State Bank of Pakistan

These banks are the likely candidates to be acquired by another bank. Out of these 8 banks, 2 have already been acquired and 1 is already in the process of being possibly acquired:

- Samba Financial Group has acquired Crescent Commercial Bank.
- ABN Amro Bank has acquired Prime Commercial Bank.
- Tamasek Group of Singapore is conducting due intelligence process for possible acquisition of PICIC Commercial Bank.

That leaves 5 banks that are still available. Out of these Bank of Khyber and Bank of Punjab (BOP in our coverage) are public sector banks. We believe that it is unlikely that a potential acquirer would be interested in these banks mainly due to the

predominantly rural distribution network and a state run culture that is difficult to change.
Now we are left with only 3 banks. Askari Commercial Bank has primary shareholding of the armed forces of Pakistan and we have doubts about their willingness to put their bank up for sale. As a result we narrow our list down to 2 candidates: Bank Al Habib and KASB Bank. As these banks do not have large reserves to raise internal capital from, we expect them to issue right shares or look for a potential acquirer.

Table 2: Mergers & Acquisitions (PRsbn)

Date	Acquirer	Target	shares (%)	Price-to-Book	PRs/ Shares	Cash Consideration
Sep-06	Standard Chartered	Union Bank	95.3	5.4	91	29
Mar-07	SAMBA Group	Crescent Bank	68.5	-	-	6.0
May-07	ABN Amro	PCBL	93.4	4	54	13.8
Jul-07	NIB	PICIC	63.4	5.3	78	20.5

Source: Company Reports & IGI Research

EMERGENCE OF ISLAMIC BANKING

Potential markets for domestic and foreign banks

ISLAMIC BANKING:

Islamic banking is gaining popularity in the country. Many efforts are being made to make it workable in the era of conventional banking. The SBP has initiated a process of converting the commercial banking system into Islamic banking. Government of Pakistan has initiated a parallel banking strategy of promoting Islamic banking alongside conventional banking. There is huge scope for Islamic and modaraba banking system in the country. MCB, Faysal bank, Al Meezan banks and ABAMCO ltd. ABN AMRO, Standard Chartered Bank, and Dubai Islamic Bank are already in the Islamic banking field. Pak-Kuwait Investment Company limited, which is one of the countries premier joint venture financial institutions, is launching the first ever Islamic insurance company in Pakistan. There is huge market of Islamic banking i.e. $2.5-3 Billion In the country. The government in the near future will ensure a level playing field, and shape Islamic banking into an attractive endeavor. In order to infuse the market with trust and confidence, the SBP has been proactive, focused and determined in its approach towards Islamic banking. In the current scenario, they instituted an Islamic banking division in SBP.

The islamization of banking is a gradual process and requires time to grow. It is predicted that Islamic banks will be more successful in rural areas. The country's first full fledged Islamic bank, which is Meezan bank, is still a young venture, and a premier one.

CONCLUSION & RECOMMENDATIONS

ISSUES CONCERNING PAKISTAN'S BANKING SECTOR

PAKISTAN IS AN UNDERBANKED SECTOR

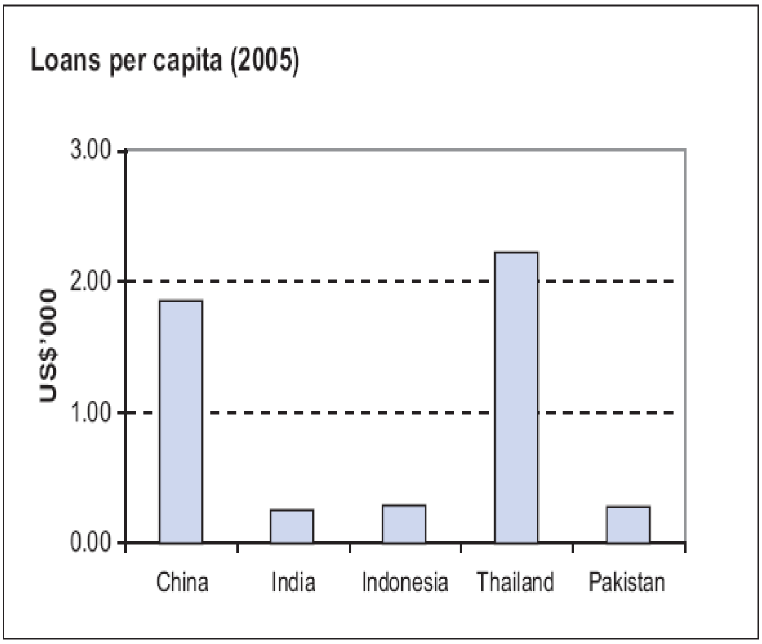
The analysis provides an indication that with loans at such low proportion of GDP there is an immense potential for growth in bank advances. Moreover, consumer banking is also growing in importance as banks fear losing their favourable margins.

CONCENTRATION OF CREDIT IN CORPORATE SECTOR DUE TO UNDERDEVELOPED BOND MARKET

Having a low loan to GDP ratio masks the fact that most of the banks are concentrated in the corporate sector. This gives rise to the issue of a high level of gearing on the balance sheets of corporate and whether banks are taking too much risk. However, we believe that this view is too simplistic. After all some of the best quality banking sectors (Hong Kong and Singapore) are in the economy with the highest loan to GDP. Furthermore, we believe that high usage of credit in the absence of well developed bond markets is the reason for concentration of corporate loans. As bond markets develop and replace credit with bond issuance (as happened in the US) such fears will subside. In an emerging market loan to GDP ratio is justified by the fact that the level off development in the economy does not suggest a high credit use (low loans per capita). Equally, we also believe that any dramatic changes in this ratio should be a source of concern suggesting a rapid acceleration in the level of gearing. In Pakistan's case the ratio has been increasing steadily at a Compound Annual Growth Rate (CAGR) OF 23%. Moreover, looking at the bank's balance sheets we may find that most banks have been actively been trying to spread out their exposure in different types of sectors.

Loans Per Capita

Low loans per capita suggest low usage of credit and potential for growth



Source: Bloomberg

IMPACT OF PAKISTAN ECONOMIC ENVIRONMENT ON BANKING SECTOR

Economic Data

	2002	2003	2004	2005	2006	2007e
GDP growth (%)	3.2	4.9	7.4	8	6.6	7.0
Consumer prices (%)	3.5	3.1	4.6	9.3	7.9	6.5
Private comsumption (%)	1.6	0.5	11.5	13.1	8.1	6.1
Trade balance (PRs bn)	(73.7)	(62.1)	(188.8)	(369.6)	(515.4)	(838.3)
3 month T-bill rates (%)	5.68	1.87	2.37	6.88	8.51	N/A

Source: State Bank of Pakistan & IGI Research

One of the principal attractions of investing in this sector is the fact that it is based in an attractive economy in addition to the inherent lucrativeness of the banking business in itself. This is illustrated with the attractions of the economy highlighted above. These include steady and reasonable GDP growth and growing private consumption.

The outlook of the economy shows continued GDP growth coupled with further reduction in inflationary pressures which had reached worrying levels in 2005. The principal concern is the widening trade deficit which is expected to worsen in the coming years owing to rising imports. We believe that this issue coupled with the changing geoplolitical scenario remains the two principal risks to the performance of the country.

Real GDP Growth

	2002	2003	2004	2005	2006
World	3.1	4.1	5.3	4.9	5.1
United States	1.6	2.5	3.9	3.2	3.4
Euro Area	0.9	0.8	2.1	1.3	2.4
Japan	0.1	1.8	2.3	2.6	2.7
China	9.1	10.0	10.1	10.2	10.0
India	4.3	7.2	8.0	8.5	8.3
Indonesia	4.5	4.8	5.1	5.6	5.2
Thailand	5.3	7.0	6.2	4.5	4.5
Pakistan	3.2	4.9	7.4	8.0	6.6

Source: State Bank of Pakistan

The GDP growth in 2006 is even more remarkable given the fact that a major earthquake hit northern Pakistan in October 2005. The Pakistan economy has shown remarkable resilience inspite of the earthquake's impact.

IMPROVED ASSET QUALITY STRENGTHENS BANK RISK PROFILE.

Bank's asset quality is affected by the state of the economy. The quality of banking assets has continued to show improvement in the past few years. Meanwhile, the regulator SBP has continued to raise provisioning requirements which will further insure against potential loan losses in the future.

HIGH LEVELS OF INFLATION- A MAJOR CONCERN

A cause for concern is the prevailing high level of inflation in the economy. Inflation levels have been higher than most of the other countries of the region, the only exception being Indonesia. The Central Bank SBP has continually followed a tight monetary policy and the effects are only just starting to materialize. Banks have benefited from this situation immensely as the resultant rising interest rate environment has allowed them to enjoy highly favourable margins. However, too much tightening pressure can also stifle economic growth.

Consumer Prices

%

	2002	2003	2004	2005	2006	Average
World	3.4	3.6	3.7	3.7	3.8	3.64
United States	1.6	2.3	2.7	3.4	3.6	2.72
Euro Area	2.2	2.1	2.1	2.2	2.3	2.18
Japan	(0.9)	(0.3)	0	(0.6)	0.3	(0.3)
China	(0.8)	1.2	3.9	1.8	1.5	1.52
India	4.5	3.7	3.9	4	5.6	4.34
Indonesia	11.8	6.8	6.1	10.5	13	9.64
Thailand	0.6	1.8	2.8	4.5	4.9	2.92
Pakistan	2.5	3.1	4.6	9.3	7.9	5.48

Source: State Bank of Pakistan

RISING INTEREST RATE ENVIRONMENT HAS LEAD TO FAVOURABLE MARGINS

The recent interest rate environment has become stablilized but has remained on the higher side. The banks have reaped rich benefits as most of the banks with large deposit base (NBP, UBL AND MCB) have highly favourable funding costs in the form of cheap benefits. This has allowed the banks to enjoy highly favourable margins. The central bank is now geared towards improving the deposit rates offered by banks. However, we believe this is highly unlikely. Our forecast show an erosion of the more favourable margins seen in the recent years since we do not view the current low funding costs as sustainable in the medium term.

In out analysis of banking sector's key financial indicators, we have conducted a comparison of key performance indicators of banks in our coverage.

Profitability of the banks remains strong.

Sector margins have soared over the years with large Tier-I public sector banks posting margins well over 5% in 2006. Moreover, banks have depicted increased reliance on Net Interest Revenue (NIR) and NIR posted double digit growth in 2006. Looking at individual banks, HBL (5.5%) and MCB (6.6%) posted the highest margins in 2006. The high margins in the sector are a result of large spreads (difference between average lending and average deposit rates) of around 7% in recent years. Going forward our view is that margins will eventually squeeze with rising cost of funding, however, remaining intact in the near term. Furthermore, the lending rates are expected to remain high in-line with the tight monetary stance by the central bank. In a regional comparison, we conclude that margins of around 5% for large Tier I banks are supernormal, compared to large Indian banks with margins in the range of 3%.

Declining trend in Loans-to-Assets Ratio.

The year to date analysis of CY07 reveals that unprecedented growth in assets continued at an increasing rate, fueled with surging growth in deposits (15% in 1HCY07). Recently, the asset mix of the banking system has changed with significant increase in investments share of total assets. Previously, advances have contributed the most prominent share in the revenues of banks; however, investments formed the major share in later part of CY07. Going forward, based on the low credit penetration in the country we expect loans-to-assets ratio to bounce back.

Pakistan banks show surprising cost efficiency.

The cost-to-income ratio has posted a declining trend over the years. The growth in operating costs has lagged the growth in revenues, which have compounded at an increasing rate, thus causing the cost-to-income ratio to decline. Looking at individual banks, larger banks like UBL and MCB have cut back on their expenses and aggressively sought to increase cost efficiency. Whereas, the ratio has increased for BAFL because of aggressive branch expansion. Going forward, as margins get squeezed we see further pressure on the cost ratios lo rise. In a regional comparison, Pakistan banks have lower cost-to-income ratio primarily due to higher margins and not as a result of operating efficiency.

Level of NPLs on a decline-improved asset quality.

The level of Non-Performing Loans (NPLs) has posted a declining trend over the years implying improving asset quality. NPLs-to-Advances ratio has been decreasing over time, however, along with improved asset quality this decline is also attributed to the base effect of phenomenal growth in advances. The recent withdrawal of Forced Sale Value (FSV) benefit against NPLs for calculating provisioning requirement is expected to have a negative impact on the earnings of the banks. Profitability for CY07 will be affected the most due to covering up of provisions short fall for prior years. In our opinion HBL will experience the most adverse impact of over PRs6 per share. However, this regulation would eventually benefit the banks in the future in form of expediting recoveries, and exercise more prudence in extending credit and risk management.

Capital ratios are generally high.

Capital Adequacy Ratios (CAR) of Pakistan banks have been on the rise in the wake of regulatory pressures. The central bank has pursued a strategy of strengthening the capital base in order to instill stability into the banking system. The central bank has set a moving target of the Minimum Capital Requirement (MCR) of PRs6bn by the year 2009. MCR of PRs3bn had to be achieved by December 2006. The requirement increases by PRs1 bn in each subsequent year till 2009. In the current setting, larger banks are generally over capitalized while some smaller banks are short of the MCR.

Robust growth but high valuations

In the backdrop of strong underlying economic environment, the assets of the banking system have witnessed exceptional growth. Going forward, we expect the banking sector to post robust g rowth.

The strong fundamentals and earning power has already been discounted by the market, especially for large banks. Based on this, we maintain a 'Market Weight' stance on the banking sector.

High margins likely to decline

In wake of the tight monetary stance by the central bank and current rising interest rate scenario we foresee that the margins are going to eventually squeeze, however being intact in the near term. Banks would need to find other avenues like strong fee generation for sustained profitability in the future.

State Bank tightens NPL provisioning

In the near terra the after-tax profitability of roost banks will decline significantly due to withdrawal of collateral's forced sale value benefit in determining NPL provisioning. The negative charge will vary from bank to bank depending upon the size of uncovered NPLs. Based on our analysis HBL will have the most significant impact on 2007E earnings per share.

MGR – A moving target driving consolidation

The banking industry has recently witnessed increasing trend of mergers and acquisitions in response to SBP's increased Minimum Capital Requirement (MCR). Although, major consolidation in the industry has already taken place, however, we may see some activity with regard to smaller banks in the future due to MCR shortfall.

Changing Credit Mix – Mortgages on the rise

In 1HCY07 consumer finance has experienced a slowdown after tremendous growth in past few years. A detailed analysis reveals slowdown in auto loans and a shift towards residential mortgage lending. The share of mortgage lending increased by 1.24% (18% growth), as compared to last year.

Recommendation

Within the region, Pakistan bank valuations are on the higher side. The banking sector has an average Price-to-Book (PIB) multiple of 2.97x. Based on our analysis using Normalized Required Return analysis with 2008E adjusted equity we rake the following recommendation.