

PRIMER

Commercial Banks



Pakistan

BACKGROUND

Credit rating is rapidly gaining acceptance as an integral part of the endeavor for increased transparency. In the last one year alone, JCR-VIS Credit Rating Company Ltd. has rated many of Pakistan's premier financial institutions, as well as majority of the leading banks in the country.

However, we at JCR-VIS believe, that the understanding of the credit rating concept and the process is yet at an incipient stage, and that the questions in an investor's mind need to be addressed. This primer aims to elaborate particular characteristics of the Pakistani economy and their unique effect on the risk profile of institutions, as reflected in the assigned ratings. Herein, we have comprehensively described the rating methodology used for commercial banks. This is the first in a series of publications, each of which would separately pertain to other sectors.

We believe that these will render improved comprehension and appreciation of credit rating as a credible, independent opinion, of an organization's ability to meet its financial obligations in a timely manner.

A relatively new development towards improved financial discipline in the Pakistani banking sector, credit rating contributes to increased transparency, allowing an individual/institutional investor to assess risk as associated with possible investment avenues. As a third party's estimation of an entity's repayment ability, ratings serve to benchmark institutions with regard to their respective risk profiles. A circular issued by the State Bank of Pakistan (SBP) in June 2000 made credit rating mandatory for commercial banks. All listed banks were to publicly announce their respective ratings by June 30, 2001 and all non-listed banks had another one year before compulsory public disclosure.

Some financial institutions in Pakistan like the 'Big five' of the banking sector have also been rated by international rating agencies. These were *foreign currency ratings* that express the ability of an entity to meet its international obligations in the currency of another country, say the US dollar, and were therefore capped by the sovereign ceiling. International rating agencies also assign *local cur-*

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INTRODUCTION

currency ratings on an international scale expressing the ability of an entity to meet its international obligations in its local or domestic currency.

Local currency ratings on a national scale assume the local government to be risk free. These represent an entity's ability to meet its domestic obligations in the local currency. JCR-VIS assigns local currency ratings on a national scale and assumes that the Government of Pakistan is domestically, a 'AAA' rated entity. Though sovereign risks are largely ignored, the vulnerability of institutions to the changing economic and regulatory environment is never the less built into the assigned ratings and an institution's financial strength is gauged both in absolute terms, as well as in relation to all other market players. This is to say that the assigned national local currency ratings do factor in, the effect of both general and specific risks on an institution's risk profile, with the exclusion of sovereign risks.

Since general risks tend to be more severe, it takes a larger resource base to be able to absorb serious economic stress. Larger banks usually have stronger shields in terms of market access,

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economies of scale and franchise value, and fare better withstanding systemic risks. Furthermore, as the banking sector matures and corporate governance takes root in large banks, their national franchise and a strong mar-

ket share better equips them to determine their pricing structure. On the other hand, smaller banks may run into difficulties where banking systems are liberalized and competitive. In such markets, smaller banks derive earnings from niche markets, where they may command some degree of pricing latitude.

In Pakistan, however, the concept of asset diversification in terms of type of asset product is largely absent. Also, the customer base is not clearly segmented for differentiated financial products, making it difficult for small banks to identify their particular domain of operations. Therefore, as set

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and equity size, though not a key driver of credit ratings does affect ratings of an institution, in as much as it affects its risk appetite and earning potential. As such, rating ceilings are applied in most circumstances to smaller sized entities, unless overriding factors including strong group or sovereign support exist that will be a source of credit enhancement. However, if general risks become too acute and credit impairment becomes unavoidable for the financial sector as a whole, JCR-VIS may apply rating ceilings across the board.

In evolving banking systems, the competitive environment may assume critical importance as privatization, deregulation and mergers mark the transition. As new

forms of financial activity take ground, mergers and acquisitions are the more expeditious way to capture new markets as opposed to internal growth. Integration issues and resulting synergies are critically analyzed from the credit strengthening point of view, before arriving at credit assessment of the merged entities. The shift in a bank's franchise value, in changing banking environments, is a key, rating factor, as a function of its long-term earning potential, and as engendered by a competent management team.

An other feature of emerging markets is increasing disintermediation, potentially affecting the traditional business of banks by reducing the scope of lending. Increasing competition, over the medium term would lead to straining the profitability of banks. However, over the longer term, banks are likely to prosper in developed financial markets, with more opportunities to diversify their earnings through new financial products. Depth and diversity of the economy and capital markets therefore directly affects the overall strength of banks.

Ratings are also influenced by the ability of the regulators to ascertain the soundness of banks in the system and their capacity and willingness to intervene to prevent institutional failures. The transparency in the system as inculcated by the regulatory framework and the reliability of audit practices, are also given due weightage. Similarly, the promptness of decision-making in the legal system has a direct bearing on the

rating as certain factors like realizability of collateral in a timely manner are dependent on the efficiency of the courts.

A bank's ability to honor its financial commitments is also affected by the degree of external support. Creditworthiness of financially weak banks may be enhanced, if backed by a strong third party. The strength of sponsors, shareholders, group, sovereign or even the peers, is a positive influence on the ratings. By the same token, the financial viability of associated concerns is also taken into account and translated into any stress that may impact the risk profile of the entity being rated.

Support mechanisms are counted towards credit enhancement, provided a viable mechanism is in place for the timeliness of the support. The timeliness of discharging financial obligations is crucial in the rating definition, highlighting the fact that it is not the eventual repayment capacity that the ratings drive to establish but the timeliness of that repayment, which is to be benchmarked.

Third party support is at its most effective in the form of sovereign support. Though the presence of implicit support from the sovereign prevents economy-wide repercussions of a failed bank and may result in a higher credit rating, strong predictability of state support often hinders the development of the local banking system.

The strength of sponsors, shareholders, a sovereign or even the peers, is a positive influence on the ratings, given that a viable mechanism is in place for the timeliness of the support

Other than the sovereign, strong boards can be a significant strength to an institution subject to the autonomy of the members and the diversification in their backgrounds. In the recent past, weak boards were found to be significant contributors to bank failures in Pakistan.

The latest regulatory move in this regard limits sponsor directors of the same family to 25% of board members, for all banks other than the state-run banks, and is a welcome step for strengthening of the boards.

While considering the specific risks relevant to a bank, a multitude of factors are considered by JCR-VIS, as part of the commercial bank rating methodology. The relative importance of these elements may how

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ever, vary amongst institutions and the analysis of a bank's fundamen

tals is aimed at identifying the key rating drivers for that particular bank.

Above or below a certain threshold level, any of these rating elements may become the deciding factor. Though sustainable earnings (profits before all extraordinary items, provisions and taxes) and risk profile of the institution are given due coverage in the analysis, JCR-VIS is of the opinion that the bank's franchise value and the ability of the management to enhance and capitalize on its franchise value, determines its financial strength

over the long term. Therefore, it is entirely possible for banks with weaker financial ratios to have high ratings based on management quality, support factors and franchise.

The last three years were marked with a string of bank failures in Pakistan, beginning with Bankers Equity Ltd. and followed by Indus Bank, Prudential Commercial Bank and most recently the moratorium declared on the deposits of National Development Finance Corporation (NDFC). The institutionalization of third party vigilance and the credibility of the rating process have since acquired a great deal of significance. Credit rating gets further impetus from the single-minded focus on privatization by the current authorities, that has generally emphasized improved practices and disclosure requirements. There is pressure from multilateral donor agencies to wind up non viable financial institutions, specially the distressed Development Financial Institutions. This perhaps was the end objective of the recent cross-sector merger of NDFC, one of the largest specialized players, with the National Bank of Pakistan. Other cross sector mergers are also in the offing and are expected to strengthen the financial sector.

The impending privatization of two of the five large commercial banks and the partial sale and listing of

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shares of the largest commercial bank, so far entirely owned by the Federal Government, on the national stock exchanges are the most significant recent developments, in the local banking sector. Pressure from the State Bank of Pakistan,

to develop a culture of good governance, has resulted in a phase of restructuring in all large commercial banks, decreasing the number of branches and staff to curtail operational costs to the minimum.

As part of the SBP's endeavor to restructure the banks and minimize the spread to a more depositor friendly level, the applicable tax rate has been reduced from 58% to 50% with expectations of further reduction in national budgets to come. This will, in the longer run, encourage investment in the banking sector and strengthen the balance sheets. JCR-VIS believes that these recent regulatory developments have been positive and may improve ratings for the entire financial sector.

Large Commercial Banks - 'The Big Five'

The banking sector in Pakistan is dominated by five banks, two of which, namely Habib Bank Limited (HBL) and United Bank Limited (UBL) are entirely owned by the Government of Pakistan. The National Bank of Pakistan and the largest of the local banks, was also until recently owned entirely by the GOP. Lately however, its shares were listed on the stock exchange and public ownership is expected to amount to 10% of total shares by year-end. The remaining, Allied Bank of Pakistan and Muslim Commercial Bank are also partially owned by the Government. The GOP is expected to divest its remaining 9% shares in MCB and 49% shares of ABL in the coming months.

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BANKING SECTOR OVERVIEW

These five banks were among the few players in the local market, along with some foreign banks, prior to the mushroom growth in the sector during the 80s and 90s. Unhindered by competition, and with their wide web of branches, these banks captured the deposit base and maintain a market share of over 70% to date. Other than the government's stake, the bearing that the performance of these banks has on the country's financial markets suggests that government's support is most likely to be forthcoming, under duress.

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Put differently, these banks may be referred to as being, 'too big to fail', since they exhibit all characteristics, including a very large market share and importance to the economic system, that render them capable of defying failure. The relative importance attached to these banks affects their risk profiles and enhances the credit rating of the institution.

Government support is magnified for banks that are wholly owned by the GOP. A unique feature of this support is a statutory guarantee provided to the deposits of banks, where the government holds 74% or more of the shares, and as identified in the bank's nationalization act of 1974, according to which the Federal Government has guaranteed the safety of deposits. As such, blanket protection is afforded by way of an explicit guarantee asures that their credit profiles are similar to

that of the sovereign itself, being the ultimate entity responsible for the safety of deposits. As mentioned earlier, on a national scale, the sovereign is almost invariably rated AAA for its local currency obligations, in its capacity as the strongest entity in the country. The partial or complete privatization of these nationalized institutions will render the guarantee void, but till such time, sovereign's backing, both in the form of an explicit guarantee and implicit support, is the biggest contributor to the continued strength of these entities. Similarly banks, where a sub-sovereign has a substantial shareholding, also enjoy implicit support of the respective sub-sovereign, even though deposits are not covered by an explicit guarantee.

Once the guarantee of state-owned banks stands suspended, the element of support diminishes considerably, and it becomes important to determine the financial strength of the institution in the absence of government support. To be able to isolate the rating process from the overriding effect of a sovereign guarantee, JCR-VIS has also assigned ratings on a *standalone* basis to entities that were rated AAA due to the government's statutory guarantee.

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Like some other emerging markets, the government's ownership and its direct control, brings with it increased vulnerability to

provide funds for socio economic expediencies. Consequently, these five banks in particular, are expected to fund public sector enterprises, some of which are facing acute cash flow deficits and propped on ever increasing debt levels. This relative inability to make business decisions based solely on business expediencies affects the institution's prospects to be highly rated on a standalone basis. However, the government has now put independent management teams in place, introducing corporate governance and separating economic and business interests.

Foreign & Small Commercial Banks

The foreign banks began setting up operations in the local market and reaped benefits of an internationally established brand name and improved service quality. With a restricted clientele, these banks have a reduced proportion of market share in comparison to the partially privatized and nationalized commercial banks.

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Local branches of most Middle-Eastern and South Asian banks however, required being

rated for their ability to meet local currency obligations. It is important to note that branches of sovereign supported foreign banks are treated differently from local government owned banks.

Though external enhancement is given to foreign government support if indicated, sovereign guarantee on its borrowings will be considered in

terms of the currency risk of the entity's national currency, and JCR-VIS will assess the ability of the branch to repay financial obligations in Pak rupee.

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The third group of market players are the private sector banks some of which have emerged as community banks and mostly have a closely held share holding pattern. Of the 12 private banks, some are owned by groups that have had substantial experience in the banking sector in the pre nationalization era. These banks have a market share of almost 15% and are restricted by their smaller network of branches.

The following key exhibits the definition of the categories used for the banking sector in Pakistan, and the number of institutions in each category pertaining to our rated universe, used for developing the statistics given in this paper:

Large Commercial Banks (LCBs): Commercial banks with an asset size greater than Rs

100b. Number of institutions: Five
(5)¹

**Foreign Commercial Banks
(FCBs):** Branches of commercial banks incorporated outside Pakistan. Number of institutions: Six
(6)

**Small Commercial Banks
(SCBs):** Commercial banks with an asset size less than Rs 30b.
Number of institutions: Five (5)

Only audited accounts
(FY1998-FY2000) have been used
and unrepresentative data has
been excluded from some ratios
to avoid distortion.

¹ includes Habib Bank Limited (HBL). HBL is in the process of being rated by the JCR-VIS.

As discussed in the earlier sections of the paper, ratings are governed by a set of factors, both quantifiable and intangible, and any of these factors may become a key rating driver. Major rating components comprising risk evaluation, capital strength, and earning potential have been detailed in the following pages in context of the banking sector in Pakistan and are illustrated with key ratios used for analysis. However, it is important to look beyond the financial ratios and arrive at an opinion on the ability of the management to enhance an institution's franchise value, which is the most significant rating consideration over the long-term. A comprehensive analysis of the qualitative factors, in conjunction with the numbers, is carried out to evaluate the risk of an untimely payment of principal and / or markup.

Capitalization

The foremost tool used to assess the adequacy of the bank's capital is the minimum capital requirement (MCR) as propounded

Capital base serves as the buffer against sudden deterioration in asset quality or acute dips in earnings in a particular year

by the Basel Agreement which measures

capital with respect to risk weighted assets. The relatively risky assets are assigned higher weights, that increases the need to have a larger capital base. In emerging economies where environmental conditions are likely to be volatile, equity size is of critical importance as banks may at times

be compelled to take the loss on non-performing loans all at once, rather than being able to spread the loss over the years by way of provisions. As such, capital base serves as the buffer against sudden deterioration in asset quality or acute dips in earnings in a particular year.

In Pakistan's context, the measure of CAR (Capital Adequacy Ratio including both tier 1 and tier 2 capital) needs to be considered with a pinch of salt. Loans accorded to the public sector are assigned weights between 0-50% depending on the degree of government's control and whether the loan is/is not guaranteed by the government of Pakistan. For banks with large public sector exposures, a function of public ownership, risk adjusted assets may not be reflective of the risk profile of the bank's assets and an MCR of 8% may fall short of capital adequacy standards. Invariably, the proportion of risk weighted assets (RWA) to total assets is considerably lower in public sector banks.

RWA % TOTAL ASSETS

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	30.2	25.4	29.5	35.0
FCBs	36.0	29.8	41.5	45.0
SCBs	46.2	41.9	44.5	54.7

Q1: First Quartile, Q2: Median, Q3: Third Quartile

These banks also benefit from tier 2 capital to meet capital adequacy requirements, mostly a surplus on revaluation of fixed assets. Private sector banks in Pakistan and the foreign bank branches on the other hand, largely do not fi



nance the public sector and CAR is a more reliable indicator of capital strength.

As evident from the table, the larger banks though mostly above the waterline have relatively lower equity bases in relation to risk adjusted assets, despite a lower proportion of risky assets and the effect of tier 2 capital, unlike the other two categories of banks. The

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foreign banks are in variably the best-capitalized banks in the sector, but often do not have full access to it for employment as an earning asset, due to regulatory requirements that call for depositing the capital amount with the SBP either as cash in rupees or US dollars or FIBs. This has contributed to a low proportion of risk adjusted assets to total assets.

CAR (%)

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	9.9	8.5	10.2	11.2
FCBs	57.7	23.1	35.4	52.3
SCBs	14.6	11.9	13.0	16.7

Q1: First Quartile, Q2: Median, Q3: Third Quartile

An other aspect to be thoroughly evaluated is the level of unimpaired capital, having factored in the effect of unprovided losses on the balance sheet. In Pakistan the quantum of unprovided loan losses is the most significant contributor to the total balance sheet loss. If the banks are not given any credit for the value of collateral held in view of the delays in legal redress, the equity of all

large banks would be seriously impaired.

NET NPLS % TIER 1 CAPITAL

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	192.6	147.9	174.5	213.3
FCBs	4.1	-	2.8	7.3
SCBs	70.6	28.4	69.7	85.1

Q1: First Quartile, Q2: Median, Q3: Third Quartile

By the same token, understated values of fixed assets or any other hidden reserves have to be assigned due weightage in the ratings.

The continued adequacy of capital as reflected in the growth in equity in relation to the growth in assets is of critical significance to ratings as a reflection of risk.

The State Bank in a circular issued in December 2000, has increased the minimum paid up capital requirement to Rs 750m by January 1, 2002 and Rs 1b by January 1, 2003. JCR-VIS looks at these developments positively. In case of non-compliance, banks will be de-scheduled on the said dates. In this regard, some small banks are seriously short of the requirement. This may force some banks to wind up operations or merge with other banks.

Credit Risk

Credit risk of a commercial bank is largely concentrated in its loan portfolio that is analyzed to assess the level of infection (NPLs/Gross Loans). The analysis looks back at past trends in asset quality, the deterioration in assets to day and the ability to withstand

any impairment in future. Prudential Regulations for commercial banks lay down comprehensive guidelines to classify non-performing assets and all banks are required to disclose the level of non-performing loans.

INFECTION (%)

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	26.2	17.6	20.4	30.8
FCBs	11.9	2.6	5.0	22.3
SCBs	15.8	6.3	12.7	24.3

Q1: First Quartile, Q2: Median, Q3: Third Quartile

The above tables elucidate the extent of non-performance within the large local commercial banks. In contrast, two of the large American banks, Bank of America and First Union Corp. had an infection ratio of 1.0% and 0.7% respectively, while the largest Japanese bank, also the largest bank in the world, the Mizuho, has an infection level of 4.8% for the same period (Dec. 2000).

The extent of net non-performing assets determines the quality of the bank's asset base.

NET INFECTION (%)

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	15.6	9.4	13.7	18.1
FCBs	2.2	0.0	0.8	1.4
SCBs	11.9	4.6	9.9	18.2

Q1: First Quartile, Q2: Median, Q3: Third Quartile

In this regard, contingent liabilities against non-performing credit of the bank are also assessed for a possible impact on the bank's future cash requirement. The aggregate impact of

non-performing credit and contingent liability thereof is measured against provision held and the forced sale value of available security. In another step, the coverage of bad credit through provisions is assessed excluding the benefit of security held, due to the long drawn out legal proceedings that precede realization of collateral value.

The quantum of loans rescheduled on non-performance is another possible source of credit risk. The prudential regulations do not allow a rescheduled loan to be excluded from classified loans unless the loanee has serviced financial obligations according to the rescheduling agreement for a minimum period of 1 year after conclusion of the grace period. It is considered advisable at JCR-VIS to assess the rescheduling agreement and whether 1 year is an adequate time period for performance review. Unless 30% of the outstanding exposure has been repaid and 30% of rescheduling period has concluded, the asset is considered impaired.

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Furthermore, while assessing total loss on the balance sheet, JCR-VIS also looks for quantum of unclassified credit facilities, if any, against non-performing facilities extended to the same loanee or group.

The mandatory requirement for provisions against loan losses allows banks the benefit of forced sale value of held security and

prudential regulations enforce annual assessment of this value to determine the extent of erosion of security value against extended credit and protection available against credit risk. In Pakistan, general provisions are not an allowable expense for taxes payable, and therefore banks are reluctant to carry general provisions. Non-availability of these loan loss reserves against possible future losses also drags ratings.

So far the emphasis of credit risk management in Pakistan has been on collateral management. Total volume of non-performing loans (NPLs) in the banking sector amount to approximately Rs 175b (Source: Annual reports of commercial banks) as of December 31, 2000. The nationalized commercial banks are the worst affected players, despite the fact that they have extensively financed the public sector under loan agreements guaranteed by the Federal Government that do not require being classified. Here it is important to make a distinction between the wholly owned government banks and the partially privatized ones that are far less exposed to the public sector in comparison and therefore their declared levels of non-performance are more reflective of actual inflection.

In a recent move, a Corporate and Industrial Restructuring Corporation (CIRC) was established to purchase collateralized non-performing assets from the government owned banks, for subsequent disposal. Similar vehicles had been established in USA and

Japan, and aimed at a quicker resolution of non-performing assets through auction of collateral. These corporations have seen mixed success, from limited success in Japan to very effective in the US banking sector. The performance of this new system remains to be seen in Pakistan.

As set mix is analyzed to ascertain the diversification in operations and concentration by asset type and by sector, entity or a business group. International standards limit aggregate concentration of credit and contingent liability to 25% of paid up capital and allowance for loan losses, in any one individual client/group of companies or an industry. In this regard, it is worth while to note that Pakistan's economy does not have the depth of well-developed markets and a few sectors dominate the country's industrial production. As such credit concentration in terms of exposure to some sectors is an unavoidable occurrence. However, as far as concentration enhances the risk profile of an entity, it nevertheless impacts its credit rating.

An institution's vulnerability to a sector's performance as a result of concentration is the focus of credit analysis, whatever the business rationale of concentration may be

As an illustration, the textile boom of the late 80s resulted in large exposures taken in the textile sector, as the largest industry in Pakistan, however, the slump of mid 90s seriously affected the asset quality of banks, deeply concentrated in this industry. An institution's vulnerability to a see

tor's performance as a result of concentration, is the focus of credit analysis, whatever the business rationale of concentration may be. Particularly disturbing, is concentration in exceptionally volatile assets. Again with reference to Pakistan's economy, excessive concentration in equity markets, that have been historically volatile and lack depth, invariably caps ratings to a lower investment grade band.

Liquidity Risk

The funding mix of commercial banks, requires them to maintain higher levels of liquidity against demand and time liabilities due to a higher proportion of demand liabilities. Liquidity requirements imposed on commercial banks by the State Bank of Pakistan are particularly stringent. The statutory cash requirement at 5% of demand and time liabilities and a statutory liquidity requirement (including cash) at 20% is a substantial margin against unanticipated stress.

LIQUID ASSETS % TOTAL ASSETS

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	37.4	32.9	36.8	43.7
FCBs	47.0	34.8	42.9	52.7
SCBs	39.3	33.3	37.8	47.1

Q1: First Quartile, Q2: Median, Q3: Third Quartile

Depending on the particular borrowing mix of the institution, liquidity benchmarks, including the level of liquid assets against total borrowings, as set by JCR-VIS, may vary. The borrowing mix considers the mix of core and non-core deposits. Various indicators

are used to assess this among which is the proportion of retail and corporate deposits. Liquidity indicators are sensitized to measure coverage against total borrowings and in the second step, assess maximum possible stress by measuring coverage against a proportion of contingent liabilities that may mature within the rating horizon. Liquidity benchmarks are also dependent on the deposit base of the bank. For smaller banks, minimum liquidity for qualifying them to higher rating bands is relatively higher than the larger banks, due to a lower risk appetite of smaller banks.

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LIQUID ASSETS % TOTAL BORROWINGS

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	41.1	35.8	40.4	49.0
FCBs	60.0	39.7	55.6	69.8
SCBs	44.0	37.1	41.7	52.6

Q1: First Quartile, Q2: Median, Q3: Third Quartile

In developed markets, the concept of deposit insurance assures the banks' small and core depositors of financial security and increases confidence in the system.

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The concept is absent in Pakistan's financial sector and though some nationalized financial institutions are covered by a blanket statutory guarantee on all deposits, the smaller banks not falling under the

government's deposit guarantee will immensely benefit, if deposit insurance is introduced. Insurance premiums may then be determined based on the respective risk profile of the banks, and the policy may cover all deposits below a certain cut-off amount that would define a small deposit.

Market and Currency Risk

For emerging market economies, interest rate risk management becomes a key driver of sustained profitability. The regulatory environment has made substantial efforts to instill a culture of risk management by making mandatory the establishment of the asset liability management committee in banks. Traditionally, commercial banks in Pakistan are not exposed to equity market risk and concentrate investments in fixed income government securities, mostly liquid in nature and counted towards liquidity requirements mentioned earlier. A substantial investment in fixed income securities provides some degree of protection against volatility in interest rates. JCR-VIS further checks for the maturity profiles of markup bearing assets and liabilities to assess the risk associated with re-pricing of maturing financial instruments, both on and off balance sheet. We further take into account the access banks may have to the money markets and other resources, under duress.

Risk arising from forward contracts and purchased foreign bills, foreign currency placements with central banks (SBP/others) and net balances are the main con-

stituents of currency risk. In Pakistan this risk is largely controlled through strictly enforced regulations regarding net open positions and net balances. At the time of writing this report, the limit on net balances had been removed whereas that on the net exposure has been maintained, which still effectively controls currency risk. For banks with foreign operations the value of its foreign currency denominated assets and liabilities, currency risk is still greater.

Profitability

The level of basic earnings and its sustainability is the focal point in assessing profitability as an entity's integral strength. Basic earnings of an institution exclude the effect

The sustained earning potential of an institution is a key determinant of franchise value and effective management

of provisions and taxation (PPP). Profitability determines an institution's ability to build reserves and be able to provide for unrealised losses, without affecting the bank's existing capital base. The sustained earning potential of an institution is a key determinant of franchise value and effective management and allows a bank to continually invest in new products and technology.

PPP % NET LOANS

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	1.9	1.2	1.7	2.8
FCBs	13.2	3.1	4.4	27.4
SCBs	2.4	1.3	2.7	3.5

Q1: First Quartile, Q2: Median, Q3: Third Quartile

Some of the FCBs rated by JCR-VIS derive a major portion of their basic earnings from sources other than lending activity, as also reflected in above statistics.

The adequacy of earnings is also assessed by determining the proportion of net loans covered by basic earnings. The objective is to assess the extent of performing loans that may become non-performing in future years and may be provided for, without having to dig into capital reserves.

Growth in pre-provision profits is largely a function of an expanding earning asset base and the yield mix of assets, whereas sustainability of earnings is a question of effective interest rate management, efficiency of operations and the contribution of stable income in total revenues. JCR-VIS checks for the alignment of an institution's strategy with the interest rate structure prevalent in the economy and also the assumptions underlying its future course of action. As regards sustainability, basic returns are calculated to arrive at an estimation of recurring returns. Sizeable growth in earnings level in a particular year will not contribute positively towards the ratings, if achieved through sources believed to be volatile.

BASIC ROAE (%)

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	23.8	16.5	27.4	33.4
FCBs	22.6	5.9	21.7	36.6
SCBs	18.2	8.9	20.2	28.3

Q1: First Quartile, Q2: Median, Q3: Third Quartile

As capital markets develop, disintermediation squeezes the interest rate spread. Banks then have the option of either investing in high risk/return assets or develop fee based business to substitute thinning margins. Though core business income is important, diversification in the earnings mix ensures stability over the years.

NON-MARK UP INCOME % TOTAL REVENUES

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	37.8	28.4	32.6	46.5
FCBs	67.7	47.0	50.2	64.5
SCBs	44.4	34.9	41.9	48.5

Q1: First Quartile, Q2: Median, Q3: Third Quartile

Control over administrative expenses are analyzed in relation to net revenues. NCBs with the largest branch networks and overstaffed establishments fare worse in this regard with high inefficiencies. In this regard the median (Q2) for efficiency in the large American banks (asset size greater than \$20b) was 59.4% for the year ending December 31, 2000.

EFFICIENCY (%)

CATEGORY	AVG.	Q1	Q2	Q3
LCBs	85.0	75.1	83.1	88.9
FCBs	75.5	31.4	48.5	60.7
SCBs	68.3	52.3	55.2	78.6

Q1: First Quartile, Q2: Median, Q3: Third Quartile

Operating costs are also analyzed in relation to deposit base and small and foreign commercial banks show considerably improved numbers over the LCBs.

Management

The control procedures of the bank and the future of the entity as envisioned by the top management is the most significant and intangible of all rating factors. The trickle down of the top management's vision and the clarity of the strategy identified, are factored into the ratings. The stability of the management as indicated through succession plans and employee turnover ratios affect the continuity of the management's long-term plans, and in stability in management will discount the assessment

The bank's management style is the foremost consideration here, in terms of conservative versus risk taking strategies and proactive versus reactive styles

of the strategy. Control measures undertaken by the management including contingency plans in effect and the degree of centralization are separately analyzed. Factors such as effectiveness of credit appraisal and monitoring procedures are also given due weightage.

The ability of a stable management is the surest indicator of a bank's franchise value over the long-term and is reflected in the earning potential of the entity. The bank's management style is the foremost consideration here, in terms of conservative versus risk taking strategies and proactive versus reactive styles. It is important to have an opinion as to whether management will lead the bank through new avenues or manage it as a follower of market trends. The resource base of the bank also plays its due role in determining the strength of the management to maneuver within the market.

Staffing levels are considered to arrive at an estimate of cost redundancies if any. The following are typically used tools:

STAFFING EFFICIENCY (AVG.)

CATEGORY RS. ('000)	DPT/ EMP	PFT/ EMP	CST/ EMP
LCBs	13,550	40	400
FCBs	41,120	380	490
SCBs	23,180	80	340

DPT/EMP: Deposit per Employee, PFT/EMP: Profit per Employee, CST/EMP: Cost per Employee

Information systems in place are assessed for their adequacy as an integral element of internal controls in terms of their ability to generate and transfer data and ensure its timely availability to management for decision making. By the same token, the efficacy of internal audits, their frequency and their usage by the management is also counted towards the strength of systems and procedures.

From a rating perspective, JCR-VIS uses published financial statements as a baseline tool for analysis. Limited disclosure from companies results from a combination of a lack of willingness and inability of systems to yield requisite information. Lack of information pertaining to certain areas is viewed in the context of undisclosed potential risk and though this may not directly be linked to the rating assigned, it does constitute a negative rating factor.

The use of information technology as a benefit to the customer is also factored in and whether the bank will in future be

able to use it as a competitive edge. This is particularly important in the financial sector, where products and services are mostly homogeneous in nature. Banks that have a large resource base are better equipped to be market leaders in the introduction of new products and services. Therefore, it is important to be able to identify the players among the large banks that are poised to increase their relative market share based on their technology driven endeavors.

Rating Scale & Definitions

Medium to Long-term

AAA

High est credit qual ity. The risk fac tors are neg li gible, be ing only slightly more than for risk- free Gov ern ment of Paki- stan debt.

AA+, AA, AA-

High credit quality. Protection factors are strong. Risk is modest but may vary slightly from time to time be cause of eco nomic con di tions.

A+, A, A-

Good credit qual ity. Pro tec tion fac tors are adequate. Risk factors may vary with the pos si ble changes in the econ- omy.

BBB+, BBB, BBB-

Ade quate credit quality. Pro tec tion fac tors are rea son able and suf fi cient. Risk factors are considered variable if changes oc cur in the econ omy.

BB+, BB, BB-

Obligation deemed likely to be met when due. Pro tec tion fac tors are ca pa- ble of weakening if changes occur in the economy. Overall quality may move up or down fre quently within this category.

B+, B, B-

Obligations deemed less likely to be met when due. Protection factors are capable of fluctuating widely if changes occur in the economy. Over- all quality may move up or down fre- quently within this category or into higher or lower rat ing grade.

CCC

Con siderable uncer tainty exists to- wards obligations when due. Pro tec- tion fac tors are scarce and risk may be substantial.

CC

A high de fault risk.

C

A very high de fault risk.

D

Defaulted obligations

Short-term

A-1+

Highest certainty of timely payment. Short-term liquidity, including internal op er at ing fac tors and /or ac cess to al- ter na tive sources of funds, is out stand- ing and safety is just below risk free Government of Pakistan's short-term obligations.

A-1

High certainty of timely payment. Li- quidity factors are excellent and sup- ported by good fundamental pro tec tion fac tors. Risk fac tors are mi- nor.

A-2

Good certainty of timely payment. Li- quidity factors and company fun da- men tals are sound. Al though on- going funding needs may enlarge total fi- nanc ing re quire ments, ac cess to capi- tal markets is good. Risk factors are small.

A-3

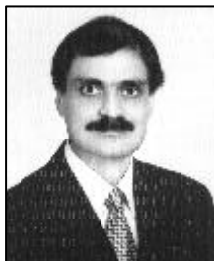
Sat is fac tory li quid ity and other pro tec- tion fac tors qual ify is sues as to in vest- ment grade. Risk fac tors are larger and subject to more variation. Never the- less, timely pay ment is ex pected.

B

Speculative investment charac ter- istics. Li quid ity may not be suf fi cient to en sure timely pay ment of ob li ga tions.

C

Ca pac ity for timely pay ment of ob li ga- tions is doubt ful.



*President & CEO,
JCR-VIS*

Founder, VIS Group

Mr. Faheem Ahmad has diverse experience with international consulting agencies in USA & Middle East. He has also held senior positions with local industrial and financial groups. In 1994, he established Vital Information Services, which is a leading capital market research house. VIS holds the largest data bank of Corporate Pakistan. His major research work includes copy righted F&J, financial strength rankings, Musharaka Variable Income Securities and stock market indices. The VIS group also includes JCR-VIS Credit Rating Company Limited and NEWS-VIS Credit Information Services, the first private credit bureau of Pakistan. The majority of shareholders in Group Companies include the largest publication house and major financial institutions.

He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has a Masters degree in Engineering and Business Administration from USA. His research work was published in international journals.



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