FINANCIAL STABILITY AND RISK ASSESSMENT

This section presents an assessment of financial stability during 2008 (CY08) and the first half of 2009 (H1-CY09), based on risks emanating from both the domestic and external macro-financial environment which have a bearing on the stability of the domestic financial system. The objective is to highlight the key risk factors and vulnerabilities in the financial sector in Pakistan, and the potential implications of these risks and vulnerabilities on financial stability.

Without doubt, the year 2008 will henceforth be remembered as the most turbulent year in the modern world's economic and financial history. Impact of the sequence of **global events**, ranging from the global financial market turmoil to the surge in global commodity prices, impacted various regions in the world differently and unevenly. Concerns shifted during the year from taking policy actions to alleviate the severe liquidity crunch, to how to prevent insolvency of the global banking system, with the eventual focus of policy measures resting on ensuring the revival of the global economy.

2009 however, has turned out to be better than initially projected, given the degree of intensity of the crisis and its resurgence in September 2008. The year has actually been the bearer of good news with the emergence of the green shoots of economic recovery, albeit these come hand in hand with concerns about the premature withdrawal of the monetary and fiscal stimulus packages in various countries. On the other hand, the continuation of these policies is stoking concerns of inflationary pressures and of building up of asset-price bubbles, with the added worry that the weakening US Dollar at a time of historically low interest rates is fuelling carry trades.

Even though the process of recovery has started, albeit more pronouncedly in the US in comparison with the Eurozone, household and corporate balance sheets remain under stress. Financial markets have however started to open up gradually, and wholesale funding channels are showing some signs of life, though the credit channel remains under pressure.

Pakistan's economy, on the other hand, had suffered from stresses of its own in addition to the second round impact of the crisis transmitted through the trade channel, and the reversal of capital flows. Notably, the implementation of the macroeconomic stabilization program with the support of the IMF SBA since November 2008 has facilitated the process of economic recovery, though at a quite gradual pace at this stage. CPI Inflation has declined to 8.9 percent in October 2009 since touching its peak of 25.3 percent in August 2008. The current account deficit has narrowed to US$ 540 million in Q1-FY10 as compared to US$ 4,258 million in the same period last year. The performance of the fiscal and the real sectors, however, remains tenuous, as does the flow of credit to the private sector. With the improvement in some macroeconomic indicators and the upgrading of the country's sovereign ratings by Moody's and S&P's, portfolio flows have resumed, with positive cumulative net flows of USD 314.0 million recorded from July FY10 until mid-November FY10. As a result of all these developments, SBP's foreign exchange reserves have increased to USD 10.4 billion by mid-November FY10.

While not directly impacted by the events in the global financial markets, various developments over the period of assessment did alter the risk profile and outlook of the financial sector: (i) banks faced a temporary liquidity strain in Q4-CY08 which translated into solvency problems for some of the weak small banks, (ii) the liquidity stress brought forth NBFIs' dependence on the banking sector more visibly as their credit lines from banks dried up, (iii) rising NPLs, monetary tightening and structural impediments in the economy hampered the flow of credit to the private sector, (iv) deposits growth slowed down, (v) banks' exposure to the public sector increased substantially, and (v) the equity market's

capitalization declined by around 63 percent by end-CY08 while the exchange rate depreciated by over 20.0 percent against the USD. In view of these various adverse developments, a detailed assessment of financial stability is given below.

Financial Stability Assessment

The domestic financial sector has remained largely stable in the midst of upheavals of various types. The stability of the financial system is largely derived from the predominant position of the **banking sector**, as other components of the financial system continue to grow at a more gradual pace (**Table 1**). As opposed to the speculative tilt in conducting the business of banking in western economies,[1] the underlying operating model of the banking sector in Pakistan fulfills the basic requirements of the function of financial intermediation: loans and advances are funded by a large and growing base of deposits, with virtually negligible reliance on borrowing, or the short-term wholesale market for financing assets.

Table 1: Asset Composition of the Financial Sector

	CY02	CY03	CY04	CY05	CY06	CY07	CY08	H1-CY09
Asset (bln Rupees)	3417.7	3943.7	4518.3	5201.5	5957.5	7115.2	7710.6	8269.4
Growth Rate (percent)	12.3	15.4	14.6	15.1	14.5	19.4	8.4	7.2
As percent of Total Assets								
MFIs	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2
NBFIs	6.2	6.6	7.0	7.6	7.8	8.0	7.6	5.6
Insurance	3.8	3.8	3.8	3.9	4.1	4.6	4.4	4.1
CDNS	24.9	25.0	21.7	18.0	16.1	14.6	14.8	16.5
Banks	65.0	64.5	67.3	70.4	71.9	72.7	73.0	73.6
As percent of GDP								
MFIs	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
NBFIs	4.6	4.9	5.2	5.6	5.7	5.9	5.0	3.5
Insurance	2.8	2.9	2.8	2.9	3.0	3.4	2.9	2.6
CDNS	18.2	18.8	16.1	13.3	11.7	10.8	9.8	10.4
Banks	47.7	48.3	50.1	51.8	52.4	53.9	48.1	46.5
Overall	73.3	75.0	74.4	73.7	72.9	74.1	66.0	63.1

Notably, the growth in deposits did slowdown to 9.4 percent in CY08 after growing successively at an average rate of 18.1 percent for the last 5 years, despite the increase of 17.2 percent (in USD terms) in home remittances; a reflection of both the slowdown in the economy, preference for hard currency due to the prevalent environment of uncertainty, and competition from the National Savings Schemes (NSS) offering a higher rate of return than bank deposits. The rates on NSS schemes were raised by the government in June 2008 to tap non-bank sources of financing at a time when government borrowing from the central bank was at an all time high, and banks were experiencing liquidity strains due to aggressive monetary tightening, continued high demand for credit and deceleration in the growth of their funding base i.e. deposits, as mentioned above. These adverse developments even overshadowed the potentially positive impact of introducing the minimum rate of return of 5.0 percent on all PLS savings deposits by the SBP, w.e.f. June CY08. A visible increase in the currency to deposit ratio and a slowdown in the money multiplier during H2-CY08 also highlights the challenging operating environment of the banking sector. Notwithstanding, deposits growth has picked up pace in H1-CY09, growing by 8.2 percent in H1-CY09 alone. But the impending transfer of government deposits from banks to a single treasury account maintained by the State Bank of Pakistan can potentially have a significant impact on those banks which have a large reliance on these deposits.

[1] Prompting Mervyn King, Governor Bank of England, to call for a split between functions of public good and speculative trading activities, in October 2009.

On the asset side, banks' exposure to the government increased tremendously during CY08, with particular concentration in the power sector due to the issue of circular debt and unprecedented increase in lending to Public Sector Enterprises (PSEs) and commodity finance in general. Notably, a new emerging risk is the gradual build-up of yet another circular debt in the commodity financing sector, though a more definitive assessment can be made as more information becomes available over time. In view of the deterioration in asset quality since Q1-CY08, banks have adopted a risk-averse attitude as reflected in the rising investments to assets ratio. There are also concerns that some banks' liquidity will remain held up in their investments in the two TFCs issued for the resolution of the circular debt problem, with a cumulative amount of Rs. 165.1 billion.

In H1-CY08, demand for credit by the private sector had increased as mounting inflationary pressures pushed the real lending rates into the negative territory. Consequently, the loan portfolio of the banking sector grew by 18.4 percent to Rs. 3.2 trillion by end CY08, against YoY growth of 12.6 percent in CY07. The asset composition of the banking sector has undergone significant changes during H1-CY09, as the investment portfolio grew by 30.4 percent during this time, pushing its share in assets to 23.2 percent as against 19.2 percent at end CY08. In sharp contrast to this, the loan portfolio saw a contraction of 0.2 percent during the same period, and its share in assets dipped to 52.2 percent by end H1-CY09 compared to 56.6 percent at end CY08.

As also highlighted in FSR 2007-08, concentration of credit among a small number of large-sized borrowers needs to be monitored closely in its capacity as a potential source of systemic risk. Furthermore, concentration of bank credit in the textile sector is also a cause for concern, gives its relatively higher infection ratio. As mentioned earlier, the increasing concentration of loans to the power sector at 14.5 percent of total loans as of end-June CY09 is another emerging indicator of sectoral concentration.

As mentioned earlier, heightened concerns on credit risk surfaced in Q1-CY08, and became pervasive as the year progressed: NPLs rose by 68.4 percent in CY08 to Rs. 359.3 billion by the end of the year – the biggest increase in a single year since CY97. While aggressive credit expansion in the last few years played its role in this visible deterioration of asset quality, the widespread rise in NPLs is seen to be a direct consequence of macroeconomic instability, and largely a *cyclical* rather than *structural* factor. This assertion is supported by the slowdown in the growth of incremental NPLs in the first half of CY09 to Rs. 397.9 billion, as the process of economic recovery picks up pace.

Notwithstanding, the substantial rise in the volume of NPLs has had an adverse impact on the financial performance of the banking sector, given that it required banks to create provisions amounting to Rs 105.9 billion during CY08, which was Rs 46.0 billion higher than the provisioning amount of the previous year. This was despite the concession given by SBP to consider the benefit of 30 percent of the forced-sale value (FSV) of collateral when calculating provisioning requirements, as against the more stringent requirement for CY07.

Although the banking sector had surplus provisions of Rs 13.8 billion as of end CY08, a significant proportion of NPLs in the initial categories highlights the potential for incurring incremental provisioning expense in CY09. The increased risk to the solvency position is also visible from the surge in the net NPLs to capital ratio of the banking system to 19.4 percent in CY08, compared with only 5.6 percent for CY07. Some comfort is drawn from the marginal decline in the ratio to 19.0 percent by end-June CY09.

Encouragingly, banks' ability to absorb unexpected losses is on a strong footing. Implementation of the minimum capital requirements in a phased manner continues to strengthen the capital base. The aggregate risk-weighted capital adequacy of the banking

sector as of end-CY08 was maintained at the CY07 level of 12.3 percent against the minimum requirement of 9.0 percent, despite the inclusion of the capital charge for operational risk under Basel II requirements. This is also due to the *anti-cyclical* policy support extended by SBP in response to the difficult operating environment, as reflected in the rationalization of the MCR requirements, with a subsequent enhanced concession in the FSV rules in October CY09.

The level of profitability is seen to be the front line of defense in absorbing losses expected to emerge from normal operations. The banking sector earned a profit (before tax) of Rs. 63.1 billion in CY08 (as against Rs. 106.9 billion in CY07). The impact of the absolute decline in banks' profit is also visible from the key indicators of profitability, i.e. return on assets (ROA) and return on equity (ROE). The ROA of the banking sector dipped to 0.8 percent during CY08 as against 1.5 percent in CY07, and ROE followed a similar trend, declining to 7.8 percent in CY08 as compared to 15.4 percent in CY07. A look at other indicators closely related to the profitability of the banking sector reveals that the decline in ROA and ROE is actually accompanied with a small increase in the net interest margin (NIM) and average spread during the year. Notably, SBP's intervention in the market mechanism of price discovery in the banking system has borne mixed results, given that NIM and average spread inched up by 27 bps and 29 bps to 5.3 percent and 5.4 percent respectively, indicating that banks were generally able to pass on the impact of the minimum return on deposits to the customers.

With strong *aggregate* resilience to the headwinds of instability, bank-wise information shows that some small banks were not able to withstand the various negative developments in their operating environment, and are now in an increasingly vulnerable position. Given the current MCR requirements, it is expected that these banks will either have to merge in order to survive, or exit from the industry altogether.

With an eye on containing systemic risk and safeguarding the stability of the overall banking system, SBP has established a transparent and formal mechanism to resolve temporary bank-specific problems with support for liquidity and solvency till such time that their improved financial performance enables them to stand on their own feet or facilitates the process of their merger with other banks.

In doing so, SBP in its capacity as the leading regulator of the financial sector is striving to strengthen its system of financial safety nets (FSN), with the impending introduction of a Deposit Protection Scheme and a legal framework for consumer protection. Notably, the element of moral hazard continues to exist even in a privatized banking system as long as banks in the private sector are perceived to have implicit state guarantees. It is only with the implementation of the requisite FSN that the potential for moral hazard can be minimized.

Moving on to other components of the financial sector, the dormant element of funding risk in case of **Non-Bank Financial Institutions** (NBFIs) emerged as a strong threat to their commercial viability in CY08: NBFIs are largely dependent on banks to fund their assets, and in wake of the liquidity strains faced by the banking sector in Q4-CY08, these credit lines dried up to the extent that the viability of their ongoing operations came under threat. Notably, NBFIs have long lost their niche in the face of competition from the banking sector, and the leasing companies, investment finance companies, modarabas, venture capital companies seriously need to rethink their business model if they are to remain commercially viable. Mutual funds is the only sub-sector which has grown progressively in recent years, despite the setback in Q4-CY08 when the imposition of the floor on the KSE-100 index and the freezing of TFC redemptions, resulted in a decline in their net asset value (NAV) by Rs. 130 billion from its peak level of Rs. 334 billion. Notwithstanding, mutual funds managed to regain lost ground and recovered some of their value in CY09, with current assets under

management (AUM) at Rs. 234.7 with the subsequent resumption of normal trading at the Karachi Stock Exchange.

Insurance sector, on the other hand, continues on its sluggish pace of growth and gradually increasing penetration of insurance services. The insurance industry has enjoyed robust growth in the last few years, driven by favorable economic conditions, expansion of the financial sector as a whole, privatization of large state-owned entities and foreign investments. But factors such as the emergence of macroeconomic instability since late 2007, turmoil in global financial markets and dislocation of the domestic equity market along with the deteriorating security situation has posed substantial challenges to the performance of the insurance sector in CY08. The sector continues to be ridden with inefficiencies of its own, primarily emanating from the continued concentration of business in the hands of a few, such that 70 percent of the general-insurance business is concentrated in the top 5 companies, and life-insurance continues to be dominated by the state-owned entity. With 45 companies operating in the industry, this indicates a considerable degree of fragmentation. To instill competition and efficiency, it is essential that insurance sector reforms proposed by both the Ministry of Commerce and the SECP as joint regulators of the sector, are implemented without further delay, foremost among which is the proposed privatization of the State Life Insurance Company. It is also important to encourage consolidation in the sector to increase its strength and resilience.

CY08 was also the year when the domestic **equity market** touched its highest ever peak before suffering a severe setback: the KSE-100 index rose to 15,676 points in April CY08, subsequent to which a confluence of factors led to a high degree of volatility in the market, forcing the regulator to place a floor of 9,144 points in August CY08 to prevent further loss in value and protect investors' interest. The placement of floor in effect added to the uncertainty faced by both domestic and foreign investors in preventing voluntary exit from the market, and in hampering the process of efficient price discovery. The market has resumed normal functioning subsequent to the lifting of the floor in December CY08, but not before it touched its lowest level in 5 years in January CY09.

The impact of these developments in the equity market on the banking sector was mostly felt in the erosion of the surplus on revaluation of assets, and even that was mitigated by: (i) the decision taken by the SECP and SBP to defer the impact of impairment losses on securities held in the Available for Sale (AFS) portfolio to CY09, and (ii) banks' limited exposure, both direct and indirect, to the equity market.

Given the relatively gradual pace of implementation of capital market reforms, the equity market has not proved itself to be an avenue for raising funds and has operated more as a trading platform. This is reflected in the virtually negligible amount of financing raised as compared to bank credit (listed capital of Rs. 781.8 billion as of end FY09 as compared to bank credit outstanding of Rs. 3.2 trillion). Not surprisingly, the significant volatility seen in CY08 had little impact on financial stability, given its limited role in meeting the financing needs of the economy, and the bank-based structure of the financial sector. The impact of the *wealth effect* however, cannot be ignored, as indicated by the decline in value of investments in investors' accounts maintained with the Central Depository Company (CDC).

At the end of the day, an efficient financial system is one which is diversified, and in which all components function in meeting the financing needs of the economy. Not only does Pakistan's economy continue to have an undue reliance on the banking sector, the emergence of the government as the major user of bank credit has led to the crowding out of the private sector even as the economy is headed towards a gradual recovery.

Notably, banks have to focus on their core business activities i.e. channelize funds to private sector business enterprises, instead of diverting funds to investments in government securities and extending loans to the PSEs and the government sector. While this strategy may work well in improving the risk profile of the banking system, it can have potentially negative consequences in an economy which is gradually getting back on its feet.

State Bank of Pakistan derives its goal of safeguarding financial stability from its legal mandate specified in the SBP Act, 1956. To achieve this objective, SBP strives to play a facilitating role in enhancing the growth of the financial sector with a principles-based approach to effective regulation and supervision. The financial system in Pakistan has shown strong resilience to shocks emanating from challenging macroeconomic environment and some structural weaknesses especially in case of the NBFIs. With the exception of few small weak banks, the banking sector was able to absorb the loan losses stemming from the deterioration in asset quality. While huge government borrowing and credit demand from the PSEs helped banks in making profits on investments along with prudently managing their credit risk, this has essentially served to crowd out the private sector. Consequently, the flow of bank credit to the private sector remains hampered. Being mindful of the adverse consequences of this situation for economic recovery and financial stability, SBP places great emphasis for banks to play their role as agents of development in the economy, and extend the outreach of financial services both in terms of geographical access as well as underserved sectors such as agriculture, SME and microfinance, in order to substantially enhance financial penetration and depth from the existing low levels (**Table 2**).

Table 2: Indicators of Financial Deepening

percent

Indicators	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10[1]
M2 to GDP	36.6	36.2	39.6	42.6	44.1	45.6	45	46.7	44.8	39.2	39.2
Money multiplier	2.8	2.9	3.0	3.1	3.2	3.3	3.4	3.4	3.2	3.4	3.3
Currency to total deposits	34.3	32.9	33	31.3	30.3	29	27.7	26.1	26.5	28.9	32.2
Currency to M2	25.4	24.6	24.6	23.8	23.2	22.4	21.7	20.7	20.9	22.4	24.3
Currency to GDP	9.3	9.0	9.9	10.3	10.2	10.1	9.6	9.6	9.4	8.8	9.5
PSC to M2*	49.5	49.2	45.6	46.7	51.2	57.7	61.9	61	61.6	56.6	55.9
PSC to GDP*	18.1	17.8	18	19.9	22.6	26.3	27.8	28.5	27.6	22.2	21.9

* PSC = Private Sector Credit, [1]. up to 24-Oct-2009

Source: SBP