EXECUTIVE SUMMARY: FINANCIAL STABILITY AND RISK ASSESSMENT

This section presents an assessment of financial stability for 2009 (CY09) and the first half of 2010 (H1-CY10), based on available data and information on various components of the domestic financial sector, operating in the larger macroeconomic environment. The objective is to highlight the key risk factors and vulnerabilities currently prevalent in the financial sector which have potential implications for financial stability in the future.

As 2010 draws to a close, reverberations of the Global Financial Crisis (GFC) which started in 2007 continue to be felt in various parts of the Eurozone, most recently in the form of the sovereign debt crisis in Greece, Portugal and Ireland. Emerging economies like Pakistan remained largely insulated from a direct impact of the GFC, given the low level of integration with the global financial system, and consequently, virtually negligible exposure to the toxic assets responsible for the contagion impact. These economies were, however, indirectly impacted once the financial crisis gave way to a recession in advanced economies, given trade linkages and drying up of capital flows. The process of global economic recovery, which had started earlier than expected, is now starting to wane and is propelled forward by the growth potential in emerging economies.

Notably, expansionary fiscal policies driven by large financial rescue programmes, and the need for providing necessary stimulus to ailing economies during the GFC, essentially led to a situation where the fiscal position of major advanced economies deteriorated dramatically, to levels not seen since the Second World War. The extent and pace of deterioration (government debt to GDP ratio exceeding 100 percent and even higher in some cases) has been such that stringent austerity measures are now being frantically adopted and implemented to bring down the budget deficits to more sustainable levels. This is in recognition of the fact that high levels of public debt raised to finance these deficits, serve to increase these economies' vulnerabilities to adverse shocks, reduce their long-run growth potential and endanger prospects of monetary stability.

Pakistan, on the other hand, was suffering from rising fiscal deficit and public debt burden even before the onslaught of the GFC. Structural weaknesses in the process of revenue generation, significant rigidities in government spending and the necessity of spending sizable sums to counter the acts of terrorism, led to increase the fiscal deficit to 6.3 percent of GDP in FY10, from 5.3 percent in FY09. Expansion in quasi-fiscal operations (which includes lending to public sector agencies and financing government's commodity operations), together with a weak cash management system, added to the fiscal burden which is increasingly financed from the financial system.

Financial Stability Assessment

An attempt to assess financial stability in the prevalent circumstances presents a conundrum of sorts. Notably, 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. The size of the domestic financial sector increased to Rs. 9.2 trillion by end-June CY10, with a growth of 20 percent since end-CY08 (**Table 1**).

With such a heavy reliance on the banking system for meeting the financing needs of the economy, the continued presence of the government with an insatiable appetite for banking system resources, is a key risk factor in: (1) achieving the basic objective of the financial system in Pakistan i.e. enhancing financial sector development and penetration, and (2) meeting the financing needs of the private sector, and thus jeopardizes prospects of long term growth and investment. Both these factors have serious implications for monetary and financial stability.

Table 1: Asset Composition of the Financial Sector									
	CY02	CY03	CY04	CY05	CY06	CY07	CY08R	CY09	H1-CY10
Asset (bln Rupees)	3417.7	3943.7	4518.3	5201.5	5957.5	7115.2	7710.6	8866.2	9266.1
Growth Rate (percent)	12.3	15.4	14.6	15.1	14.5	19.4	8.4	15.0	12.0*
As percent of Total Assets									
MFIs	0.1	0.1	0.1	0.2	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	5.3	5.1
Insurance	3.8	3.8	3.8	3.9	4.1	4.6	4.4	4.4	4.4
CDNS	24.9	25.0	21.7	18.0	16.1	14.6	14.8	16.6	17.1
Banks	65.0	64.5	67.3	70.4	71.9	72.7	73.0	73.5	73.2
As percent of GDP									
MFIs	0.1	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	3.4	3.2
Insurance	2.8	2.9	2.8	2.9	3.0	3.4	2.9	2.8	2.8
CDNS	18.2	18.8	16.1	13.3	11.7	10.8	9.8	10.8	10.8
Banks	47.7	48.3	50.1	51.8	52.4	53.9	48.1	47.6	46.2
Overall	73.3	75.0	74.4	73.7	72.9	74.1	66.0	64.7	63.2

R= Revised, * YoY

The Government in Pakistan has had a historically traditional recourse to central bank borrowing for financing the budget deficit, with consequent challenges for monetary management. For one, borrowing from the central bank is akin to printing money, feeds directly into inflationary pressures and tends to increase currency in circulation. In effect, such monetization of the fiscal deficit dilutes the monetary policy stance, as has been the case in Pakistan where the impact of monetary tightening in controlling inflation has only been partially successful given government's heavy reliance on borrowing from the State Bank of Pakistan (SBP). Such financing thus jeopardizes monetary stability. Empirical evidence suggests that persistently high inflation has a negative correlation with economic growth. A study on the reasons for the rise in NPLs in the banking system, conducted for FSR 2008-09, concluded that cyclical patterns in the economy have an inverse relationship with non-performing loans, the major indicator of the quality of advances of the banking sector. Rising NPLs in a recessionary period, as seen most recently in CY08 and CY09, have a detrimental impact on banks' financial health, and hence on financial stability.

In recognition of the negative consequences of borrowing from the central bank for both monetary and financial stability, and given the need for compliance with the IMF-SBA's structural performance criteria which limits net quarterly borrowing from the central bank to zero, the government then looks to meet its funding needs from commercial banks through T-Bills and PIBs auctions and borrowing for commodity operations, in addition to quasi-fiscal borrowing by Public Sector Enterprises (PSEs). Such borrowing carries implications for banks' incentives to undertake risky ventures when profitability can still be maintained, or even enhanced, by investing in government securities or lending to the public sector, especially where such lending is backed by government guarantees. This is particularly true for banks looking to consolidate their risk profile given the rising stock of NPLs in the last two years.

Finding the government to be a captive client, banks' behavior to lend more to the government and to public sector agencies impedes the process of productive activity in the economy, more so in a period of rather gradual economic recovery. This causes crowding out of the private sector, to the extent that demand for credit exists, which in turn carries long term implications for economic growth, with feedback impact on banks' asset quality and hence on financial stability.

The conundrum referred to earlier arises from the fact that on the face of it, financial system stability seems to have improved in CY09 and H1-CY10, simply because of the *shift* in banks' focus from the riskier private sector to investments in government securities, lending to public sector agencies and quasi-fiscal financing. This shift in focus has had a favorable impact on banks' Capital Adequacy Ratio (CAR) due to growth in low risk-weighted assets. However, it is exactly this shift and the reallocation of banks' loanable pool of funds, which is the underlying potential source of financial *instability.* Notably, share of the public sector in outstanding advances has increased from 9.4 percent in December CY03 to 18.4 percent by June CY10, whereas the share of private sector loans has decreased from 90.6 percent in December 2003 to 81.6 percent in June 2010 – a trend with an inherent element of potential *instability*, if not reversed.

Going forward, the current stock of MRTBs at Rs 1,347.2 billion,[1] the continued dependence on the IMF SBA and the expected promulgation of SBP Amendment Bill 2010,[2] which restricts SBP not to give direct or indirect credit to the federal and provincial governments or to any other public agency or state owned entity with the exception of intra-day credits to ensure the smooth functioning of the payment system, suggest that government's dependence on commercial banks will increase even more in 2011 and beyond. Additionally, the emphasis on monetary tightening in a period of rising inflation can also have a potentially detrimental impact on banks' NPLs.[3]

Executive Summary

Banking System

On an overall basis, banks' financial position in CY09 reflects resilience to various adverse developments in the economy, as discussed in detail in Chapter 4.

As a stable source of funding for the banking system, with consequently little reliance on borrowings, bank deposits have a key contribution in maintaining financial stability. Deposits grew by 13.5 percent in CY09, and 8.2 percent in H1-CY10, bringing the total deposit of the banking system to Rs. 5.1 trillion by end-June CY10. This bodes well for enhancing prospects of financial stability, especially keeping in view the slowdown in deposits growth in CY08. Deposit growth is largely driven by the growth in home remittances of 23.9 percent (in USD terms), gradual economic recovery, and the substantial increase in government borrowing, a portion of which flows back into the banking system in the form of deposits. Healthy deposit growth is indicative of banks' resilience to the competition from the National Savings Schemes (NSS), which generally offer a higher rate of return than bank deposits. The rates on NSS schemes were last raised by the government in October CY10 in an effort to tap non-bank sources of financing, and limit central bank borrowing on a quarterly basis (detailed assessment in Chapter 3).

On the asset side, banks' exposure to the government increased significantly during CY09, with particular concentration in the power sector due to the ongoing issue of circular debt, and continued increase in lending to PSEs and commodity finance in general. The risk of the gradual build-up of yet another circular debt in the commodity financing sector, highlighted in the risk assessment for FSR 2008-09, has not assumed alarming proportions as in case of the circular debt problem in the power sector, however concerns arise when these self-liquidating loans are required to be rolled over by the government instead of being retired with the proceeds from the sale of the financed commodities. Banks are now pricing in the

[1] As at November 12, 2010.
[2] These amendments require the government to restrict its outstanding borrowing from SBP to only 10 percent of its revenues. A 5-year period is given to the government to bring this outstanding borrowing (currently at 65 percent of revenues) from the day of enactment.
[3] To assess the impact of the rising policy rate as one of the factors for NPLs growth, a macro-stress testing exercise carried out in FSR 2007-08 calculated that an increase of 100 bps in real interest rates will increase the NPLs to loans ratio by 35 bps.

cost of liquidity stuck in these loans in the overall pricing structure for loans to government, causing price distortions such that the government is charged more than the relatively riskier private sector. Notably, pricing for loans for commodity operations is based on 3-month KIBOR + premium ranging from 100-275 bps, and is higher than the T-Bill cut-off rate over the period of assessment (detailed assessment in Chapter 2).

With an eye on risk consolidation in CY09, banks directed their loanable pool of funds to investments in government securities by participating actively in T-Bill and PIB auctions. Consequently, the asset composition of the banking sector underwent significant changes, with a rising share of investments in total assets while advances grew by only 2.1 percent. This particular composition of banks' assets has continued in H1-CY10.

As also highlighted in FSR 2008-09, 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. Concentration of bank credit in the textile sector with almost 20 percent share in total loans is naturally large given its importance in the economy. A source of concern is that the infection ratio in textile sector is relatively higher than those of other sectors. Given the current rising trend in domestic and international cotton prices, the textile sector has started to show substantial signs of improvement, and it is expected to reassert is dominance as a strong performer in FY11, with a corresponding improvement in its loan servicing capacity.

As mentioned earlier, the increasing concentration of loans to the power sector at 9.5 percent of total loans as of end-June CY10 is another indicator of sectoral concentration. Notably, in periods of slow economic growth, banks prefer to lend to better performing economic sectors, and within these sectors, to strong corporate clients. This behavior causes a rise in the concentration of exposure.

After the biggest ever increase in the stock of NPLs (since CY97) in CY08 alone, the pace of deterioration in the quality of advances slowed down considerably in CY09, such that NPLs increased by 24.2 percent to Rs. 432 billion by end-CY09, and further by 6.4 percent to Rs. 460 billion by end-June CY10.

Given the strong correlation of NPLs with economic activities, a major portion of the increase in NPLs since CY08 was primarily of a cyclical nature due to the deceleration in real GDP growth, with negative implications on incomes and hence the repayment capacity of the average borrower. In a similar vein, the gradual process of economic recovery has had an impact in slowing down the accelerated pace of growth of NPLs in CY09. Notably however, a large part of this deceleration also emanates from banks' risk-averse behavior.

The classification of NPLs into various categories lends credence to this observation, as unlike CY08 when the initial categories (requiring partial provisioning) contributed 62.4 percent in the growth of NPLs, in CY09 their contribution declined to -4.7 percent, indicating negative growth in incremental NPLs in these categories. Notwithstanding, NPLs booked in partially provided initial categories in CY08 matured into losses during CY09, and as a result the share of the loss category in total NPLs increased.

Irrespective of the factors responsible for the rising volume of NPLs, the high infection ratio has implications for the overall financial performance of banks. During CY09, banks booked Rs. 97 billion as loan loss expenses, lower than the amount of Rs. 106.1 billion booked in CY08. This slight reduction is in line with the decelerated growth of NPLs. However, these expenses carry implications for banks' profitability, especially when majority of the outstanding NPLs (65.5 percent) are categorized in the fully provided loss category. Nevertheless, a substantial reduction in the proportion of initial categories in gross NPLs

(OEAM, Substandard and Doubtful) indicates that in CY10, the provisioning requirement would fall, with a consequent positive impact on banks' bottom line. Provisioning coverage was maintained in CY09 at 69.9 percent of NPLs compared to 69.6 percent in CY08, increasing to 73.2 percent by end-June CY10. Given that banks have focused more on investments in expanding their asset portfolio, especially in risk-free government securities, therefore future provisioning requirements are not expected to rise substantially. Nonetheless, banks need to step up their efforts to improve the quality of the loan portfolio by closely monitoring loan recovery prospects and restructuring of existing classified loans.

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 20.4 percent, from 19.4 percent in CY08, compared with only 5.6 percent for CY07. However, some comfort is drawn from the decline in the ratio to 17.2 percent by end-June CY10.

Banks' ability to absorb unexpected losses is on a strong footing due to the increased exposure to low risk-weighted assets, especially investments in government securities. 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-CY09 increased to 14.0 percent against the minimum requirement of 10.0 percent. This is partly due to banks' portfolio rebalancing from advances to investments, especially in risk-free government securities. The anti-cyclical policy support extended by SBP in response to the difficult operating environment, as reflected in the enhanced concession in the FSV rules in October CY09 and rationalization of the MCR requirements (effective from 2010), are attempts to further ease pressure on banks profitability and capital adequacy."

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.

Non-Bank Financial Institutions

Moving on to other components of the financial sector, the dormant element of funding risk in case of Non-Bank Financial Institutions (NBFIs) which emerged as a strong threat to their commercial viability in CY08, continues to be a source of systemic risk. 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 (detailed assessment in Chapter 5).

Insurance Sector

Insurance sector, on the other hand, continues to provide requisite support to the economy despite its small size and low penetration. Notably, it is the only component of the financial sector with a predominant ownership of the government in all three spheres i.e. life (State Life Insurance Corporation), non-life (National Insurance Corporation Ltd) and re-insurance (Pakistan Reinsurance Corporation Ltd) (detailed assessment in Chapter 6).

While SLIC has a virtual monopoly in life-insurance business, it is interesting to see the level of persistently high but declining level of concentration in the non-life business, despite the presence of NICL. This concentration of business is clearly visible in the top 5 and top 10 companies in the sector, where the total number of companies was 34 at end-CY09. Clearly, the non-life sector has a large number of small players, indicating market fragmentation.

While the presence of the government was an important pre-requisite of the insurance sector in the country, it now needs to be phased out in a gradual manner by allowing market forces to take hold, the need for private sector companies to increase outreach and enhance customer awareness about the significance of insurance not only in its capacity for risk indemnification, but also as a lucrative savings instrument.

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.

Financial Markets

Having given an assessment of financial institutions, this section gives a summary assessment of the financial markets. In contrast to the volatility in global financial markets since the inception of the GFC, financial markets in Pakistan have continued to strengthen primarily due to the low level of integration with global financial markets, and in response to the ongoing reform process, and provide requisite support to the financial system in performing its function of financial intermediation.

Specifically, the functioning of the money market in FY10 gained strength from the ongoing policy measures and supported both the SBP monetary policy stance and financial sector stability. Although persistent increase in government borrowing from the banking system resulted in intermittent pressures on market liquidity during the year, robust deposit growth and net expansion in NFA of the banking system partly offset these pressures. Moreover, SBP also provided liquidity support to the market through OMOs and discounting when needed. As a consequence, the overnight money market repo rate moved in tandem with the policy stance through most of FY10.

The domestic foreign exchange market also benefited by strong growth in worker remittances, marginal increase in foreign investment flows, receipt of tranches of IMF loans and rising trade activities in FY10. As a result, country's overall reserves reached a level of US$ 16.9 billion by end-June FY10. These developments in turn allowed SBP to continue to liberalize the foreign exchange market. The most important measure on this front is the complete shifting of oil payments to the interbank market by December FY10. This policy shift was supportive in containing a further drain of SBP reserves. More encouragingly, the relative stability in the exchange rate during FY10, despite shifting of oil related payments, is primarily a reflection of the increasing depth of the inter-bank foreign exchange 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. Not surprisingly, the significant volatility seen in CY08 and subsequent gradual pace of recovery 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.

In the current circumstances, while it may be prudent for banks to allocate their loan and investment portfolio in favor of public sector to maximize profits in the short run and minimize risks, a long term strategy requires an allocation of their portfolio in favor of the private sector, which is the main engine of growth and productivity.

At the moment, the flow of bank credit to the private sector remains hampered, and the basic objective of financial intermediation i.e. efficient allocation of resources, is not being met. A continuation of this trend, if not preempted and reversed on a priority basis, will negatively impact financial penetration and depth which is already at a low level (**Table 2**).

Table 2: Indicators of Financial Deepening

percent

Indicators (end-June)	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11**
M2 to GDP	36.6	36.2	39.6	42.6	44.1	45.6	45.0	46.7	44.8	40.3	39.4	40.1
Money multiplier	2.8	2.9	3.0	3.1	3.2	3.3	3.4	3.4	3.2	3.4	3.4	3.2
Currency to total deposits	34.3	32.9	33.0	31.3	30.3	29.0	27.7	26.1	26.5	28.9	28.9	32.3
Currency to M2	25.4	24.6	24.6	23.8	23.2	22.4	21.7	20.7	20.9	22.4	22.4	24.4
Currency to GDP	9.3	9	9.9	10.3	10.2	10.1	9.6	9.6	9.4	9.0	8.8	9.8
PSC to M2*	49.5	49.2	45.6	46.7	51.2	57.7	61.9	61.0	61.6	56.6	52.3	51.3
PSC to GDP*	18.1	17.8	18	19.9	22.6	26.3	27.8	28.5	27.6	22.8	20.6	20.6

* PSC = Private Sector Credit, ** up to 29th October 2010.

Source: SBP