EXECUTIVE SUMMARY

Global and Domestic Developments: Financial Stability Implications

The benign global macroeconomic environment which prevailed for an extended period until a year ago, and was even termed as the 'great moderation', gave way to a financial crisis with global reverberations in August 2007: something which would have seemed like a far-fetched idea at best while the going was good, with easy access to credit, low risk premiums, and the average (four-year) growth rate for the global economy at 5.0 percent. The crisis emanated in the sub-prime mortgage loan portfolio, which incidentally thrived on the (flawed) assumption of continued increases in house prices, and entered a tumultuous new phase in September 2008 which badly shook the confidence in global financial institutions and markets.

Central banks' hard-earned credibility in the domain of monetary stability, with an extended period of low and stable inflation during this period of great moderation, has also come under close scrutiny due to some of the unorthodox measures employed by them to overcome and minimize the threats to financial stability.

Pakistan, which remained largely unscathed from a direct impact of the crisis, has been more concerned with issues relating to monetary stability due to rising inflation since before the advent of the crisis. With a thriving banking sector, increasingly resilient to a wide variety of shocks, increasing but still relatively less correlation of domestic financial markets with global financial developments, a proactive and vigilant regulatory environment, and most importantly, no direct exposure to securitized instruments, risks to financial stability were largely contained and well-managed as the crisis unfolded and impacted the financial sectors in advanced economies.

However, growing macroeconomic imbalances and other adverse developments have resulted in credit stresses of its own kind. Pakistan has faced a challenging economic environment since the last quarter of 2007, with growing macroeconomic imbalances, high levels of inflation, an expansionary fiscal policy and a plethora of factors emanating from the domestic political environment. The growth rate moderated in FY08 to 5.8 percent due to a combination of factors, in particular the impact of the rise in the global commodity prices, specifically oil and food, showing up in domestic inflation and the growing macroeconomic imbalances.

With a visible slowdown in economic growth in leading developed economies as a consequence of the protracted duration of the crisis, and spillover effects from increasingly fragile financial sectors in the advanced economies, repercussions from second round effects cannot be disregarded. While assessing the impact of these second round effects on the domestic economy and the financial sector, it would be well to bear in mind that a factor peculiar to Pakistan i.e. political instability since November 2007, was also pervasive during most of the period under assessment. Importantly, it would be difficult to disentangle the combined influences of the financial markets turmoil, the bizarre trends in the commodity market, and the largely unstable internal conditions which almost exactly coincided with the unfolding of the crisis.

Macroeconomic stability in Pakistan has been under stress on account of both domestic and external vulnerabilities. The fiscal stress continues to be high. After registering record borrowings of Rs 689.0 billion from the central bank in FY08, government borrowings have continued to rise unabated in FY09 also. This excessive recourse to the central bank continues to cause complications for effective liquidity management. Weaknesses in the external sector, in particular, constitute a major source of concern. Despite the consistently strong inflow of workers' remittances and a reasonable export performance, the external current account deficit

remained at an unsustainable level of 8.4 percent of GDP in FY08. With considerable slowdown in private as well as public financial inflows, the financing gap has widened and consequent outflow of foreign exchange drained the rupee liquidity from the system, straining the domestic money market: the Net Foreign Assets (NFA) of the banking system have depleted by Rs 317.4 billion in FY08 (and 346.4 billion during the first few months of FY09).

The unprecedented rise in commodity prices in 2007 and the first half of 2008, has had a most damaging impact on Pakistan's economy. Pakistan was one of the most severely hit economies due to the surge in global commodity prices, which peaked in mid-July 2008, and which have seriously impaired its macroeconomic stability. The twin deficits, brought down to sustainable levels in the recent past, had started to widen since FY05, but witnessed an unexpectedly unprecedented rise during FY08. Besides the excess demand pressures already persisting in the economy, a key source of these macroeconomic imbalances was the massive rise in commodity prices in the international market, given the dependence of the country on oil and food imports.

The other channel of contagion effect for the economy is through trade volumes. Evidence shows that countries with the strongest trade links with the United States and Europe are slowing down markedly.

While the exports figure for the first four months of FY09 has shown an increase of 16.3 percent YoY, continued downside risks to the growth of the exports base in Pakistan can be mitigated by focusing on high growth destinations, and striving to diversify the product base. Encouragingly, cement exports have increased by 11.7 percent during FY08 (in response to demand from Middle East, India and Africa), while rice had the largest contribution (18.0 percent) in the overall export increase during the year.

Pakistan, which had re-entered international capital markets in 2004 on the back of improved macroeconomic performance, and currently has 4 outstanding sovereign bond issues, faced a challenging environment in FY08. External financing inflows into Pakistan have deteriorated considerably since October 2007, impacted both by the global economic conditions as well as the uncertainty caused by domestic economic and political factors. Importantly, while FDI flows were strong and even exceeded marginally the flows in FY07, foreign portfolio investment (FPI) which takes a more short-term view, was more fickle and all but disappeared in FY08, after registering a tremendous growth in FY07.

As one of the fastest-growing Asian economy, Pakistan's financial sector has undergone a sea-change in the last decade or so. Predominantly bank-based in performing the function of financial intermediation, the financial sector is strong and resilient, with a strong regulatory framework. While capital markets are still small and shallow in terms of liquidity and the size of new offerings, the ongoing implementation of financial sector reforms is gradually addressing these issues, with the broad objective of enhancing financial sector depth. Economic growth in Pakistan on the other hand, is in contrast with Asia, based on a consumption-led model, with low levels of financial savings, and a rather gradual increase in the investment to GDP ratio.

Given this confluence of factors, challenges to financial stability in Pakistan are largely transmitted through the real sector. Given the growing macroeconomic imbalances and high inflation, stability of the financial sector can be potential jeopardized by the spillover effects on customer's balance sheets, from adverse developments in the macroeconomic environment, as well as repercussions from monetary instability, as evidenced in the high inflation and current liquidity constraints being faced by financial institutions. The economy's capacity to service the

persistent and large external account deficit will remain in question until the macroeconomic situation is visibly improved, and inflation is reined in.

Dimensions of Monetary and Financial Stability

Irrespective of whether they directly regulate and supervise the financial sector, central banks around the globe are responsible for maintaining financial stability alongwith their primary objective of monetary (or price) stability. Two aspects of monetary and financial stability are widely debated, regarding: (a) the formal mechanism that a central bank must adopt in order to monitor and maintain financial stability, and (b) whether these objectives are closely aligned or entail any trade-off in the associated policy-response.

The framework for maintaining financial stability is still evolving largely because of the lack of consensus on the varying institutional structures for banking supervision and central banking functions around the world. Another point of divergence is that the objective of safeguarding financial stability does not have a single purpose which can be attained with a specific set of instruments. Moreover, there is no single accepted definition of financial stability that can be used to develop a robust framework; various central banks have adopted their own definitions. Despite the nature of complexities involved in the process, the significance of a formal mechanism for safeguarding and ensuring the stability of the financial system is irrefutable. The focus of this formal mechanism for financial stability assessment is on identifying the sources of vulnerabilities in the financial system which can lead to potential risks, and the channels through which these risks are propagated, such that pre-emptive policy actions can either minimize the occurrence of such vulnerabilities, or ensure an optimal level of preparedness to address them when they do.

The mandate for maintaining financial stability in Pakistan rests with the State Bank of Pakistan (SBP) in its capacity as the central bank and the regulator of the banking sector. Given the division of regulatory responsibilities, SBP's existing framework for financial stability assessment is primarily focused on the stability of the banking system. In terms of organization, the assessment is undertaken as a shared responsibility within the central bank: the Banking Policy and Regulation (BPR) group undertakes policy formulation on the basis of the off-site surveillance of the banking sector in monitoring developments and keeping an active dialogue with banks. The Banking Supervision group, on the other hand, undertakes both off-site enforcement and on-site inspection. The newly established Financial Stability Department (part of the Monetary Policy and Research group) is mandated to independently assess financial stability from a policy-formulation and research perspective, and is also responsible for preparing the annual Financial Stability Review (FSR) and for developing a macro-prudential framework for financial stability. As part of its financial stability assessment mechanism, SBP also undertakes an independent review of the Non-Bank Financial Companies (NBFCs), the Insurance sector, Pension Funds, and Capital Markets, though these segments of the financial sector are under the oversight of the SECP.

Regarding the trade-off between monetary and financial stability in terms of the required policy response, recurring emergence of financial imbalances in an environment of stable prices, as seen most recently in events leading up to the 2007 (and ongoing) financial crisis in the US, seriously undermine the importance of price stability as a sufficient condition for financial stability. Similarly, financial crises in the United States during the 1920s and 1990s, and Japan in the late 1980s, are widely used examples of financial instability in an environment of stable prices. In addition to the emergence of financial imbalances in a benign inflationary environment, Borio et al (2001) and Borio and Lowe (2002 & 2003), reflect on a number of structural changes in the economy, which in their view constitute a *new environment*. This is primarily characterized by: (1) low and more stable inflation under a well-established anti-

inflationary credibility of central banks, (2) liberalization of financial markets, and (3) moderation of business cycles.

The relevance of this debate to Pakistan is assessed by reviewing changes in the macroeconomic environment of the country. Descriptive analysis clearly shows that there are indications that, barring inflationary pressures since May 2007 or so, the economy is moving towards a relatively low and stable inflationary environment as compared to the past: recent resurgence of inflation is seen as an outlier given the long-term perspective of this analysis. Domestic bank credit has witnessed substantial rise in the recent past, also coinciding with strong increase in asset prices.[1] However, there is little evidence of moderation in output fluctuations. All this suggests that the macroeconomic environment in Pakistan exhibits some signs of a shift as envisaged by the New Environment Hypothesis (NEH). In terms of policy implications, it may be noted that the SBP is not strictly an inflation targeting central bank in the first place. It also already takes into account the presence of financial imbalances in the economy (with potential feedback effects into the conduct of financial stability) in monetary policy formulation. Specifically, the impact of changes in indicators which are common to the conduct of both monetary and financial stability, such as interest rates, savings investment balances, credit growth, credit spreads, level of exchange rate and volatility, equity prices, sectoral distribution of credit etc. generally feed into decisions on the monetary policy stance.

Stability of the Banking System

Despite the challenging domestic and international economic environment, the banking sector in Pakistan has shown strong resilience to early headwinds on the back of a robust capital base and healthy profitability. Heavy provisioning on account of incremental NPLs during CY07 and H1-CY08, withdrawal of the benefit of the Forced Sale value (FSV) of collateral against non-performing loans during CY07, and write-offs amounting to Rs 60.1 billion during CVY07 were all absorbed by the banking system without showing any sign of instability. Key performance indicators present a healthy picture of the sector during CY07. The bottom line continued to remain in a comfortable zone, with after tax return on assets (ROA) of 1.5 percent for the year: a more sustainable level of profitability compared with the peak level of 2.1 percent in CY06. The overall net profit of the banking sector for CY07 was Rs 73.3 billion (approximately USD 1.0 billion). This was shared across a large number of banks, as 23 out of 39 banks, with a cumulative asset share of 87.2 percent, have their respective ROA at more than 1.0 percent at end CY07.

In addition to healthy profitability, capital to risk weighted asset ratio (CAR) saw a rise of 50 bps to reach 13.2 percent by end CY07: well above the minimum requirement of 8.0 percent under the prudential regulations.[2] Distribution of CAR across the banks shows that 30 out of 39 banks, with cumulative asset share of 73.8 percent, have their respective CAR at more than 10.0 percent at end CY07. The core capital to risk weighted asset (RWA) ratio of 10.5 percent provides further comfort about the risk-bearing capacity of the banking sector. The apparent risk to the capital base has also remained on lower side as the net NPLs to capital ratio has dipped to an all time low level of 5.6 percent by end CY07, against 9.7 percent in CY06.

The positive changes in the risk absorption capacity of the banking system are accompanied with noticeable changes in some risk factors which require close vigilance. On the credit risk front, despite slower growth of 10.8 percent in the loans and advances of the banking sector (lowest in the last five years) during CY07, credit growth in excess of 25.0 percent per annum during CY03-06 continues has been a source of concern, in terms of its implications on the quality of the credit

1 Recent market decline, specifically since April 18, FY08, is again seen as an outlier.

[2] Minimum requirement on CAR has now been increased to 10.0 percent, and banks and DFIs have been advised to meet this requirement by 31st December 2009. For details, please see BSD Circular No.19 dated September 05, 2008 and BSD Circular No 30 dated November 25, 2008.

portfolio. Credit concentration stands out as an even bigger concern, as the top 0.5 percent of total loan account holders have a 67.7 percent share in banks' advances, with an average loan size of Rs 68.6 million. Sectoral composition of loans also indicates concentration of credit in the corporate sector, which accounts for 59.0 percent of banks' loan portfolio (as of end June CY08), with an increase in share of 5.7 percentage points over CY06. Furthermore, loans to the textile sector constitute 18.5 percent of the total loans as of end CY07, indicating another source of concentration risk. The current composition of the credit portfolio, along with an obvious deterioration of macroeconomic indicators during H1-CY08, further aggravates concerns about the potential credit risk.

Traditional indicators of credit risk (asset quality) indicate that NPLs of the banking sector increased by Rs 30.6 billion (YoY growth of 17.4 percent) in CY07, to reach Rs 206.1 billion by end CY07. The NPLs to loan ratio also saw a rise of 30 bps during the year to reach 7.2 percent, as against the continuous decline seen since CY00. Fortunately, this increase is not shared across the industry, as banks with NPLs to loan ratio of less than 5.0 percent own 97.7 percent share of assets. Moreover, a single factor sensitivity analysis also reflects the stability of banking system towards credit risk. A 10.0 percent hypothetical increase in NPLs, with provisioning requirement of 100.0 percent, is likely to reduce the CAR of commercial banks by only 50 bps. Similarly, a 10.0 percentage point (assumed) increase in the NPLs to loans ratio of consumer finance (which incidentally had the lowest infection ratio of 4.4 percent in CY07) is expected to cause a decline in the CAR of commercial banks by 90 bps to 12.7 percent. All other such shocks have a relatively smaller impact on the CAR of commercial banks.

Although indicators of asset quality do not pose an immediate threat to the stability of the banking sector, the backward-looking nature of this assessment, and the deterioration in the operating environment of the banking system in recent months (specifically since November CY07) requires strong vigilance of the loan portfolio. The latest data (as of end H1-CY08) indicates that the NPLs to loans ratio has risen further by 55 bps to reach 7.7 percent. Net NPLs to loans ratio, another indicator of asset quality, has reached 1.3 percent by end H1-CY08, compared to 1.1 percent as of end CY07. In line with the new provisioning requirements laid out by SBP, the banking system was required to create provisions of Rs 28.5 billion during H1-CY08 compared to only Rs 11.2 billion during H1-CY07.

Healthy growth in the loans and advances portfolio of 8.7 percent during the first half of CY08 pushed its share in the overall assets of the banking sector up to 53.0 percent compared to 52.0 percent as of end CY07. Investments, the second largest component of assets, recorded a decline of 11.9 percent over the same period. However, these changes in the asset mix have had a negligible impact on the liquidity position of the banking sector due to the healthy growth of 8.7 percent in banks' deposits over the same period. It may be noted that the impact of the most recent monetary tightening measures and the introduction of a minimum rate of return of 5.0 percent on all types of savings deposits with effect from June 1, CY08, on various financial indicators of the banking sector, is yet to be seen. The minimum savings deposit rate will increase the cost of funding, especially for the big banks. This measure, aimed at ensuring a minimum return to the depositors, will also help in narrowing the high banking spreads.

Concentration and Competition in the Banking System

While the banking sector in Pakistan is widely acknowledged for its rapid progress in recent years, debates still abound about the concentration of business and the associated impact on efficiency and the evolving market structure of the industry, especially since competition is an important dimension of efficiency. This is of particular relevance at a time when the industry has undergone a structural transformation due to consolidation in the last few years, a process which is expected

to continue in view of the recent announcement by the central bank which aims to increase the Minimum Capital Requirement to US$ 300 million by 2013. Consequently, the emergence of organizations which are “too big to fail” and the significant role of large foreign banks and their subsidiaries raises concerns regarding the degree of market contestability in the industry, an issue which is explored at length in this chapter.

A value of less than 1000 for HHI for all three major indicators of the banking sector, improvement in other concentration ratios and a PR-H statistic which lies between 0 and 1, altogether suggest that the structure of the banking sector can at best be described as monopolistically competitive. This also seems to be in line with ground realities as banks compete aggressively to increase the size of their loan book, in addition to venturing into relatively new areas like SMEs, consumer and agricultural finance due to stiff competition in the corporate sector which has a limited client base.

On the issue of market contestability, the above findings and practical examples seen over the period of analysis, also support the conclusion that the banking sector in Pakistan, despite the presence of the implicit moratorium on bank licenses, is reasonably contestable.

However, the conclusion that the banking sector is monopolistically competitive needs to be qualified on the basis of the nature of the existing branch network, with the large five banks enjoying an extended outreach and the other banks still in the process of expanding their network.

Perspective on Consumer Finance in Pakistan

Rapid growth in the consumer finance portfolio of the banking sector in recent years has generated an ensuing debate, mostly critical of its alleged role in inducing consumption-led growth in the economy. Given that the total consumer financing portfolio currently forms around 12.0 percent of the total loans and advances of the banking sector in comparison with substantially larger portfolios in peer countries, and its conducive role in promoting economic development, concerns about the potential risks of this product need to be viewed in perspective. This is particularly so because the household sector in Pakistan is financially sound and under-leveraged by international standards.

Providing access to purchasing power to the middle-class consumer has been the most significant achievement of this product class. Not only have people been able to raise their standard of living by purchasing various consumption goods which were previously treated as luxuries in reach of only a few, demand for these goods has also led the manufacturing sector to expand its capacity, such that both backward and forward linkages have contributed to the expansion in economic activities. Banks’ auto loans product and loans for consumer durables, for instance, have been instrumental in this aspect. Though still small in proportion, the rising demand for mortgage finance reflects the individual consumer’s need and financial capacity, to acquire private ownership of housing units. Hence in promoting their consumer financing products, banks have played their due role in promoting economic development in the country.

Notwithstanding, given the pace of growth of this particular asset class and its increasing popularity, financial institutions need to carefully plan the expansion of their respective portfolios by minimizing the impact of the potential risks with adequate systems and resource support, in order to be able to sustain and positively avail the benefits of its growth.

Emergence of Financial Conglomerates: Need for Consolidated Supervision

In its efforts to introduce and implement financial sector reforms essential for the smooth functioning and progress of the financial sector, the State Bank of Pakistan (SBP) recently released its 10-year vision and strategy. One of the several reform pillars in the 10-year Strategic Plan is the implementation of consolidated supervision of conglomerate groups that include banks.

The rationale for implementing a consolidated approach to the supervision of banks is based on the need to protect banks from contagion risk. Unlike commercial businesses and many other financial institutions, banks are highly leveraged and support liquid liabilities with less liquid assets. They are therefore inherently vulnerable to swings in confidence. Where banks are closely associated with other institutions, either through common shareholding or common branding, their reputation and stability is exposed to weaknesses or perceived weaknesses in those other institutions. History is replete with cases of banks that have failed after being undermined by a subsidiary or affiliate.

The challenge for regulators is to facilitate conglomeration involving banks, while monitoring and managing the risks that conglomeration can pose to individual institutions and to the financial system as a whole. The importance of this challenge is reflected in the fact that a number of countries refuse foreign banks the right to enter their retail markets unless the local (host) regulator is satisfied as to the quality of the consolidated supervision carried out by the foreign (home) regulator.

Recognizing the various challenges, SBP has sought in principle approval from the requisite forums, for amendments in the Banking Companies Ordinance, 1962 (BCO) to enable it to supervise banks, groups and financial holding companies in line with international trends. Besides forestalling various risks, these amendments would enable significant benefits in the form of operational efficiency, lower costs, reduced prices and innovation in products and services.

Stability Assessment of Financial Markets

In contrast to developments in the global financial markets, financial markets in Pakistan continue to provide requisite support to stakeholders and market participants, and contribute to the stability of the financial system. FY08 represented a marked difference from FY07 in terms of the composition of the funds driving both the money and foreign exchange markets. Whereas FY07 had substantial inflows of both domestic and foreign liquidity, i.e. high Net Foreign Assets (NFA) with a reasonable level of Net Domestic Assets (NDA), FY08 had a heavier component of NDA due to the substantially higher government borrowing from the central banks, and rapidly declining NFA, which caused liquidity strains in both the money and foreign exchange market, in particular from November FY08 onwards. The ensuing operating environment proved to be a challenge for the central bank and market participants.

While the functioning of the **money market** continues to gain depth and aid the effective implementation of the monetary policy stance, it is still faced with some issues and challenges. The foremost issue is that in both the MTB and PIB auctions, the bid acceptance is yield driven and not volume driven, due to which market participants tend to anchor their perceptions of interest rates on the cut-off yield, rather than the discount rate as the main policy instrument.

Secondly, the investor base in government securities is not well developed. Banks dominate the holdings of MTBs and short and medium tenor PIBs. There are few investors at the long-end of the yield curve, with virtually only a single institutional investor holding 15, 20 and 30 years PIBs.

The secondary market continues to be thin and illiquid, and the investors exhibit a strong buy-and-hold behavior. Conducting more frequent, but smaller-volume (as opposed to less frequent, but larger volume) auctions could improve price discovery and reduce inventory risk for primary dealers. Until the investor base at the long end of the curve is developed, it will be difficult to move to volume-based acceptance of bids in auctions.

The **foreign exchange market** faced a challenging environment in FY08. While FY07 was characterized by record foreign inflows in the form of FDI, GDR floatations, foreign portfolio flows, privatization proceeds, workers' remittances etc., which helped finance the current account deficit, FY08, in particular from November onwards, saw a slowdown, and even reversal, of some of these inflows. These developments were driven by a host of factors in the global and domestic markets, such as rising commodity prices which added pressure to the import bill, an unstable political environment which carried with it a certain degree of uncertainty and consequently a negative impact on both domestic and foreign investor sentiment, and a more challenging global financial environment, which made access to international financial markets for raising funds more difficult. As a result, the trade deficit widened, foreign equity flows dried up, the privatization process was deferred and access to international markets was severely impacted, both due to the ongoing financial crisis, as well as the downgrading of Pakistan's sovereign rating by Moody's and S&P due to the weakening macroeconomic environment. Consistent flows of workers' remittances and still strong FDI flows (marginally higher in FY08 over FY07) constituted the bulk of forex inflows during the year. These developments exerted great pressure on the external current account deficit and the rupee-dollar parity, which depreciated by 11.5 percent during FY08, in marked contrast with relative exchange rate stability seen in the last few years.

Total volume of the **derivatives market**, on the other hand, has reached Rs. 393,239 million as of end-June FY08, from Rs. 212,611 million as at end-June FY07, a growth of almost 85.0 percent in one year. Bifurcation of outstanding (notional) market volume among different derivative classes shows that Cross-Currency Swaps continue to have a dominant share in the volume of total outstanding derivatives, while FX options and Interest rate swaps also have large shares. FRAs, however, continue to have a negligible share in total outstanding derivatives. While perceptions of stable exchange rate prevalent until Q2-FY08 were responsible for the increase in CCS transactions and FX Options, movements along the yield curve resulting from the increase in the discount rate (by 250 bps) in FY08 explains the decline in the share of PKR interest rate swaps by over 10.0 percentage points. Another reason is the lack of depth in the interbank market, which is essential for the development of the swap market. FRA volumes have also remained stagnant mainly due to the inactive interbank market. Incidentally, most of the transactions are concentrated among three ADDs, and their combined share constitutes 82.0 percent of total market share.

While financial sector reforms in Pakistan have led to a successful transformation of the banking sector into a healthy and profitable industry, with increasing competition, diversification of credit portfolio, and incentives and opportunities for both domestic and foreign players alike, the pace of development in the **capital markets** was slower in comparison. In a real sense, it was not until FY03 that trading volumes at the Karachi Stock Exchange (KSE), which was established soon after independence in September 1947, gathered momentum. From there onwards until April FY08, despite some upheavals along the way, the growth in the KSE-100 index and market capitalization has been unprecedented and remarkable. Subsequent to April FY08, however, the equity market has seen a period of rapid decline: the KSE-100 index has fallen by over 41.0 percent since touching its peak in April.

Notwithstanding the increase in value over the years, much of which has disappeared in the post-April FY08 period, the equity market in Pakistan has performed more as a trading platform rather than an avenue to raise financing. With limited listings, concentrated trading and a small amount of resource mobilization in the form of Initial Public Offerings (IPOs), listed debt issues etc, capital markets in Pakistan still have substantial room for improvement.

While issues related to macroeconomic stability and political noise impacted investor sentiments and contributed to the decline in value, lack of adequate corporate governance measures and an ad hoc approach to institute quick-fixes, exacerbated the situation. To halt the continuing decline in value, the KSE management placed a floor of 9,144 points on the KSE-100 Index from August 28, FY09 which served to prevent further decline and insulated the market from all kinds of global and domestic developments, while also reducing trading to negligible levels. Incidentally, there is no known precedence of such an action in any developing, emerging or advanced economy.

As against FY07, FY08 saw a net reversal of the substantial Foreign Portfolio Investment (FPI) flows. Despite the fact that the foreign investment in the equity market is not of a sizable amount, it does tend to sway the sentiment of the domestic investors. Depreciation of the rupee since H2-FY08 has added to the foreign investor's risk averse sentiments.

Risks to financial stability from banks' direct stake in the equity market remain low, as banks' equity investment has been 3.9 percent (average) of their total investments in the last four years, well within the limits specified is SBP's Prudential Regulations.

The listed corporate bond market, having taken its roots in Pakistan in 1995, still constitutes a miniscule portion of total financial asset, with the outstanding amount at less than 1.0 percent of GDP: a negligible as compared to other emerging economies. Issuances in FY08, however, had a substantially larger amount than in the previous 2 years. Moreover, in the last 3 years, most of the TFCs have been issued by banks and other financial institutions to meet their tier 2 capital requirements.

Islamic Banking

Islamic banking has made swift progress in Pakistan since its re-launch in 2002 as a parallel mode of financial intermediation alongwith conventional financial institutions, as evidenced by the commendable growth rate in excess of 60.0 percent per annum in both the assets and deposit base. Importantly, this parallel system is moving forward on the strength of its own merit, and not because of any religious or legal obligation or compulsion. As a proportion of the overall banking industry, the combined share of Islamic banks and stand-alone Islamic branches of conventional banks is 4.2 percent in deposits, and 4.3 percent in assets. In comparison with other countries, these shares reflect an impressive performance in a short span of 6 years: Bahrain, Malaysia and Indonesia have respective shares of 8.0 percent achieved over 30 years, 13.0 percent over 25 years and 1.7 percent over the last decade or so. To capitalize on the pace and momentum of this growth, SBP has recently launched its Strategic Plan for the Islamic banking industry, which envisions increasing its share to 12.0 percent of the overall banking industry by 2012.

The rapid growth is attributed to the entry of four new players in the market in CY06 and CY07. At present there are six Islamic banks (IBs) operating in Pakistan with a branch network of 228. Additionally, SBP has also allowed conventional banks to open stand-alone Islamic bank branches (IBBs), and there are 103 such branches of 12 conventional banks, taking the total number of branches to 331 by end August, CY08.

Though the performance in terms of growth of assets is impressive, it has not translated into a proportionate increase in profitability as reflected in the ROA and ROE for Islamic banks. At 0.6 and 3.3 percent for CY07 respectively, these ratios for Islamic banks are below the overall banking sector average. Notably however, these indicators do not portray the actual picture due to the entry of four new banks in the market which started operations as recently as CY06 and CY07, and are still in the process of establishing their business, expanding their deposit base and enhancing the scope of their operations. It would normally take a new bank 3-4 years to become profitable and start operating efficiently, i.e. once the start-up costs and the expenditure on the development of management systems and related infrastructure, start to yield results. This is evident from higher ROA (2.6 percent) and ROE (16.3 percent) in CY05, when there were only 2 dedicated Islamic banks operating in the industry. Both indicators declined sharply in the subsequent year (with a marginal improvement in CY07) simply due to the enhanced capital and asset base effect: the new banks contributed a significant amount to the total capital and asset base of the Islamic banking industry, but the earnings are still largely concentrated in the two previously established banks in the sector. Both ROA and ROE for the industry are expected to increase in coming years, as the new banks establish themselves on a sound footing. That said, the current strains on the macroeconomic environment might exacerbate this process.

Performance of Non-bank Financial Institutions

The assets of the NBFIs registered a YoY growth of 22.7 percent during FY07, in comparison with growth of 17.4 percent in FY06, to reach Rs 567.0 billion. The number of operative entities in FY07 was 209, which subsequently increased to 237 in FY08, in comparison with 188 in FY06. The size of the total assets of the sector relative to GDP at 5.9 percent, and total financial sector assets at 8.0 percent (end-FY08), is small, as is the proportion of its deposits in the total deposits of the financial sector at 1.1 percent.

A detailed review of performance indicators suggest that the NBFC model has had limited success in shaping the growth opportunities for non-bank financial services, and the performance of the various sub-sectors has been undermined by the increasingly challenging operating environment in the broader financial sector, of which the NBFCs form a small component. Some urgent remedial measures are needed to enhance market outreach, promote product innovation, increase capitalization and restructure the under-developed segments, to ensure sustained growth of the NBFCs as a whole.

In November FY08, the SECP implemented some necessary measures to revamp the regulatory framework for the Non-Banking Finance Companies (NBFCs), the concept of which was introduced in 2002 when the regulatory responsibility of these financial institutions was shifted to SECP from SBP. The new regulations specify the requisite parameters for the formation of various types of NBFCs, and address all operational aspects and issues for NBFCs and their notified entities. Notably, all the previously issued Prudential Regulations for NBFCs have been merged into these Regulations. In August FY09, SECP issued a revised version of the 2007 Regulations in the form of the (Draft) Non-Banking Finance Companies and Notified Entities Regulations, 2008, to clarify certain legal interpretations of the 2007 Regulations and address market related operational issues. These regulations have now been finalized and issued. Consequently, the new regulatory framework now consists of: the NBFCs Rules 2003 (amended) and Non-Banking Finance Companies and Notified Entities Regulations, 2008.

Another major cause of concern for NBFCs' commercial viability stems from their limited sources for resource mobilization. The extensive reliance on credit lines from banks and other financial institutions has continued to pose problems for NBFCs in terms of the high cost of funding, in addition to being a potential source of systemic risk in case these credit lines dry up in an

environment of a liquidity crunch, as seen most recently in October FY09. While some NBFCs are allowed to raise retail deposits in the form of Certificates of Investments (CoIs), the amount so raised is generally not sufficient for them to finance their business activities and expand their operations. As a result, NBFCs continue to operate at a disadvantage in comparison with the banking sector which has access to relatively low cost funds.

The 2008 Regulations addresses this issue by allowing NBFCs offering leasing, housing finance and investment finance services to raise deposits from COIs with tenors of 30 days and above, as opposed to the previous restriction on the minimum tenor of deposits to be of 3 months. In a similar vein, the resource mobilization capacity of Modarabas has also been enhanced with the introduction of the Model Financing Agreements and the conceptual framework for the issuance of sukuks for Modarabas by the Religious Board. The impact of all these developments is yet to be observed on financial performance of these institutions.

Risk Assessment of the Insurance Sector

Despite its continued small size and low penetration level, the insurance industry performed well in CY07 by posting strong growth, with rising reserves and enhanced equity base, indicating its growing financial strength. The profitability of the general insurance companies increased further on account of higher returns on investments. However, the rising claim ratio in the general insurance sector raises some concerns. Furthermore, the concentration of general insurance premiums in motor insurance also signifies concentration risk. With rising interest rates and lower demand for auto finance, dependence on the motor insurance business would need to be reassessed.

The life insurance sector also posted strong gains on account of handsome gains on investments. However, in contrast with general insurance, the claim ratio in life insurance has decreased marginally. In the reinsurance sector, Pak Re has also performed well and has posted a strong growth in its profits in CY07.

In CY07, the insurance sector continued to consolidate its position by enhancing its capital base. The capital requirements imposed by the SECP require the general insurance companies (conventional and Islamic) to gradually enhance their paid-up capital from Rs. 120 million (at end 2007) to Rs. 300 million by 2011. The life insurance companies are also required to enhance their paid-up capital from earlier benchmark of Rs. 300 million to Rs. 500 million by the end of 2011. The overall response of the insurance sector has been very encouraging to this directive and most of the insurance companies are progressing towards enhancing their capital base. Furthermore, the asset base of the insurance companies has also been rising on account of raising the capital level. The total assets of the insurance sector have increased by 32.1 percent in CY07. The distribution and pattern of assets show that share of the top ten companies which was 85.8 percent in CY02, showed a declining trend until CY05, and subsequently started to increase in CY06 and CY07. This is probably due to the fact that the general insurance companies that are part of large financial groups are more equipped to grow than other small isolated companies.

There are currently 3 General Takaful and 2 Family Takaful operators which have been issued licenses by the SECP. SECP is working to formulate a robust regulatory framework for Takaful business in Pakistan. Going forward, concerted efforts are being made to increase the availability of insurance protection to the less privileged segments of the society, and introduce innovative products which facilitate stakeholders in the financial sector, for instance the Crop Loan Insurance Scheme, which was launched in August, 2008. Encouragingly, contribution of bancassurance as a distribution channel continues to gain ground with the passage of time. Other initiatives such as micro-insurance have also been taken, and SECP is in the process of

formulating a regulatory framework for the provision of micro insurance for both public and private sector insurers. All these measures are expected to bear fruit in the near future.

Payment and Settlement System

The State Bank of Pakistan (SBP), in its capacity as the central bank and the leading regulator of the financial sector, is responsible for the oversight of the payment system. Over the years, it has endeavored to ensure the smooth functioning of the payment and settlement system in the country, while continuing to upgrade its scope and capacity in response to the changing dynamics of the financial landscape. Recent innovations in information technology have had a profound influence on the functioning of payment and settlement systems, as a result of which both their capacity and efficiency has increased manifold. While the numerous technological solutions developed by financial institutions are available for both retail and large value transactions, the advancements in the former are more visible to the public.

An assessment of retail payment system (RPS) of Pakistan reveals that it is still dominated by traditional paper-based transactions. Both the volume and value of paper-based transactions is largely driven by cheques for cash withdrawals, and funds transfers through cheque-clearing. The share of all other paper based instruments (Pay Orders, Demand Drafts, Telegraphic Transfers etc.,) is less than 10.0 percent in terms of the total value and amount of paper-based transactions.

High, but declining share of paper-based transactions in the total number of transactions is an indication of the increasing number of electronic transactions in recent years. Specifically, the number of electronic transactions has increased from 11.5 million in Q1-CY05 to 33.9 million by Q2-CY08: an increase of almost 3 times in just three and half years. Disaggregated data on electronic transactions reveals that all modes of electronic transactions have seen a significant rise in recent years, however the increase in ATM related transactions has outpaced the growth in the other modes. Specifically, ATM related transactions constitute over 50.0 percent of total electronic transactions.

Since inception, ATM services have recorded tremendous growth in terms of both the number and value of transactions. As of end-June CY08, the number of ATMs has reached 3,121 compared to only 206 as of end-December CY00. As all ATMs are linked through a centralized ATM Switch network, this helps customers in accessing their accounts through any ATM in the country. These facilities have led to a tremendous growth in ATM transactions which increased to 19.0 million during H1-CY08 compared to only 8.6 million during the corresponding period 3 three years ago: an increase of 2.2 times in just three years. The average size of ATM transactions, which is limited by the cap on single-day withdrawals imposed by banks, suggests that this mode of e-banking is primarily used for low value transactions including cash withdrawals, payment of utility bills etc.

Moreover, over 64.0 percent online branches of the banking system are offering real time online banking (RTOB) including cash withdrawals, deposits and fund transfers. Recent trends in the numbers and values of RTOB transactions depict significant growth in these activities. Specifically, quarterly data on RTOB transactions shows that the number and value of such transactions at end-June CY08 has increased by 49.2 percent and 68.4 percent respectively over the past two years. Moreover, the average size of RTOB transactions is around Rs 400,000 at end-June CY08. The relatively large size of the average transaction suggests that this mode of electronic transactions is primarily used to transfer funds by the small and medium sized businesses.

Over the years, SBP has also strived to modernize the payment infrastructure in the country. In doing so, it facilitated the establishment of the National Institutional Facilitation Technologies (Pvt) Limited (NIFT) for automated conventional clearing services (for instance, overnight clearing, same-day high value clearing, inter-city clearing etc.). More importantly, the launch of the Pakistan Real-Time Interbank Settlement System (PRISM) on July 1 2008, which is owned and operated by the SBP, is a major achievement on this front. PRISM is a systemically important payment system and is designed to settle all large-value payments in the country.

Finally, with the successful implementation of PRISM, SBP is now working in cooperation with all payment service providers and financial institutions to develop and promote standardization of relevant procedures, while also engaging in educational and awareness programs so that customers are better informed of the availability of new payment instruments and services. Some of these efforts have already been implemented with the introduction of detailed guidelines by SBP for: (1) Card-holders; (2) Standardization of ATM-Operations; and (3) Operational guidelines for ATMs.