

FINANCIAL STABILITY AND RISK ASSESSMENT

This section presents an assessment of financial stability during 2007 and the first half of 2008, based on risks emanating from both the domestic and external environment which have a bearing on the domestic financial system. The objective is to highlight key risk factors and vulnerabilities in the financial system, and the potential implications of these risks and vulnerabilities on the soundness of the financial system.

Hit by an unprecedented series of multiple events and shocks, the **global financial system** is in a state of deep distress. One after another, large global banks have faced extensive losses, some were subjected to runs, others wrapped up their business, while yet others went for bail outs, mergers or other forms of restructuring. Stock markets tumbled, indices declined and their market capitalization was severely eroded. The financial crisis, triggered by an isolated problem of subprime mortgages and other alternative investment vehicles which constituted only a small proportion of global financial assets, first hit one sector of the economy i.e. housing, and has now transmitted its contagion effect across all segments of financial markets and institutions, with spillover effects into the real sector. The global economy is now witnessing a significant slowdown after a sustained period of growth. What was perceived initially as purely a liquidity crunch in advanced financial markets has now turned into a solvency crisis.

Recognizing the complexity and depth of the crisis, central banks have adopted multi-pronged approaches to come up with a solution to the crisis. In the initial phase, there was emphasis on injecting liquidity to lubricate the financial markets, however these efforts did not have the desired impact of stabilizing the market, and the aggressive sentiments combined with growing losses forced some banks into insolvency. While continuing to infuse liquidity, central banks and governments have evolved packages to recapitalize banks to take away some stress off the balance sheets. However, irrespective of the size of the bailout packages, the nature and amount of liquidity injections, and the numerous unconventional solutions offered to support the institutions, financial markets continue to show strains, more so because initial fears of an impending recession are now a certainty. There is no doubt that there have been tremendous losses, both at the individual and institutional levels, in addition to increasing strains in the real sector of the economy, and that there are tremendous lessons to be learnt regarding the nature of financial products, and financial regulation and supervision. It is now expected that the coordinated actions of the central banks will bear fruit, and that markets will turn around. Transformation by way of consolidation and new regulatory architecture will augur well for the global financial system.

Pakistan's economy, on the other hand, has been impacted only by the indirect, or second-round, effects of the global financial crisis, while being impacted directly by the unprecedented rise in the global commodity prices. On this score, Pakistan is perhaps one of the most severely hit economies: the surge in global commodity prices has been a predominant factor in derailing the macroeconomic fundamentals. For instance, 81.7 percent of the external current account deficit in FY08 is due to the oil import bill which shot to over US\$ 11 billion in FY08, relative to an average of US\$ 5.3 billion during FY04-FY07. Similarly, a large increase in the FY08 fiscal deficit was on account of the delay in the pass-through of the international price hike at the retail level. Rising macroeconomic imbalances, along with the hike in global commodity prices, have resulted in an unprecedented rise in inflationary pressures, with both core and food prices reaching record highs. The priority for Pakistan is to correct the root cause of the problem i.e. the macroeconomic imbalances, rather than seek solutions to deal with symptoms that are now impacting other segments of the economy.

Recognizing this, the Government and the central bank have attempted to address these challenges by a combination of measures. Given the rising demand pressures as manifested in the rising core inflation, the central bank had to resort to further monetary tightening in line with some countries that were facing similar pressures. At the same time, the Government also recognizes the need for curbing macroeconomic imbalances. On the fiscal side, the upward adjustment in retail domestic prices as well as structural reforms to facilitate food production and alleviate power shortages etc. are some of the ways to curtail both the fiscal deficit while addressing the constraints facing the productive sectors.

Table 1: Asset Composition of the Financial Sector

	CY01	CY02	CY03	CY04	CY05	CY06	CY07	H1-CY08
Asset (bln Rupees)	3042.7	3417.7	3943.7	4518.3	5201.5	5957.5	7115.2	7646.6
Growth Rate (percent)		12.3	15.4	14.6	15.1	14.5	19.4	7.5
As percent of Total Assets								
MFIs	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2
NBFIs	6.6	6.2	6.6	7.0	7.6	7.8	8.0	8.0
Insurance	3.7	3.8	3.8	3.8	3.9	4.1	4.6	5.5
CDNS	25.8	24.9	25.0	21.7	18.0	16.1	14.6	14.2
Banks	63.8	65.0	64.5	67.3	70.4	71.9	72.7	72.1
As percent of GDP								
MFIs	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
NBFIs	4.7	4.6	4.9	5.2	5.6	5.7	5.9	5.9
Insurance	2.6	2.8	2.9	2.8	2.9	3.0	3.4	4.0
CDNS	18.1	18.2	18.8	16.1	13.3	11.7	10.8	10.3
Banks	44.8	47.7	48.3	50.1	51.8	52.4	53.9	52.6
Overall	70.2	73.3	75.0	74.4	73.7	72.9	74.1	73.0

While there has been no direct impact of the global financial crisis on the **financial sector in Pakistan (Table 1)**, this was a period in which financial stability concerns emerged due to the strains emanating from the macroeconomic environment, and the central bank balanced its policy direction to manage issues of both monetary and financial stability. Never before were the linkages with the real sector so markedly visible as during this period: the financial sector faced headwinds from the weakening macroeconomic environment but withstood the pressures well and remained strong and resilient.

Given its bank-centric nature, the stability of the financial system is derived essentially from the banking system. An assessment of the performance of the banking sector from January 2007 to June 2008 shows that Pakistan's **banking system** has over the years nurtured itself such that it is able to withstand some of the shocks it has faced in the last 18 months or so. The banking system is on strong footing and has long term potential – a feature which has served to attract a substantial amount of FDI in the sector, with established global financial institutions now active participants in the domestic financial sector. It has been well governed and being in private hands under professional management, has witnessed outstanding financial performance during the last few years. With strong regulatory oversight, there has been a significant enhancement of capital and risk-weighted capital adequacy, supported by high provisioning requirements which were tightened in 2007. Stringent loan provisioning requirement has built sufficient reserves against the NPLs' portfolio. In contrast to the liberalized financial system in the west, which took its toll in the form of the current global financial crisis, there are stringent regulations and adequate policies in place to help the banking system manage its risks.

Aggregate financial soundness indicators have improved since early 2000, and continue to exhibit strong performance. Tighter provisioning requirements may have reduced profits, but have

positioned banks well. Ongoing consolidation and mergers have enabled a number of banks to position themselves better. The solvency profile has improved, and given the pressures from the macroeconomic environment, there is an indication of marginal deterioration in asset quality, which banks are well-equipped to handle. Stress tests conducted on June-CY08 data indicate that the large banks are relatively robust, with the medium and small-sized banks positioning themselves in niche markets.

Capital adequacy of the banking system is strong, 12.1 percent at end-June CY08, well above the internationally acceptable minimum requirement of 8.0 percent. Core capital constitutes about 80.0 percent of the total capital, and Tier 1 to risk weighted assets ratio of the banking system is at 9.7 percent. This strong capital base is accompanied by adequate reserves on the back of stringent provisioning requirements against classified assets – the net NPLs to net loans ratio is reasonably well-contained i.e. at 1.3 percent in June CY08, comparable to international best standards. Profitability of the banking system continues to be impressive, largely emanating from the persistent growth in high-yield earning assets and expanded business volumes. Before-tax ROA of the banking system remains strong at 2.3 percent in June CY08. The strengths built up over the years are now coming in handy in managing the recent financial strains.

The weaknesses in the external sector, in particular, were a major source of concern in recent months. At the same time, the demand for credit from both the government and the private sector has further tightened the liquidity conditions. Adding to the pressures of the market liquidity conditions was the reduction in the deposits of the banking system in October 2008 and an increase in the currency in circulation. These trends in banking system liquidity partly reflect seasonality, as the currency in circulation normally increases around the period of the Eid festival, putting temporary pressure on the interbank liquidity. The strains in liquidity faced by some individual banks emanated from the combined impact of their weak deposit mobilization and low interest rates offered on deposits, in view of maintaining their high profitability. Additional complications have arisen because of the Government's and public sector organizations' excessive borrowings from the banking system. Notwithstanding, the liquidity strains were temporary and the inter-bank market is now functioning normally.

Albeit going forward, the banking sector faces a significant challenge in maintaining its deposit base and in attracting new deposits, given the three rounds of increase in the rates of return on NSS instruments in the first few months of FY09. This will in a way force them to enhance the quality and returns on their liability products, and strengthen competition.

Among the various risks faced by the banking sector, credit risk emanating from the concentration of the loan portfolio in a small number of large borrowers needs to be monitored closely, as it can be a potential source of systemic risk. Declining but still strong sectoral concentration, as evidenced in the loans to the textile sector at 18.5 percent of the total loan portfolio of the banking system, is another source of concern, given the relatively higher infection ratio of these loans at 12.6 percent at end-June CY08, in comparison with the infection ratio of the overall loan portfolio at 7.7 percent.

Notably, the liquidity position of banks also had an impact on the **Non-Banking Finance Companies** (NBFCs), whose main source of funding continues to be credit lines from banks. Notably, 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. 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 Q4-2008. 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 new NBFCs Regulations 2008 serve to address these concerns to a large extent. In particular, the enhancement in the minimum capital requirements for each type of business allowed under the NBFC umbrella was a much needed measure, as the low capital base of NBFCs and modaraba management companies has been a major challenge in mobilizing low cost funding, while effectively ensuring low barriers to entry. Consequently, the NBFC sector has suffered from widespread fragmentation in the form of a large number of small and weak entities, with limited market share. The increase in minimum capital requirements is expected to not only strengthen the resilience of the sector once the new requirements are implemented in a phased manner by 2011, it has also given impetus for further consolidation, by encouraging small institutions to join hands and operate on a stronger footing.

Notably, an excessive dependence on the banking system to meet the financing needs of the economy, *as well as* other participants of the financial sector, is quite stark in comparison with other emerging economies, where in general, the growth in other components of the financial sector, such as capital markets, complements and supplements the financing capacity of the banking sector.

While **financial markets** (money market and foreign exchange market) remained resilient to the developments in the macroeconomic environment and functioned well in maintaining financial stability, the imposition of the floor of 9,144 points on the KSE-100 index in August 2008 has adversely impacted investor sentiments by effectively blocking the exit mechanism generally taken for granted in a market based system. Incidentally, there is no known precedent of placing a floor on a market index, albeit temporary suspension of trading in equity market has been implemented in some cases as an extreme measure. Having taken the decision to place the floor, the choice of the optimal time for its removal is now posing to be a serious challenge, with a view to protecting the investor's interests.

While the decline in the equity market and erosion of market capitalization has had a significant wealth effect on the household and the corporate sector, its systemic implications have spread to the mutual funds industry which is dominated by equity funds. With substantial deterioration in the growth of mutual funds, which have faced increasing redemption pressure since the imposition of the floor, the regulator had to resort to freezing the redemption of equity funds, subsequent to which some debt funds have also stopped redemption. As a result, Net Assets under management have declined by over 20.0 percent in a matter of three months, serving to retard the previously remarkable growth in this asset class.

The **insurance sector**, on the other hand, continues to have a small share in the overall financial sector, and is also in the need of a more focused strategy for strengthening its regulatory framework, and reducing fragmentation in the sector. Concerted efforts to increase penetration with the introduction of new products in collaboration with other stakeholders are expected to yield positive results in coming years.

Given the low level of national and financial savings, a robust framework for the promotion of occupational savings in the form of private pension schemes has recently been launched by the SECP. While private pension funds, managed by professional asset management companies, form

a negligible proportion of total financial sector assets, this asset class has tremendous potential for mobilizing long-term funds in the economy and to increase the level of savings.

Table 2: Indicators of Financial Deepening
percent

Indicators (end-June)	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09**
M2 to GDP	36.6	36.2	39.6	42.6	44.1	45.6	45.0	46.7	44.8	39.9
Money multiplier	2.8	2.9	3.0	3.1	3.2	3.3	3.4	3.4	3.2	3.2
Currency to total deposits	34.3	32.9	33.0	31.3	30.3	29.0	27.7	26.1	26.5	32.4
Currency to M2	25.4	24.6	24.6	23.8	23.2	22.4	21.7	20.7	20.9	24.4
Currency to GDP	9.3	9.0	9.9	10.3	10.2	10.1	9.6	9.6	9.4	9.8
PSC to M2*	49.5	49.2	45.6	46.7	51.2	57.7	61.9	61.0	61.6	65.5
PSC to GDP*	18.1	17.8	18.0	19.9	22.6	26.3	27.8	28.5	27.6	26.2

*: PSC = Private Sector Credit, ** Upto Nov 22, 2008.

Source: SBP

Despite the several achievements of the financial sector in recent years, financial depth and penetration in Pakistan continues to be low (**Table 2**), and SBP's financial inclusion strategy, as well as the recently launched strategic plan for the Islamic Banking Industry, are both aimed at extending the net of financial services. Having observed the experiences of the global economy, the way forward for the financial sector is to maintain both the simplicity and transparency of product structures and a gradual pace of financial liberalization to enable the financial sector in expanding further in a more sound, healthy and efficient manner. Effective regulation is the preferred route for central banks responsible for safeguarding both monetary and financial stability.