Overview:

The international financial crisis is lingering on yet due to the escalating sovereign debt problems in the Euro area amid funding difficulties faced by the European banks, and increased risk aversion in the international financial markets. Pakistan, not tied in strong international financial linkages, has remained largely unaffected by this global crisis. However, the decelerated global growth, especially in the Euro area and US, has serious implications since Pakistan's GDP growth rate has also tapered due to rising trade deficit (as demand for exports have fallen), unfavorable law and order situation and persistent energy crisis.

Weak global growth and challenging local environment is impeding the economic growth….

The efforts of the government, amid the prevailing adverse macro-economic situation and political uncertainty, to channel foreign funds into the economy both by enhancing exports and arranging foreign exchange from international financial institutions (IFIs) has thus far no significant impact on the external account. The growing workers' remittances[1] is the only relief to the deteriorating current account balance.

The persistently rising budget deficit, internally, has also contributed to the overall adverse macro-economic condition. The government's demand for extra credit has resulted in crowding out of private investment. Despite the existence of twin (trade and budget) deficits, agriculture sector has recorded reasonable growth. This growth has trickled down to other sectors using agriculture produce as inputs. Similarly, large-scale manufacturing (LSM) growth has shown a marginal improvement by the end of H2-CY11. Inflation rate has also remained relatively lower compared to the past couple of years due to improvements in food supplies, although this improvement is vulnerable to projected floods in the coming year.

Asset base of the financial sector registered a growth of 15 percent during CY11 (Table 1)[2]. This expansion, though broad based, was largely driven by the growth in banking sector. Overall operating performance of the financial sector improved over the year as ROA rose to 1.4 percent in CY11 from 0.9 percent in CY10. However, the share of financial sector in GDP (FGDP) declined marginally to 57.4 percent during CY11 due to double-digit inflation (Table-1). The improved performance indicates resilience of the financial sector, though it remains vulnerable to the risks faced by the macro-economy.

…while financial sector, though resilient, remains vulnerable to the risks facing the economy

Banking system[3] remained relatively strong due to improved capital adequacy and solvency indicators, contributed by higher level of profits and equity injections made in CY11. However, risks to the banking system somewhat increased since publication of the last FSR, mainly due to the prevailing macroeconomic situation.

Banking system remains strong, though risks somewhat increased….

[1] Remittances stood at USD 13.2 billion as of end FY12.

[2] Data on DFIs, MFIs, Insurance, CDNS and banks is on calendar year (CY11) basis. Whereas, data on Modarabas, IFCs, Leasing Companies and Venture Capital is on financial year (FY11) basis. NBFCs include DFIs, Mutual Funds, Modarbas, IFCs, Leasing companies and Venture Capital.

[3] Analysis of banks and DFIs is for the second half of 2011(Jul-Dec), while performance of remaining institutions is for the full year.

Table 1: Assets Composition of the Financial Sector

	CY05	CY06	CY07	CY08	CY09	CY10	CY11
Assets (Rs. Billion)	5,202	6,028	7,117	7,712	8,867	9,655	11,107
Growth rate (percent)	15.1	14.5	19.4	8.4	15.0	8.9	15.0
Percent of total assets							
MFIs	0.2	0.2	0.2	0.2	0.2	0.2	0.2
NBFIs	7.6	7.8	8.0	7.6	5.3	4.4	4.7
Insurance	3.9	4.1	4.6	4.4	4.4	4.4	4.3
CDNS	18.0	16.1	14.6	14.8	16.6	17.3	17.2
Banks	70.4	71.9	72.7	73.0	73.5	73.8	73.6
Assets as percent of GDP							
MFIs	0.1	0.1	0.1	0.1	0.1	0.1	0.1
NBFIs	5.6	5.7	6.0	5.1	3.4	2.6	2.7
Insurance	2.9	3.0	3.4	3.0	2.8	2.6	2.5
CDNS	13.3	11.8	11.0	9.9	10.7	10.2	9.9
Banks	51.8	53.4	54.7	49.0	47.3	43.3	42.2
Overall assets	73.7	74.0	75.2	67.2	64.4	58.8	57.4

....as growing exposure to Federal Government Securities continues to reduce assets diversification and limit financial intermediation ...

During H2-CY11 major contribution to the increase of 5.91 percent in asset base of the banking sector came from persistent and heightened investment in government paper. Government's inability to bring about any structural shift in correcting the twin deficit left it to rely on the banking system for funding the budget deficit. The inelastic demand for funds by the government coupled with no capital requirement against local currency sovereign debt and eligibility for statutory liquidity requirements incentivized the banks to invest even more in government securities. However, increased government exposure of banks is reducing assets diversification and curtailing their role of financial intermediation.

Credit risk increased marginally during H2-CY11 as lending activity remained slow and banks managed to limit the flow of infected portfolio through restructuring/rescheduling of recoverable loans. The overall credit flows registered a first half yearly contraction in gross advances of the banking sector over a decade, an outcome of one-off settlement of inter-corporate public sector circular debt in November 2011. Consequently, public sector advances registered a decline during the period under review.

.... consistently high and rising commodity finance further adding to public sector exposure...

The government's policy of maintaining relatively higher support prices for major food crops contributed to the increase in share of commodity financing in overall public sector advances from 33 percent in September 2008 to 65 percent in H2-CY11. However, one-off adjustment of Rs 78 billion on account of unpaid subsidy related to public sector commodity operation only facilitated in providing a marginal cushion for further commodity financing. With the recent increase in wheat support price by Rs100/40kgs demand for funds for government's procurement needs are expected to go up even further.

... slowing down of loans to private sector due to both demand and supply side issues ...

Private sector demand for funds, though positive, remained restrained due to persistent energy shortages, poor law and order situation, and slowdown in external demand (exports). The domestic demand for private sector advances revolved around corporate working capital needs and seasonal demand for advances in the last quarter of the year. However, demand for fixed investment declined due to the already installed but underutilized industrial capacity[4]. Further, banks' contained lending to risky segments like SME and

[4] The State of Pakistan's Economy - Second Quarterly Report 2011 – 2012.

Consumer Finance, led to further decline in their share in overall lending portfolio.

...and rising concentration of loans to corporate sector pose additional risk

Increasing concentration of advances to the corporate sector may pose certain risks for banks. Sensitivity analysis of group exposures show that capital adequacy of the banking system would be affected the most, in case top three private sector corporate groups default. Though the regulatory exposure limits are in place, banks should effectively manage such concentrated portfolios to avoid adverse effect on their solvency and systemic implications for the banking system.

Infection increased marginal, but overall impairment levels remain high

With decline in advances, accumulation of non-performing loans (NPLs) also slowed down considerably as banks added up NPLs of Rs12.4 billion during H2-CY11 against an increase of Rs 31.4 billion in H1-CY11. Nonetheless, infection ratio, with a marginal rise of 40bps to 15.7 percent in H2-CY11, remains high. Also, due to improved provisioning, particularly of top five banks, net NPLs to loan ratio came down marginally. Textile sector, with 18 percent share in aggregate loans, remained the leading user of bank credit. However, the infection ratio in textile sector, at 28 percent, was much higher than the banking sector infection ratio and remains a cause of concern.

Funding mainly driven by moderate deposits growth....

On the funding side, in H2-CY11, deposits registered a modest growth of 4.7 percent on account of deceleration in customer deposits. Attractive National Saving Scheme (NSS) rates and increased investment in the Investment Portfolio Securities (IPS) accounts might be the cause of this deceleration. Most of the growth in deposits came from customers' deposits in fixed and saving categories, along with an unexpected jump in financial institutions deposits. A healthy 10 percent increase in foreign currency deposits, due to 4.6 percent depreciation of Pak rupee, significantly contributed to the growth of deposits. With stagnancy in current deposits, the share of the low cost current account saving account (CASA) diluted over H2-CY11, which may increase the cost of deposits in the system in the coming months. However, zero statutory cash and liquidity requirements on long-term fixed deposits would compensate banks and allay liquidity risk in case of maturity mismatch.

Banking data also revealed that the growth in deposits was mainly driven by large sized (amount exceeding Rs.10 million) deposits comprising corporate client, government, and high net worth individuals. Further, the mid sized banks (6^{th} to 21^{st} in assets size), which are also offering relatively better deposit rates, contributed to majority of the rise in customer deposit. This is indicative of enhanced competition in the banking sector and improved customers' confidence in these institutions.

The share of banks' borrowing from financial institutions, which generally remains within the range of 8-10 percent of their assets, witnessed an increase due to stressed short-term liquidity and sluggish deposit growth. Major portion of this enhanced borrowing comprised repo borrowing from State Bank of Pakistan (SBP) to manage short-term liquidity gap. Further, decent equity growth on account of profitability (mainly supported by FSV benefit) and fresh capital injections for meeting the prescribed capital requirements also partially supported the funding side of banks.

Incremental funds generated by banks were mainly channeled in to risk free government securities. As a result, the liquidity indicators further improved over H2-CY11. However, rising investments with restrained credit disbursements re-shaped the banking asset portfolio as reflected in decline in advances to deposits ratio (ADR) from 56.7 percent in H1-CY11 to 54 percent by H2-CY11. This situation requires diligent monitoring since continuous decline in ADR indicates the undesirable deleveraging of private sector credit. Further, continuing investments in government securities can expose banks to reinvestment risk in a declining interest rate scenario.

…most of which funneled into government securities raising re-pricing risk…

Short-term liquidity, however, remained strained, particularly in the last quarter of the year due to high and volatile overnight rates, and reflected in excessive banks' borrowing from the financial institutions. However, overall market risk facing the banks remained contained and managed, though banks need to be watchful of any adverse developments in the market to avoid losses on their exposures.

….while market liquidity pressures enhanced the interbank borrowing

The unprecedented profits further improved the overall soundness of the banking system during CY11. Banks posted before tax profit of Rs 170 billion, which was driven by large increase in net interest income on account of increased returns on growing stocks of investment in government paper. The net interest income increased by 12.4 percent duirng H2-CY11 due to wider net interest margins combined with steady growth in interest earning assets. The earnings were furhter augmented by decrease in provisions charged due to enhanced FSV benefit and increase in non-interest income from fees/commissions, dividends, and dealing in foreign exchange trading activities. Accordingly, ROA stood at 2.2 percent in H2-CY11, up from 2.1 percent in H1-CY11(1.4 percent in CY10). Also, profits were widely shared as fewer banks incurred losses. The concentration of top 5 banks in profit accumulation also decreased to 74 percent in H2-CY11 (78 percent in H1-CY11 and 106 percent in CY10).

Record profitability improved the return indicators …

The banking system remained reasonably well capitalized as benchmark CAR[5] rose to 15.1 percent. With most of the increase in capital resulting from accumulation of retained earnings and equity injections, the tier-I capital ratio increased from 11.9 percent in H1-CY11 to 13 percent in H2-CY11. Further, banks flight to risk free investment in government securities under the rising credit risk environment has shrunk both the credit risk weighted assets (CRWA) and the overall risk weighted assets (RWA). As a result solvency ratios of the banking system have gone up even higher.

….and enhanced solvency, and resilience of the banking system

Though capital base has remained robust over the years, the capital at risk (Net NPL to Capital ratio) surged continuously due to persistent flow of NPLs. However, the ratio declined marginally by 17 bps to 25.6 percent during H2-CY11, which is a welcome development but, it is still high enough with a tendency to adversely affect the solvency of the banking sector.

However, rising non-performing loans continue to threaten the capital base

Another challenge faced by some banks, particularly the smaller ones, is to meet the minimum capital requirement (MCR) that is set to grow gradually to Rs10 billion by 2013. Though banks are making efforts for meeting the above requirement by reinvesting their profits, however, they still remain short of meeting the regulatory requirement. The situation is challenging as given the uncertain macroeconomic and political outlook of the country, it is getting

[5] As per BSD circular No. 7 of 2009 banks are required to maintain a minimum CAR of 10 percent.

tougher for these banks to attract funds to further enhance their capital base.

The stress testing exercise, which now involves relatively extensive shocks, introduced recently[6], shows that the banking sector remains reasonably resilient to withstand the exceptional but plausible shocks. While after-shock CAR of the system remains above the minimum requirement, adverse impact of the credit risk shocks due to high infection ratio keeps solvency of some banks under stress.

Islamic banks continue to gain systemic importance ……

Islamic banking institutions (IBIs) continue to perform well and enhanced their share to around 8 percent of the banking assets. During the H2-CY11, the IBIs posted 14 percent growth in their assets, and like their conventional counterparts, a considerable portion of incremental assets was funneled into government securities. Murabaha and Ijarah continue to be the most widely used modes of financing while the ideal PLS modes lagged behind by a large margin. On average, IBIs remain more solvent and liquid though a little less profitable than the rest of the banking sector. Asset quality marginally deteriorated during H2-CY11 but remains considerably better than that of the conventional banks.

Although government, over the last year and a half, has increased the frequency of Pakistan Ijarah Sukuk issues, however, limited liquidity management instruments, lack of a deep and liquid Islamic financial market, and absence of lender of the last resort facility for IBIs remain the key issues that need to be addressed. To this end, the SBP is working for development of a comprehensive liquidity management solution. Furthermore, profit sharing mechanism of IBIs needs standardization, for which SBP is making efforts to streamline the profit distribution.

Phenomenal growth in mutual funds boosted assets base of NBFIs….

NBFIs, after banks and CDNS, represent a major share in assets of the financial sector. However, their size in the financial sector remained small. During CY11, NBFIs' assets surged by 22.6 percent after declining for two consecutive years. This increase was mainly driven by an exceptional 29 percent growth in mutual funds over CY11 (16 percent over H2-CY11), duly supported by increase in assets of Modarabas and DFIs. However, investment finance companies (IFCs), leasing companies, and venture capital continued to endeavor for sustained existence.

In line with the overall slowdown in economy, the share of NBFIs advances in total assets decreased to 39 percent. The contraction was observed all around as financing became more risky and funding sources remained limited. The exposure of banks on NBFIs' balance sheets, their main financing source, also fell by 7 percent over FY11. In the meantime, investment increased mainly in risk free government securities, with most of this increase contributed by DFIs.

….while improved performance of Modarabas and Leasing Companies enhanced overall profitability

NBFIs performance[7] improved over the year as return indicators; ROA and ROE turned positive after remaining negative for last two years. The profitability resulted from improved performance of Modarabas and leasing companies, while that of DFIs marginally deteriorated. Further, the profitability was concentrated to a few institutions in each of the NBFIs sub-sectors. Though improved profitability facilitated marginal increase in capital

[6] "*Guidelines on Stress Testing*" issued vide BSD circular No. 1 of 2012.
[7] Excluding mutual funds.

base of NBFIs, a number of them still failed to meet the minimum equity requirement (MER). Only DFIs exhibited healthy capital and strong solvency position but their much higher than required CAR suggest sub-optimal utilization of capital.

Exceptional performance of mutual funds on the back of money market investments was the highlight of NBFIs growth; however, they are prone to a number of risks. Tax incentives and low capital charge on banks' investments in money market funds (MMF) were the major reasons for the growth of mutual funds in CY11. However, both high concentration in MMF and expected change in the existing tax regime[8] invite caution while analyzing the downward risk in their expected future growth trend. Further, the SBP is working on possible changes in regulatory instructions on Basel Capital Accord for Collective Investment Schemes that may affect applicable capital charge on banks' investments in mutual funds.

Some sub-sectors of NBFIs struggle for their survival

The continuous consolidation and deteriorating performance of some NBFIs, over the years, is making survival of various sub-sectors difficult. Particularly, overall performance of IFCs saw further deterioration duirng the year, amid tough competition from banks and haphazardous economic enviornment. With an expected merger transaction of the largest IFC (holding 36 percent share) with a bank, the IFC sector would lose substantial ground. Additionally, non-compliance of a number of firms with capital requirements kept the chances of further consolidation open, which could be non-competitive.

Modarabas are also challenged due to the competition they face from IBIs providing similar products. However, given the flexibility available to Modarabas to involve in financial and non-financial business, they have reasonable scope to develop indigenously customized services. Also leasing sector plays a key role in SME financing; therefore, there is a need to take appropriate measures to keep it afloat.

Insurance sector registered healthy growth and improved earnings

The **insurance sector** continued to play its role of risk dispersion and mitigation- though its penetration remained low from international perspective. The sector's assets grew by 11.7 percent during CY11 with a strong growth momentum in the life insurance sector. Rising demand of risk coverage from urban population due to growing security risks improved life insurance assets by 19.2 percent in CY11 while settlement of flood related claims led to decline in non-life insurance assets by 7.4 percent.

Despite tough macroeconomic environment, the claims ratio of both life and non-life insurance sectors declined during CY11. The profitability of the life insurance sector improved largely due to rising share of investments in government securities while the non-life insurance sector's profitability marginally declined due to rising provisioning and non-underwriting costs. Besides, insurance sector remained adequately capitalized as represented by steady capital to assets ratio.

Financial markets faced stress due to challenging economic environment

In contrast to the favorable developments in H1-CY11, the **financial markets** witnessed a stressful condition as the macro-economy further weakened due to rising twin deficits. In addition to money market liquidity strain, adverse developments in the current account depreciated the Pak rupee by 4.6 percent while the import coverage ratio dropped as foreign exchange

[8] Federal Government has already announced measures for rationalization of tax structure as a part of the Federal budget.

reserves depleted. The equity market remained bearish as its benchmark index lost 9.2 percent coupled with a net outflow of portfolio investment. Furthermore, listings in the equity and debt market also remained low in H2-CY11.

Payment systems remain efficient and resilient

Payment systems -- both large value and retail payments **--** carried their momentum further while ensuring efficient payments and settlements. Various payment system channels exhibited sufficient resilience as they operated with minimum down time without any material disruption during H2-CY11.

Large value payment system--Pakistan Real-Time Interbank Settlement Mechanism (PRISM) successfully managed the increased level of transactions in H2-CY11, particularly in securities transactions due to stress in the liquidity conditions in the interbank market. Retail payments continue to shift to electronic modes due to increased awareness, technological advancements, and ever expanding customer base. Though paper based transactions still dominate the retail payments by value, however, due to robust increase in e-banking transactions, its share continues to shrink. Among e-banking modes, Real Time Online Banking (RTOB) emerged as the main catalyst of growth for e-banking in retail payments.