



## External Relations Department

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### **Financial system of Pakistan remains sound and stable, says Financial Stability Review of SBP**

The financial system of Pakistan remains in a sound and stable state at the end of CY15, said the Financial Stability Review (FSR), released by State Bank of Pakistan (SBP) today.

The FSR – which highlights the performance of the financial sector during CY15 and identifies key risks (both idiosyncratic and systemic) states that the asset base of the overall financial sector has increased at a decent pace of 15.1 percent during CY15 (12.6 percent, on average, during CY13-15). Consequently, the financial depth has improved as “financial assets to GDP” ratio has increased to 68.4 percent in CY15 from 59.4 percent in CY14 and 56.4 percent in CY13.

As reported, the financial sector of Pakistan has flourished despite challenges on the global front. The domestic economic environment, in fact, counter balanced the global economy repercussions as the economy has shown signs of improvements viz; inflation is low, foreign exchange reserves are building up and exchange rate is stable, large scale manufacturing has picked up some pace along with credit to private sector and fiscal consolidation continues.

In terms of the review, performance of the banking sector, with major share in the financial sector, improved on the back of record earnings and high capital adequacy ratio, which has enhanced the overall resilience of the sector. Strong assets growth and revival of private sector credit, along with gradual improvement in the asset quality further strengthened the overall financial position of the banking sector. The banking sector observed YoY growth of 16.8 percent in CY15 (average growth of 13.2 percent during CY13-CY15) to reach PKR 14.1 trillion as of end December, 2015. During the same period, advances grew at a modest pace of average 8.1 percent (average 8.7 percent during CY13-CY15); while Investments – mostly in government securities – increased by 30 percent (average 20.1 percent during CY13-CY15). The asset expansion has mainly been financed by deposits growth of 12.6 percent (average 12.5 percent during CY13-CY15) followed by financial borrowings.

Asset quality improved with reduction in infection ratio (11.4 percent in CY15 compared to 13.3 percent in CY13) and rise in provision coverage (84.9 percent in CY15 compared to 77.1 percent in CY13). However, banks do face challenge in reducing the high stock on NPLs. To this end, SBP is working on various legal and regulatory measures.

The operating performance observed considerable improvement as banking sector posted record after tax profit of PKR 199 billion during CY15, largely contributed by growing income share from investment in government papers. As a result, profitability indicators have improved; ROA (after tax) increased to 1.5 percent in CY15 from 1.1 percent in CY13 and ROE (after tax) increased to 15.6 percent from 12.4 percent in CY13. The solvency has also remained robust with high Capital Adequacy Ratio at 17.4 percent in CY15 (14.9 percent in CY13). Islamic banking increased its share in overall assets to 11.4 percent in CY15 ( 9.6 percent in CY13) in line with the Strategic Plan for the Islamic Banking Industry 2014-2018. While banks are maintaining high capital levels, expected growth in credit and gradual enhancement in minimum capital requirements prescribed by the regulators require banks to shore up their efforts for further strengthening their capital.



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Apart from banks, Non Bank Financial Institutions (NBFIs) including Development Finance Institutions (DFIs), Leasing Companies and Mutual Funds have performed reasonably well during the Financial Year 2015 (FY15) except for Investment Finance Companies which have continued to post losses. Insurance sector has posted healthy profits and increase in gross premiums improved the overall penetration rate of the sector to 0.8 percent in CY15 (0.5 percent in CY13).

Financial markets (Money, FX, and Equity) also performed smoothly during CY15; though, some volatility was seen in equity and FX markets during the second half of CY15 (post Yuan devaluation and anticipated rise in interest rates in the US).

FSR also highlighted few challenges facing the financial system. Though credit to private sector has improved in recent years, however, prime risk taking activity i.e. lending, is still at a low level. Consequently, Advances to Deposit Ratio (ADR) is falling for the last few years. This could be contributed by both demand and supply side factors, particularly challenging economic and business environment due to various structural issues such as power shortages facing the economy. As such, banks have increased their inclination towards risk free investments in government securities and their balance sheets – loaded with PIBs and MTBs – are more prone to market risk due to interest movements.

On the funding side, the deposit growth in past couple of years, although decent, has remained short of meeting asset growth requirements of both the private and public sector. Resultantly, banks' reliance on financial borrowing – a non-core and transitory liability – has increased. Banks, therefore, need to intensify their efforts for raising core liabilities i.e. deposits to minimize the maturity mismatches. The funding risk to some of the NBFIs and need of clientele diversification, as suggested by their business models, has also been highlighted by the review.

Lastly, global uncertainties may impact the economy and consequently financial sector of Pakistan through trade and financial linkages with Asia, EU, and UK. In addition, the low commodity prices, though beneficial for import dependant countries like Pakistan, could also impact revenues of export oriented sectors – including textile sector – which may impact the repayment capacity of borrowers of these sectors; which may stress the asset quality of the banks. However, Pakistan's banking system is fully capable of confronting these challenges.

The review also states that FSR will now be published as an annual document. The document is available at: <http://www.sbp.org.pk/fsr/index.htm>

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