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The financial sector remains in a sound
<u>and stable state, says the SBP's Financial Stability Review for CY16</u>

The State Bank of Pakistan issued today its annual publication viz., Financial Stability Review (FSR). The Review presents an analytical assessment of the financial sector during CY16, its associated risks and resilience analysis of the banking sector.

The FSR concludes that the financial sector of Pakistan remains in a sound and stable state at the end of CY16. The performance of both the financial and non-financial sectors has improved the risk profile of the system as a whole, as the risks to the financial system remained subdued but are actually reducing. However, some emerging low to moderate level risks in the short to medium term need attention and are being closely monitored by SBP.

The financial sector has operated in a relatively challenging global environment in CY16. The review highlights some global concerns such as low world economic growth, especially slow growth in advanced economies and oil-price induced economic shocks in the Gulf Cooperation Council (GCC) countries (the major export destinations and source of remittances flows for Pakistan); international trade slowdown; rising protectionist sentiments and the policy normalization in the US which might lead to tighter financial conditions in the Emerging Markets and Developing Economies (EMDEs). Going forward, it recommends that these developments warrant policymaker's attention.

The Review suggests that the domestic macrofinancial environment has been conducive in CY16: Output (both GDP and LSM) has been increasing; inflation remains subdued; exchange rate is stable amid adequate reserves; government borrowing from banking sector has receded, law and order conditions have improved and economic prospects are encouraging, more so, in view of China Pakistan Economic Corridor (CPEC). Not surprisingly, performance of the banking sector has been satisfactory and financial markets, in general, have performed smoothly. In addition, the corporate sector has also benefited from the favorable macrofinancial conditions and has posted robust profits.

Banking sector – which accounts for around three-fourth of the financial sector – has performed well. Encouragingly, the growth momentum of advances has picked up further, with private sector as the main beneficiary, while asset quality has improved with a decline in infection ratios. Specifically, gross advances have increased by 12.81 percent in CY16 compared with 8.12 percent last year while non-performing loans to total loans ratio has come down to a decade low level of 10.01 percent at the end of CY16.

Banks' profitability has, however, moderated, after seeing exceptionally high growth in the last few years. The return on assets and equity (ROA & ROE) is at 2.1 percent and 23.8 percent level in CY16, respectively, compared to 2.5 percent and 25.8 percent in CY15. The liquidity position remains comfortable while the capital adequacy ratio (CAR) at 16.2 percent remains high, albeit with some downward adjustment, primarily due to advances growth. The Review also notes the increase in CAR requirements due to higher Capital Conservation Buffer (CCB) over 2017-2019 and recommends that the banks devise their capital enhancement plans accordingly. In line with international best practices, the Review also assesses the resilience of the banking sector to adverse scenarios by means of macro-stress testing. The results exhibit that the banking system is, generally, able to withstand adverse shocks.

Financial markets, in general, have performed smoothly without any considerable disruption during CY16. Volatility in the money, foreign exchange (FX) and equity markets has remained relatively muted. The review, however, draws attention to some developments that need attention. For instance, the fiscal consideration has continued to drive the liquidity need in the money market; though, prudent management by SBP has kept the market running smoothly. The activity in PSX with high growth in KSE-100 index has outperformed various global benchmarks, yet rising Price-Earning (P/E) ratio in short span of time indicates some role of sentiments behind the market movements.

The non-bank financial sector, though small in size, has managed to grow alongside the growing banking sector. Non-bank financial institutions' (NBFIs) evolving regulatory framework and non-existence of complex and high value structures (private equity funds and hedge funds) have contained the risks within this sector. Further, the demonstrated (financial crisis episode) toxic elements i.e. excessive leverage and illiquid investments are contained within the mutual fund industry (the major participant of NBFIs) through prudential limits. Moreover, the review points out that a major share of the NBFIs sector is concentrated in few large institutions, while some small institutions are facing solvency issues. The NBFIs, generally, have limited avenues for contingency liquidity support in times of stress, it notes.

The Review also contains an analysis of the financial health of corporate sector and finds the performance of the sector to be satisfactory. According to the Review, the listed corporate companies are mostly relying upon their own resources for funding due to strong profitability, and adequate cash flows from operations. From the risk management perspective, rating culture needs to be developed in the corporate sector while concerted efforts are needed for utilizing alternative financing avenues, the Review recommends.

An attempt has also been made in the Review for assessment of financial soundness of the household (HH) sector, despite data limitations. A consistent rise in per capita income and high participation of youth in the labor force are obvious positives for the HH sector. Concomitantly, high unemployment rates for females, low-level of savings and a high-level of borrowing (as percentage of HH income) pose risks to the financial soundness of the lower income quintile of the households in the future.

As per the Review, the Financial Market Infrastructure (FMI) of Pakistan remains resilient and continues to function smoothly and efficiently. The large value payments continue their growth momentum; e-banking is fast replacing the paper based modes and the downtime of Automated Teller Machines (ATMs) has significantly improved. The rising interdependencies of different FMIs, although necessary and valuable from efficiency perspective, do pose supervisory challenges, says the Review. However, SBP has strengthened the oversight mechanism and enhanced engagement with the institutions for upgrading safety, security and resilience of their systems.

The review posits the outlook of the financial sector, in CY17, to remain largely positive amid the highlighted risks. It also notes that the SBP is cognizant of the emerging risks and has been taking measures to strengthen its regulatory and monitoring frameworks (including Macroprudential/Financial Stability), improve the efficiency and security of the payments systems, enhance financial consumer protection and reinforce corporate governance regime.

The FSR-2016 can be accessed at URL: http://www.sbp.org.pk/FSR/2016/index.htm

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