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The macroeconomic imbalances have impacted some segments
<u>of the financial sector, says the SBP's Financial Stability Review for CY18</u>

The State Bank of Pakistan (SBP) has issued today its flagship annual publication viz., Financial Stability Review (FSR) for the calendar year 2018. The Review presents performance and risk assessment of various segments of the financial sector including banking, non-banking financial institutions, financial markets, exchange companies, non-financial corporates and financial market infrastructure. In addition, it discusses the possible implications of the appraised risks to the overall stability of the financial sector.

FSR suggests that the CY18 has been a challenging year for the financial sector of Pakistan. The macroeconomic vulnerabilities emerging from twin deficits and elevated inflation level have necessitated the stabilization measures that have slowed down the pace of economic growth. The financial markets, particularly, the forex and equity markets have trended downwards with increased volatility. Accordingly, the growth of the financial sector has moderated to 7.5 percent in CY18. Similarly, the financial depth, as measured by financial assets to GDP ratio, has subsided to 73.0 percent in CY18 from 74.5 percent a year earlier. However, the financial institutions and financial market infrastructure have largely remained resilient and performed steadily during the year under review.

Among the financial institutions, banking sector has remained resilient, with strong Capital Adequacy Ratio (CAR) of 16.2 percent—well above the minimum regulatory level of 11.9 percent—and high fund-based liquidity. Among various factors, rise in rating culture in the corporate sector has facilitated enhancement in CAR. The financial intermediation has improved with a rise in advances to deposit ratio to 55.8 percent, highest in the last eight years. Growing advances have helped reduce the gross loans to NPLs ratio, but other asset quality indicators have slightly deteriorated due to rise in the quantum of NPLs during CY18. The banks have posted reasonable profits; however, higher provisioning expense along with rise in administrative cost and one-off extra ordinary expense has kept the profitability slightly below the last year's level. Encouragingly, increase in the share of interest income from financing activity has improved the Net Interest Margin (NIM), which has been falling for the last 3 years.

The FSR has also highlighted few challenges facing the banking sector. The deceleration in deposit growth that is continuing over the last few years may pose funding risk for asset expansion. The concentration of banks' exposure to public sector, though reduced due to net retirement in PIBs in CY18, remains significant. Further, the risks related to AML/CFT and cyber security need continuous attention for mitigation. Encouragingly, resilience analysis indicates that the banking sector has the capacity to absorb adverse domestic and global stress in the medium-term.

The Islamic Banking Institutions (IBIs) have maintained fast growth trajectory and now constitute 13.5 percent of the total banking sector assets. This growth is, primarily, driven by broad based financing activity to various economic sectors, with majority of financing extended under profit and loss sharing modes of Musharika and Diminishing Musharika. While financial health of IBIs remains sound, they continue to face dearth of Shariah compliant investment avenues that limit their ability to effectively manage their liquidity as well as mobilize deposits.

Due to higher volatility in the financial markets, risk averseness in equity market linked NBFIs, like Mutual Funds, has increased, that has led to contraction in assets under management and flight to safer money market instruments. On the other hand, financing based NBFIs, have observed growth and exhibited relatively better performance. Nevertheless, to allow the NBFIs to facilitate financial deepening, FSR 2018 suggests that issues like the small size and limited outreach of the capital market, difficulty NBFIs face in mobilizing low cost funds and attracting quality human resources need to be addressed through development of an industry level strategy. Similarly, the role of Development Finance Institutions (DFIs) in long-term project financing remains less than encouraging and progress on this front requires concerted efforts for mobilization of affordable long-term funding. Insurance industry has witnessed higher asset growth due to reasonable increase in gross premium, though its profitability indicators have slid down owing to increase in net-claims. Moreover, the insurance penetration remains quite low, indicating sufficient room for expansion in this sector.

The Review highlights that the Financial Market Infrastructures (FMIs) remains resilient and continue to perform efficiently without any major disruption. Both large value and retail payments have registered an uptrend in volume and value of transactions. The increasing adoption of electronic modes for payment indicates growing consumer trust. Wider use of digital financial services is also facilitating in furthering the objective of Financial Inclusion, which is one of the key priority areas for SBP. Particularly, the branchless banking and m-wallet accounts have enabled access of financial services to the underserved areas of the country. However, with an upsurge in technology-based financial services, cyber security threat has emerged as the key risk for FMIs. During CY18, the supervisory authorities have enhanced focus on this category of risk and have fortified the mitigation measures jointly in collaboration with the market players.

Commenting on the outlook of the financial sector, the Review highlights that the necessary stabilization measures may further slowdown the pace of economic activity. The external account imbalances and related uncertainties are likely to have repercussions for the financial markets. The monetary tightening may affect the debt repayment capacity of the borrowers with some lag. Under the challenging macroeconomic environment, the corporate sector, which is already showing signs of slackness in its performance, may perform below its full potential. Therefore, the financial sector performance and stability will largely hinge on the improvement in macroeconomic conditions. The successful implementation of IMF program is expected to foster macroeconomic and financial sector stability in the country.

The review highlights that SBP is aware of the emerging challenges to the financial sector and has taken appropriate steps, for its regulatees, to strengthen risk management practices and enhance stability. Moreover, SBP, in line with its strategic goal of “strengthening the financial stability regime” is working in collaboration with other stakeholders for formulating and implementing a comprehensive and well-structured Macroprudential Policy Framework (MPPF) to ensure the stability of the entire financial sector.

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