

CONTENTS

1	Global And Domestic Developments: Financial Stability Implications for Pakistan	1
1.1	Macroeconomic Imbalances – the Commodity Price impact	6
1.1	Trade Prospects	9
1.3	Access to International Markets: Sovereign and Private	11
1.4	Implications for Financial Markets	12
1.5	Conclusion	14
2	Dimensions of Monetary and Financial Stability	17
A.	FRAMEWORK FOR FINANCIAL STABILITY	17
2.1	Financial Stability: Methodological Framework	18
2.2	SBP’s Existing Framework for Financial Stability Assessment	19
2.2.1	Off-site Surveillance and On-Site Supervision	20
2.2.2	Stress-Testing	20
2.2.3	Financial Soundness Indicators (FSIs)	22
2.3	Proposed Framework for Financial Stability	22
2.3.1	Analyzing Macro-financial developments through Early Warning Systems	22
2.3.2	Macro-Prudential Surveillance	22
2.3.3	Conclusion: Policy Actions	24
B.	MONETARY AND FINANCIAL STABILITY	24
2.4	Monetary and Financial Stability: The Conventional View	24
2.5	Monetary and Financial Stability: The “New Environment” Hypothesis	25
2.5.1	New Environment Hypothesis: Case of Pakistan	26
2.6	Conclusion and Policy Implications	28
	Special Section: Framework for Macro Stress Testing	30
3	Stability of The Banking System	39
3.1	Overview	39
3.2	Assets and Funding Structure of the Banking System	41
3.3	Risk Assessment	43
3.3.1	Credit Risk	43
3.3.2	Market Risk	48
3.3.3	Operational Risk	53
3.3.4	Liquidity Risk	55
3.4	Risk Bearing Capacity of the Banking System	58
3.4.1	Capital Adequacy and Solvency	58
3.4.2	Profitability of the Banking System	62
3.5	Resilience of the Banking System: Sensitivity Analysis	64
3.6	Conclusion	67
	Special Section I: Liquidity Pressures in the Banking System	68
	Special Section II: Trends in Efficiency Indicators of the Banking System	72
4	Concentration and Competition in the Banking System	77
4.1	Banking Structure and Measures of Concentration	77
4.1.1	M-Concentration ratio	78
4.1.2	Coefficient of Variation	79

CONTENTS

4.1.3	Herfindahl-Hirschman Index (HHI)	79
4.1.4	PR-H Statistic	80
4.1.5	Robustness of Results	82
4.2	Conclusion	82
5	Perspectives on Consumer Finance in Pakistan	87
5.1	Stylized Facts	88
5.2	Consumer Finance – Myths and Facts	89
5.3	Major Issues and Challenges	90
5.4	Future Outlook	94
6	Framework for Consolidated Supervision	99
6.1	The Potential Impact of Financial Conglomerates on Banks	101
6.1.1	The Role of the Financial System	101
6.1.2	Special Nature of Banks	101
6.1.3	Conglomerate Risks to Banking	102
6.2	Regulatory Approaches to Mitigating Conglomerate Risks	103
6.2.1	Regulatory Architecture	104
6.2.2	Limits on the Ownership of Conglomerate Groups	104
6.2.3	Limits on the Scope of Participation in Conglomerate Groups	105
6.2.4	Limits on the Structure of Conglomerate Groups	105
6.2.5	Regulatory Requirements	105
6.3	Inherited Challenges in Pakistan	107
6.3.1	Regulatory Architecture	107
6.3.2	Limits on the Ownership of Conglomerate Groups	108
6.3.3	Limits on the Scope of Participation in Conglomerate Groups	108
6.3.4	Limits on the Structure of Conglomerate Groups	108
6.3.5	Regulatory Requirements	108
6.4	Recommended/Proposed Framework for Pakistan	108
7	Stability Assessment of Financial Markets	111
7.1	Money Market	111
7.1.1	Interest Rate Dynamics	115
7.1.2	Primary market for Government Securities	117
7.1.3	Secondary Market Trading	119
7.1.4	Conclusion	120
7.2	Foreign Exchange Market	121
7.2.1	Interbank Volumes and Transactions	122
7.2.2	Exchange Rate	123
7.2.3	Foreign Exchange Reserves	127
7.3	Functioning of the Derivatives Market	129
7.3.1	Policy Environment	129
7.3.2	Recent Developments	129
7.3.3	Product-wise Transactions	130
7.4	Capital Markets	132

CONTENTS

7.4.1	Equity Markets	133
7.4.2	Corporate Debt Market	138
	Special Section I : Does Foreign Investment Drive the Equity Market in Pakistan	141
	Special Section II : Financial Analysis of the Listed Corporate Sector	145
8	Islamic Banking	153
8.1	International Developments	153
8.2	Performance of Islamic Banking in Pakistan	155
8.2.1	Financial Soundness and Stability of Islamic Banks	156
8.3	Assessment of Risks	161
8.4	Conclusion	166
9	Promoting Inclusive Finance	169
9.1	Financial Inclusion Program	171
9.1.1	National Microfinance Outreach Strategy	171
9.1.2	Development of Small and Medium Enterprises (SMEs)	174
9.1.3	Increase Outreach of Agriculture Credit	175
9.2	Financial Innovation	175
9.2.1	Mobile Branch Banking	176
9.2.2	Branchless Banking	176
9.2.3	Credit Information Bureau	176
9.2.4	Credit Rating Mechanism	176
9.2.5	SMART Subsidies	177
9.3	Financial Inclusion Program and Financial Sustainability	177
10	Performance Review of Non-Bank Financial Institutions	181
10.1	Overview	181
10.2	Operating Framework	183
10.2.1	Regulatory Framework	183
10.2.2	Ownership Structure	184
10.3	Performance Review	185
10.3.1	Investment Finance Companies	188
10.3.2	Leasing	190
10.3.3	Venture Capital Investment	193
10.3.4	Discounting	194
10.3.5	Modarabas	196
10.3.6	Housing Finance	199
10.3.7	Development Finance Institutions	202
10.4	Conclusion	205
	Special Section: Profile of Mutual Funds	207
11	Risk Assessment of the Insurance Sector	213
11.1	Introduction	213
11.1.1	Global Perspective	213
11.2	Overview of the Insurance Sector	213

CONTENTS

11.2.1	Significant Developments	214
11.2.2	Performance Review of the General Insurance Sector	215
11.2.3	Life Insurance Companies	220
11.3	Reinsurance	223
11.4	Conclusion	223
12	Payment and Settlement Systems	227
12.1	Evolution of Payment Systems	227
12.1.1.	Legal Framework	228
12.2	Retail Payment System	228
12.2.1	Paper-Based Transactions and Clearing	228
12.2.2	Electronic Transactions: E-Banking	229
12.3	Pakistan Real-Time Interbank Settlement System (PRISM)	231
12.4	SWIFT	232
12.5	Impact on Risk Profile	232
12.5.1	Operational Risk	232
12.5.2	Security Risk	232
12.5.3	Strategic Risk	232
12.5.4	Reputational Risk	232
12.6	Conclusion	232
	Special Section: Trends in Financial Savings	233
	Annexes	241