# Overview

*Introduction:*

CY18 has been challenging for the financial sector of Pakistan. The rise in macroeconomic vulnerabilities on external and fiscal fronts necessitated stabilization measures that led to a slowdown in the pace of domestic economic growth. The financial markets have remained volatile and have, generally, trended downwards. However, financial institutions and market infrastructure have largely remained resilient and performed steadily during the year.

On the global front, the economic growth has moderated to 3.6 percent in CY18, after peaking at 3.8 percent a year earlier. This growth is also not broad based as 52 percent of the economies posted growth in CY18 as against 57 percent of the economies a year earlier. The limitations of fiscal and monetary policies to respond to growing challenges, especially the rising trade tensions and geopolitical risks, increased the uncertainty in the global economy. These uncertainties coupled with Fed rate hikes affected the investors' sentiments, which led to capital outflows from EMDEs, including Pakistan. The policy measures adopted by EMDEs in response to these challenges have constrained the economic growth. Though the Fed's announcement to adopt more accommodative monetary policy has allayed some of the concerns, global economic prospects in the short term have been less than favorable and the global economy is expected to further slowdown in 2019 **(See Chapter 1)**.[1]

The domestic economic developments during CY18, though idiosyncratic in nature, influenced the performance and risk profile of the financial system. The macroeconomic vulnerabilities, which started to emerge in CY17, have further intensified in CY18. The rising twin deficits and elevated inflationary pressures have necessitated the adoption of economic stabilization agenda. The consequent measures like monetary tightening, exchange rate adjustments, and fiscal consolidation have affected the economic momentum. After posting a decade high growth of 5.53 percent during FY18, the economic growth has tapered off to 3.29 percent in FY19.[2] The Large Scale Manufacturing (LSM) has also contracted by 3.64 percent during FY19,[3] while the annual average inflation has also jumped to 7.3 percent during FY19.[4] Shrinking current account deficit remains the key improvement that has come at the back of various regulatory measures and an increase in the level of workers' remittances **(See Chapter 1)**.

The tightening domestic financial conditions along with rising uncertainty among the market participants have put the financial markets under stress.[5] The bearish trend in the equity markets has accentuated risk-averse sentiments and flight to safety as the investors have preferred money market and fixed income funds over stocks. In addition, the financial institutions have tilted their investments in government securities towards short-end of the maturity structure i.e. MTBs and retired long-term

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[1] IMF, World Economic Outlook Update, July 2019. As per IMF estimates, the global economy is expected to grow by 3.2 percent during 2019.

[2] Pakistan Bureau of Statistics (PBS). http://www.pbs.gov.pk/sites/default/files//tables/Table-1_0.pdf

[3] Source: PBS http://www.pbs.gov.pk/sites/default/files//industry_mining_and_energy/qim/2019/web%20note%20June%2019.pdf

[4] 12 months moving average inflation (Source: SBP Inflation Snapshot, http://www.sbp.org.pk/ecodata/MPM.pdf)

[5] Overseas Investors Chamber of Commerce and Industry (OICCI) Survey, Seventeenth Wave, January 2019 https://www.oicci.org/wp-content/uploads/2019/02/OICCI-BCI-Survey-Wave-17-Highlights-December-20181.pdf

SBP's Business Confidence Surveys, 2018-19. http://www.sbp.org.pk/research/BCS-r.asp

PIBs on net basis to avoid any mark-to-market losses. This strategy has led to a decline in the level of outstanding investments during CY18. Accordingly, the growth of the **financial sector** has moderated to 7.49 percent in CY18, and the financial depth, as measured by financial assets to GDP ratio, has moderated to 73.01 percent (**Table 1**).

Table 1: Asset composition of the financial sector

| | CY15 | CY16 | CY17 | CY18 |
|---|---|---|---|---|
| Assets (PKR Billion) | 19,448 | 21,771 | 24,716 | 26,568 |
| Growth rate (Percent) | 15.16 | 11.94 | 13.53 | 7.49 |
| Percent of Total Assets | | | | |
| MFBs | 0.51 | 0.78 | 1.00 | 1.23 |
| DFIs | 0.98 | 0.96 | 0.92 | 0.90 |
| NBFIs | 4.89 | 5.06 | 4.41 | 4.46 |
| Insurance | 5.07 | 5.39 | 5.24 | 5.40 |
| CDNS | 15.83 | 15.10 | 14.23 | 13.93 |
| Banks | 72.72 | 72.72 | 74.21 | 74.08 |
| YoY Growth | | | | |
| MFBs | 39.00 | 73.28 | 45.21 | 32.65 |
| DFIs | 8.14 | 9.63 | 9.18 | 4.60 |
| NBFIs | 11.10 | 15.77 | -1.12 | 8.78 |
| Insurance | 11.88 | 19.03 | 10.34 | 10.88 |
| CDNS | 10.05 | 6.72 | 6.98 | 5.23 |
| Banks | 16.83 | 11.93 | 15.86 | 7.31 |
| Assets as Percent of GDP* | | | | |
| MFBs | 0.35 | 0.56 | 0.75 | 0.90 |
| DFIs | 0.67 | 0.68 | 0.69 | 0.66 |
| NBFIs | 3.37 | 3.61 | 3.28 | 3.26 |
| Insurance | 3.49 | 3.84 | 3.90 | 3.94 |
| CDNS | 10.90 | 10.77 | 10.60 | 10.17 |
| Banks | 50.05 | 51.87 | 55.28 | 54.08 |
| Overall assets | 68.82 | 71.34 | 74.49 | 73.01 |

*GDP at market prices

Note: The total assets for NBFIs and Insurance sectors have been revised for CY16 and CY17, respectively.

Source: SBP, SECP and CDNS

## *Executive Summary*

In CY18, the operations and risk profile of the domestic **financial markets** have been largely influenced by the growing external account vulnerabilities, tighter monetary policy response, and uncertainty among the market participants. While Government has succeeded in raising sizeable bilateral financial support, these flows could partially finance the high current account deficit. As a result, the SBP FX reserves depleted by around USD 7 billion and the PKR, cumulatively, depreciated by 23.61 percent against US dollar, leading to higher volatility in the FX market. Besides, uncertainties associated with the political transition and future economic direction led to bearish sentiments in equity market that pulled down the KSE-100 index by 7.58 percent (on average) during the year. However, volatility in the money market has remained contained due to interest rate corridor mechanism in place and prudent management of market liquidity by SBP (**See Chapter 2**).

**Banking sector,** the backbone of the financial sector, has generally weathered the challenging macro-financial conditions and performed steadily. The financing growth has increased, profitability remains reasonable, liquidity buffers stayed high, and solvency of the banking sector has remained adequate **(See Chapter 3.1)**.

The financial intermediation has improved with advances to deposit ratio attaining its highest level of 55.81 percent in the last eight years. The high financing growth in the private sector has mainly supported this improvement in intermediation. The demand for financing has mainly come from textile, food and beverage, cement, energy, chemical and real estate sectors. The rise in input costs, as reflected in almost 33.29 percent growth in the working capital loans, is partially responsible for the surge in demand. The funds generated through deposit mobilization coupled with net-retirement of investment in government securities enabled the banks to meet the increase in credit requirements.

The credit to private sector can get further thrust if the banking sector's exposure to government could be reduced.[6] Though, it is encouraging to note that the trend of rising credit to government has reversed in CY18, the exposure still remains high at 48.15 percent of the assets, with one-sixth of it lent to the

[6] Government exposure includes investments in government securities and lending to public sector entities.

public sector power entities and commodity finance operations. As the share of financing to these sectors is continuously growing, it is imperative to resolve the underlying structural issues related to energy sector circular debt and otherwise self-liquidating commodity operations.

Asset quality of the banking sector presents a mixed picture. A higher growth in advances has led to a decline in infection ratio, though the quantum of NPLs has increased during the year. The flow of fresh NPLs is mainly observed in sugar, energy and agriculture sectors domestically along with some impairment in the overseas portfolio in the Middle East region. Accordingly, Net NPLs and capital impairment ratios have observed some rise during the year.[7] **(Table 2)**

Table 2: Highlights of the banking sector

| | CY15 | CY16 | CY17 | CY18 |
|---|---|---|---|---|
| **Key Variables (PKR Billion)** | | | | |
| Total Assets | 14,143 | 15,831 | 18,342 | 19,682 |
| Investments (net) | 6,881 | 7,509 | 8,729 | 7,914 |
| Advances (net) | 4,816 | 5,499 | 6,512 | 7,955 |
| Lending to financial institutions | 361 | 552 | 605 | 910 |
| Deposits | 10,389 | 11,798 | 13,012 | 14,254 |
| Borrowings from financial institutions | 1,766 | 1,942 | 3,125 | 3,001 |
| Equity | 1,323 | 1,353 | 1,381 | 1,406 |
| Profit Before Tax (ytd) | 329 | 314 | 267 | 243 |
| Profit After Tax (ytd) | 199 | 190 | 158 | 149 |
| Non-Performing Loans | 605 | 605 | 593 | 680 |
| Non-Performing Loans (net) | 91 | 90 | 76 | 110 |
| **Key FSIs (percent)** | | | | |
| CAR | 17.32 | 16.17 | 15.83 | 16.19 |
| ROA (Before Tax) | 2.51 | 2.10 | 1.56 | 1.31 |
| ROA (After Tax) | 1.52 | 1.27 | 0.93 | 0.81 |
| ROE (Before Tax) | 25.83 | 23.86 | 19.51 | 17.39 |
| ROE (After Tax) | 15.63 | 14.43 | 11.55 | 10.71 |
| Cost to Income Ratio | 47.84 | 53.07 | 57.14 | 60.21 |
| NPLs to Loans (Gross) | 11.36 | 10.06 | 8.43 | 7.97 |
| Net NPLs to Net Loans | 1.89 | 1.64 | 1.16 | 1.38 |
| Liquid Assets to Total Assets | 53.81 | 53.73 | 53.97 | 48.69 |
| Advances to Deposit Ratio | 46.35 | 46.61 | 50.05 | 55.81 |

Note: Statistics of profits are on year-to-date (ytd) basis.

The deceleration in deposits, observed over the last couple of years, continues during CY18. Deposits have witnessed a growth of 9.55 percent compared to last five years' average of 12.26 percent. The slowdown is mainly driven by: a) strategy of the banks to focus on low cost deposits in a rising interest rate environment; b) scaling back of operations by few banks in the overseas markets; c) probable effect of withholding tax on banking transactions; d) enhanced KYC requirements for depositors; e) increasing placement of retail deposits in government securities through non-competitive bids; and f) liquidity generated through net retirement of investments. Among these factors, compliance with enhanced KYC is necessary to avoid ML/FT risks, while others like imposition of withholding tax needs appropriate policy tweaking for effectively pursuing the financial inclusion agenda and enhancing the banks' ability to improve intermediation.[8]

The banks have posted reasonable profit during CY18, though increase in provisioning charges against NPLs coupled with a rise in administrative expenses and one-off extraordinary pension expense have kept the profitability below the last year's level. Encouragingly, a healthy growth in advances has increased the share of interest income from core financing activity. Consequently, the net interest margin (NIM) has improved that has been falling for the last 3 years.

The solvency of the banking sector remains strong with capital adequacy ratio (CAR) at 16.2 percent – well above the minimum regulatory requirement of 11.9 percent.[9] **(Table** 2). Further, to address the possible systemic risk posed by the large institutions,

[7] Fresh NPLs, generally, require lower provisions leading to rise in net NPLs. As a result, the net NPLs to net Advances ratio and Capital impairment (net NPLs to Capital) ratio increase.

[8] The government has abolished the withholding tax on deposit withdrawals for filers while it maintained 0.6 percent tax rate for the non-filers in the interim budget 2019. (Finance Supplementary (Second Amendment) Act, 2019)

[9] This comprises minimum CAR requirement of 10 percent and capital conservation buffer of 1.9 percent that will increase to 2.5 percent by the end of CY19 (BPRD Circular No. 6 of 2013).

SBP has issued a framework for designation of Domestic Systemically Important Banks (D-SIBs).[10] Under the framework, three banks have been designated as D-SIBs that are subject to enhanced supervision; including the Higher Loss Absorbency Capital surcharge in the form of additional common equity tier-1 capital (CET1).[11]

**Islamic Banking Institutions** have maintained the fast growth over the years, and, as of end CY18, constitute almost 13.51 percent of the total banking sector assets. The growth in IBIs is mainly driven by financing activity, while healthy increase in Mudarabah based deposits provided the required funding. Among the Islamic financing categories, profit and loss sharing modes of Musharaka and Diminishing Musharaka have gained prominence with 53 percent share in financing. While IBIs have lent to diverse economic sectors, their share in financing to SMEs and Agriculture sector still remains small. As such, IBIs needs to make efforts to explore these potential financing avenues **(See Chapter 3.2)**.

IBIs have remained sound, with improved asset quality, higher profitability and CAR well above the minimum requirement. However, the sector continues to face the dearth of long-term Shariah compliant investment avenues that limits IBIs ability to effectively manage their liquidity. It is also affecting the deposit mobilization efforts of IBIs necessary for maintaining growth trajectory.

Challenging macro environment coupled with increased volatility in financial markets have particularly increased the risk aversion in **Non-Bank Financial Institutions** (NBFIs) directly linked with equity market. The **mutual funds**—the dominant segment of NBFI—have witnessed both contraction in assets under management as well as a flight to safety i.e. movement from equity stocks to money market funds. On the other hand, **Investment Finance Companies (IFCs)** and **Non-Bank Microfinance Companies (NBMFCs)** that are engaged in intermediation function have observed asset growth and exhibited relatively better performance. The improved availability of market-based funding has also facilitated the growth of NBMFCs during the year under review (**See Chapter 4.2**). Nevertheless, NBFIs continue to face various challenges that are hindering their growth. Particularly, the stiff competition from banks is limiting their ability to mobilize low cost funds and attract quality human resources. Development of an industry level strategy is needed to address the issues in order to enable the NBFIs to play an effective role in financial deepening.

The **Development Finance Institutions** remains well capitalized; though, they continue to operate with limited suite of financing products. Particularly, the role of the DFIs in their key area of project financing remains less than encouraging due to lack of affordable long term funds. However, the renewed interest in SME financing during CY18 is a positive development. The DFIs need to make concerted efforts to raise long-term funding by exploring alternate resource mobilization avenues such as capital market (**See Chapter 4.1**).

The asset base of the **Insurance sector** has expanded by 10.88 percent in CY18, funded in part by 9.45 percent increase in gross premiums. However, the profitability indictors for the sector have slid down slightly owing to increase in net claims. Further, the concentration remains a concern as the public sector insurers dominate the insurance industry. Some non-life insurers are also facing solvency issues. These insurers need to work on viable recovery plans or pursue possible consolidation avenues. Nevertheless,

[10] The framework follows two steps approach; in first step, a sample of banks based on quantitative and qualitative criteria is identified. In the second step, among these sample banks, D-SIBs are designated based on Size, Interconnectedness, Substitutability and Complexity.

[11] http://www.sbp.org.pk/press/2018/Pr-14-Jun-18.pdf

the low insurance penetration in the country provides an opportunity for the sector to grow (See Chapter 4.3).

Due to their peculiar business model of dealing in foreign currencies, the **Exchange Companies** (ECs) have benefited from the exchange rate dynamics. However, the operational risk, especially relating to AML/CFT, remains tangible for these companies. To address these concerns, SBP has further strengthened the regulatory regime for ECs during the year under review (See Chapter 4.4).

**Financial Market Infrastructure (FMI)** remains resilient and continues to perform efficiently without any major disruption. Pakistan Real-time Inter-bank Settlement Mechanism (PRISM) has settled a higher volume and value of large-value transactions, whereas the retail-value segment has also registered an uptrend. The increasing adoption of electronic modes for payment indicates growing consumers trust in use of digital financial services. Furthermore, access of the PRISM allowed to retail customers and corporate securities settlement institutions[12] has infused efficiency in high-value retail settlements and operations of the markets (See Chapter 6).

The integration between FMIs has also increased the level of interconnectedness, which involves the element of contagion risk. Coupled with this, the cyber-security risk poses additional challenges to these FMIs, with retail payment segment being more vulnerable to the latter risk category. To safeguard against these emerging threats, SBP has taken various measures to protect the integrity of the FMIs. Particularly, a comprehensive set of instructions has been issued to ensure security of digital payments. Moreover, the National Clearing Company Limited (NCCPL) and Central Depository Company (CDC), which constitute the corporate securities settlement infrastructure, have also strengthened their risk management practices.

To guard against the cyber security risk, banks have also fortified mitigation measures. Most of the banks have implemented multifactor authentication to strengthen the security of internet banking transactions, whereas they continue to work on strengthening their intrusion detection and prevention systems to protect their IT infrastructure from cyber-attacks. Furthermore, in compliance with SBP's regulations, banks have been issuing payment cards with Euro-MasterCard-Visa (EMV) anti-skimming standards.

**Financial inclusion** in the country is accelerating due to increased access to quality financial services to a wider stratum of the population. Especially, the branchless banking and m-wallet accounts have remained the key drivers in enabling the financial access to the underserved areas of the country. Microfinance banks, an important element of National Financial Inclusion Strategy (NFIS), continue to perform well with improved resilience. At present, growing financial inclusion poses minimal concerns to financial stability due to lower inclusion base, risk based due diligence of customers, and comprehensive regulatory and supervisory framework in place (See Chapter 7).

The performance of **non-financial corporate sector** has moderated as reflected in the slackness of its operational efficiency and financial standing in CY18. The leverage of the sector has inched up, whereas liquidity, debt repayment capacity and profitability have slightly declined. The investors' perception about the corporate sector has also weakened as illustrated by a drop in stock prices and other leading market indicators. Positively, the rating culture in the corporate sector is on the rise. The phased decline in corporate tax rate as proposed in

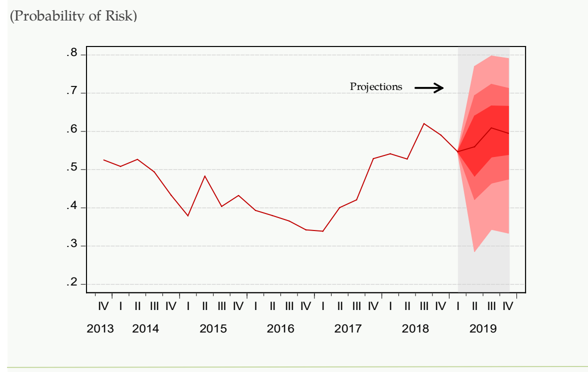
[12] CDC and NCCPL are corporate securities settlement systems which have been allowed as special participants of PRISM for settlement of transactions in the form of multilateral net settlement batches.

the interim fiscal budget is likely to augment profitability of the corporate sector (See Chapter 5).

Anti Money Laundering/Countering Financing of Terrorism (AML/CFT) is another key area where local regulatory bodies are making continuous efforts to safeguard the financial system against ML/FT risk. Though Pakistan has recently been identified as a jurisdiction with strategic AML/ CFT deficiencies, it has made a high-level political commitment to implement the action plan for overcoming the identified gaps. To this end, a number of measures have been introduced that demonstrates the seriousness of the country to ensure a robust AML/CFT regime. Key regulatory initiatives include a)- establishment of dedicated CFT desk in banks, b)- ensuring biometric verification of 100 percent portfolio, c)- issuance of guidance to bring more clarity on the regulatory expectations in the areas of consumer due diligence, corresponding banking, wire transfer, compliance with UNSC sanctions, definitions of beneficial owner and legal entity, counter measures for high-risk countries, etc., d) strengthening of regulations for NBFCs including adoption of risk-based approach, e) extension of regulatory regime to cover Designated Non-Financial Business & Professions, NGOs, Pakistan Post, etc. and f) amendment in the Protection of Economic Reform Act to strengthen the regime around foreign currency accounts and movement of foreign currency (See Box-4).

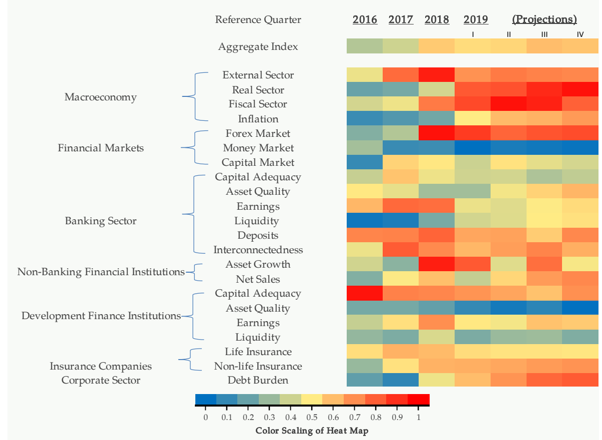
The consolidated picture thus reveals that, amid rising macro-financial challenges, risks to financial stability have somewhat increased during CY18 (Chart 1a) (Chart 1b).

Chart 1(a): Financial Vulnerability has increased in CY18




Source: Staff estimates

Chart 1(b): Rising macroeconomic imbalances has adversely affected financial sector performance




Source: State Bank of Pakistan

### *Financial Sector Outlook…*

Post CY18, the macroeconomic imbalances, particularly the fiscal deficit, have widened. The current account deficit, though narrowing gradually, remains at elevated level putting pressure on foreign exchange reserves. SBP has raised the policy rate by 325 bps post CY18 (until July 2019) to address these macroeconomic challenges. In the near future, the necessary policy measures for the stabilization of the economy such as rationalization of taxes in the budget FY19-20 and adjustment in utility prices may further slowdown the pace of economic wheel. The real GDP is expected to rise modestly in FY20. The average CPI Inflation has remained within the range of 6.5-7.5 percent in FY19 but is anticipated to be considerably higher in FY20.[13]

There are considerable uncertainties around the projected path of the financial vulnerability index (**Chart 1b**).[14] External account imbalances may have strong repercussions for the financial markets. The uncertainty surrounding the equity market may continue to strain the performance of mutual funds and insurance sector, which are more dependent upon the capital market. The monetary tightening may affect the debt repayment capacity of the borrowers with some lag. In the backdrop of this challenging economic outlook, the corporate sector could perform below its full potential. Therefore, improvement in macroeconomic conditions and successful implementation of the IMF program will be the key drivers in ensuring stability of the financial sector.

The assessment of resilience of the banking sector to probable future domestic or global stress event in the medium term is of paramount importance. This year's stress testing results indicate that the banking sector can withstand for three years the severe and protracted downturn induced by hypothetical adverse global macroeconomic conditions. The large banks, however, carry sufficiently higher capital buffers and are able to sustain the impact of hypothesized shocks for around four years **(See Chapter 3.3)**.

The 3rd wave of SBP Systemic Risk Survey (conducted in Jan-2019), reveals that foreign exchange rate risk, balance of payment pressures, widening fiscal deficit and increase in domestic inflation would remain the key risks to financial system stability for the next six months (**See Box 1**).

SBP is aware of these emerging challenges to the financial sector and has taken steps to foster risk management practices and enhance transparency in its regulated sectors, which constitute 76.21 percent of the total financial sector's assets. SBP is also working in collaboration with other stakeholders for formulating and implementing a comprehensive and well-structured Macroprudential Policy Framework to ensure stability of the financial sector (**See Box 2**).

[13] State Bank of Pakistan. (2019). Monetary Policy Statement. May 2019 http://www.sbp.org.pk/m_policy/2019/MPS-May-2019-Eng.pdf

[14] Most of the underlying indicators of FSVI have been projected using the exponential smoothing technique of Holt-Winters.