FINANCIAL STABILITY REVIEW-2020

State Bank of Pakistan

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Governor's Message

The year 2020 was exceptionally challenging as the COVID-19 pandemic—a once in a century event—triggered the deepest global economic recession since the Great Depression. Besides significant economic disruptions, loss of lives has been enormous worldwide. Anticipating heightened risks, authorities around the globe moved swiftly to enact a range of policy measures, including monetary easing, fiscal support, and rationalization of regulatory controls to support economic activity and preserve financial stability. Resultantly, turmoil in global financial markets proved short-lived and contraction in the global economy remained relatively contained, although the impact varied across countries depending upon the severity of the pandemic and availability of economic cushions.

Pakistan experienced two coronavirus waves during CY20; however, the impact on the economy has been relatively mild. Encouragingly, the output loss of 0.47 percent during FY20 was one of the lowest among Emerging Market and Developing Economies. To ward off the adverse impact, SBP also introduced an aggressive set of stimulus measures, of around 5 percent of GDP to cushion the slowdown in growth and maintain financial stability. In the wake of the swift and comprehensive policy response, receding COVID-19 intensity and easing of associated mobility restrictions, signs of economic recovery emerged in the second half of CY20. The Large Scale Manufacturing Index rebounded and Business Confidence Index became positive in August-2020, and further improved afterwards. Also, the current account posted the best result since CY03 as it turned into a surplus in CY20. The economic buoyancy persisted, and even amid an intense third wave, the economy is estimated to post a broad-based growth of 3.94 percent during FY21.

Despite the enormous challenges and vulnerabilities, the domestic financial sector remained resilient and performed remarkably well. After observing acute volatility for a brief time like the rest of the world, markets recovered quite fast, while the financial system continued to provide financial services and liquidity to the government, businesses and households. Specifically, the industry, with the support of SBP, capitalized on the unique opportunity presented by COVID-19 by accelerating the pace of digitization that allowed provision of services in a safe, convenient and hygienic manner.

The banking sector observed a healthy rise in profitability. The enhanced earnings along with capital buffers built over the years further improved the solvency and helped maintain resilience of the sector. The SBP support measures also facilitated banks to continue providing credit and keep credit risk under check. The non-bank financial sector demonstrated a mixed performance, with mutual funds witnessing net inflows. While the performance of the non-financial corporate sector improved on the back of lower financial costs and greater efficiency in administrative expenses.

Going forward, risks to financial stability will be largely driven by COVID-19 dynamics and attendant economic consequences. The intensity and duration of the pandemic, the speed of immunization and its effectiveness against new variants of virus, and success in preserving economic resilience will be the key determinants of financial stability in the near term. Stress test results also show that the banking sector maintains reasonable resilience, even against adverse economic conditions. Although, the overall policy landscape is quite dynamic and complex, the SBP remains vigilant to any risks emerging on the global and domestic fronts and will stand ready to take necessary measures to ensure financial system stability.

Dr. Reza Baqir

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Data Convention and Coverage

The FSR 2020 uses CY for the Calendar Year, FY for the Fiscal Year (starting in July of a CY and ending in June of the following CY), Q1-Q4 for the four quarters of the corresponding CY or FY and H1-H2 for the two halves of a CY or FY, as the case may be.

The review is generally based on the data reported in the unaudited or audited accounts (where available) of financial institutions for different components as follows:

- Banks (conventional and Islamic), Development Finance Institutions (**DFIs**), Microfinance Banks (**MFBs**) and Payment System are based on un-audited financial statements reported to SBP through Quarterly Reporting Chart of Accounts (**RCOA**) and various other returns.
- Data on Non-Bank Financial Institutions (**NBFIs**) is based on monthly reports submitted to SECP through Specialized Companies Return System (**SCRS**).
- Insurance is based on audited and un-audited financial statements and Insurance Association of Pakistan (IAP) for the period ending December 31, 2020.

The data pertaining to corporate sector has been obtained from the financial statements of companies, SECP, SBP, PSX and Bloomberg.

The Overview

The financial system of Pakistan remained resilient during CY20 — a challenging year marked by the COVID-19 health crisis, which created exceptional uncertainty and contracted economic activity both domestically and internationally. Strong capital and liquidity buffers, accumulated over the years under a prudent regulatory regime, enabled the financial system to maintain its stability while continuing to offer services during the pandemic. Timely policy interventions including relief measures announced by State Bank of Pakistan and the government, along with an effective strategy to handle the pandemic, further supported the financial sector to weather multifaceted challenges.

The recurrent waves of the Coronavirus continue to threaten the global community. Until June 21, 2021, the outbreak has infected 178 million individuals with 3.9 million fatalities across the world.[1]

The COVID-19 shock triggered the deepest global economic recession since the Great Depression. Even the global output contraction of 3.3 percent[2] during 2020 was considerably higher than the 0.6 percent dip experienced during the Global Financial Crisis (GFC) of 2008-09.

The output contraction in Advanced Economies (**AEs**), and Emerging Markets and Developing Economies (**EMDEs**) has been recorded at 4.7 percent and 2.2 percent, respectively, during CY20. In particular, countries that rely on commodity exports and tourism as well as those with limited policy space faced large output losses.

Incidentally, both the GFC and Global Health Crisis (**GHC**) required special but varied measures from the policy makers due to their idiosyncratic features (**see Box-1.1**). However, in the wake of the exceptional intensity of the crisis, fiscal and monetary authorities across the world acted swiftly and forcefully to contain its potential fallout. Central bank actions were extraordinary in terms of scope, speed, and size. Consequently, unprecedented turbulence witnessed in global financial markets at the inception of the pandemic receded quite early, while funding markets remained functional and investor sentiments improved.

In the highly uncertain global environment, Pakistan experienced two waves of the coronavirus during CY20. However, their impact on human health and economic indicators remained relatively mild.[3] The pandemic and its attendant precautionary measures, lockdowns and the freeze of global trade induced a 0.47 percent contraction in **domestic economic activity** during FY20, which has been one of the smallest declines among EMDEs.[4]

It deserves emphasis that Pakistan entered the crisis with relative strength as it had largely reined in macroeconomic imbalances. With sufficient policy space available, the country was able to enact policy measures commensurate with the depth and breadth of relevant risks to the economy and financial sector. Besides fiscal support[5] and a relief package for construction industry by the government, SBP introduced a wide range of measures during the year to cushion the slowdown in growth, and preserve the flow of credit, liquidity and solvency of the banks and the borrowers. These measures included a speedy and significant cut in the policy rate, new concessionary refinancing schemes to support employment, health care services and production, deferment and rescheduling/ restructuring of loans, reduction in the Capital Conservation Buffer of banks and a host of other initiatives to ensure safety of people and uninterrupted supply of

[1] World Health Organization
[2] IMF. (2021). World Economic Outlook. *April*
[3] Until June 21, 2021 infection statistics stand at around 950 thousand with 22 thousand fatalities.
[4] See Statistical Appendix of World Economic Outlook (2021), *April.*
[5] Pakistan Economic Survey FY19-20

banking services to firms and households. Overall, SBP's stimulus measures provided necessary economic support to households and businesses of around 5 percent of FY20 GDP.

In the wake of the swift and comprehensive policy response, receding COVID-19 intensity and easing of associated mobility restrictions, signs of economic recovery emerged in the second half of CY20. Large Scale Manufacturing (**LSM**) Index rebounded and Business Confidence Index (**BCI**) became positive from August 2020 onwards. On the external front, the current account posted a surplus for the first time since CY03. Moreover, financial conditions implied by low interest rates, a relatively stable exchange rate and contained volatility in equity prices remained supportive. Inflation, however, remained elevated owing to food price shocks. The recovery was duly recognized by international rating agencies, including Moody's which upgraded the sovereign rating of Pakistan from 'under review for downgrade' to 'stable' in August 2020 (**see Chapter 1**).

The performance of the **financial sector** amid pandemic-induced challenges remained satisfactory. The consolidated asset base of the financial sector rose by 14.08 percent in CY20 and financial depth—measured by financial assets to GDP—further increased to 77.53 percent (**see Table 1**).

Table 1: Assets Composition of the Financial Sector

	CY16	CY17	CY18	CY19	CY20
Assets (PKR Billion)	21,853	24,734	26,526	29,741	33,925
Growth rate (Percent)	12.55	13.18	7.25	12.12	14.07
YoY Asset Growth (Percent)					
MFBs	74.65	45.21	32.65	15.88	29.99
DFIs	9.63	9.18	4.60	58.12	16.50
NBFIs	15.77	-1.11	8.74	13.03	26.97
Insurance	31.81	8.21	6.03	14.99	13.03
CDNS	6.66	5.58	5.30	9.42	7.49
Banks	11.93	15.86	7.31	11.73	14.24
Percentage Share in Total Assets					
MFBs	0.78	1.00	1.24	1.28	1.46
DFIs	0.96	0.92	0.90	1.27	1.29
NBFIs	5.04	4.40	4.46	4.50	5.01
Insurance	5.74	5.49	5.43	5.57	5.52
CDNS	15.04	14.03	13.77	13.44	12.67
Banks	72.44	74.16	74.20	73.94	74.06
Assets as a Percentage of GDP*					
MFBs	0.56	0.74	0.90	0.95	1.13
DFIs	0.68	0.69	0.65	0.94	1.01
NBFIs	3.61	3.27	3.24	3.33	3.89
Insurance	4.11	4.08	3.94	4.12	4.29
CDNS	10.78	10.43	9.99	9.96	9.85
Banks	51.91	55.13	53.79	54.78	57.56
Overall Assets	71.65	74.34	72.50	74.09	77.73

Note: *GDP at market prices
Source: SBP, SECP, CDNS & PBS

Financial Markets observed elevated stress in the first half of CY20 owing to heightened and lingering uncertainties. However, extraordinary support measures helped the early restoration of normalcy in financial markets. Successive cuts in the policy rate and other policy measures played a vital role in lifting investors' sentiments. For instance, KSE-100 index manifested a V-shaped recovery. Similarly erstwhile volatility in the FX market abated during the second half of CY20 due to an increase in FX reserves mainly on account of the rise in the flow of remittances, reductions in the services and primary income deficits and improved external financial flows. Though the money market faced stress, SBP's proactive liquidity management through relatively higher quantum of injections ensured smooth functioning of the market. Also, the abundant flow of deposits provided much-needed support to the inter-bank liquidity (**see Chapter 2**).

The **Banking Sector** which dominates the financial system of the country —holding around 75 percent of financial sector assets and performing the majority of financial intermediation in the economy — fared quite well during the pandemic, showing strong financial soundness and resilience, and operational capabilities to continue the supply of services in challenging circumstances. The sector posted strong growth of 14.24 percent in its asset base, which was driven almost entirely by an increase in investments in government securities. Weaker private sector demand for credit, an abundant inflow of deposits and higher intake of credit by the public sector to, inter alia, fund the pandemic-related support measures remained the key drivers behind growth in investments.

Credit risk inched up in the first half of CY20 due to impairment of the repayment capacity of vulnerable segments. However, as the relief measures took hold in the second half of the year, non-performing loans (**NPLs**) started to subside. As such, the overall risk profile does not pose serious concerns. Further, the performance and repayment capacity of the corporate sector, which utilizes the major portion of banks' lending portfolio, improved with revival of economic activity from Q3CY20. Moreover, banks also exhibited prudence by proactively increasing general provisions to account for potential credit losses in their loan portfolios, in addition to specific provisions against the NPLs. An analysis of large credit exposures indicated prudent lending behavior as banks lent out to better-rated borrowers/ borrowing groups, which exhibited capacity to withstand the economic shocks.

Profitability indicators of the banking sector observed a marked improvement mainly attributable to lower interest and administrative expenses, and gains on sale of securities. Strong earnings, in turn, enhanced the resilience of the banking sector, as CAR increased by 156 basis points to 18.56 percent at the end of CY20 (**see Chapter 3.1**).

The performance of **Islamic Banking Institution** (**IBIs**)—with 30.0 percent increase in assets—remained remarkable. Healthy inflow of deposits provided the necessary funding to support the expansion in financing and investments. Profitability also remained strong though its pace moderated. Encouragingly, availability of additional Shariah-compliant investment avenues facilitated IBIs to improve their liquidity profile (**see Chapter 3.2**).

Non-Bank Financial Sector maintained its performance, though some segments faced stress. The growth in asset base of **Development Finance Institutions** (**DFIs**) decelerated due to a retardation in investments. Unlike last year's borrowings driven expansion, assets were funded by a mix of deposits, equity, and borrowings during CY20. Though DFIs posted healthy profits, CAR observed some moderation largely due to increase in market risk weighted assets (**see Chapter 5.1**).

The assets of **Non-Bank Financial Institutions (NBFIs)** grew by 26.97 percent in CY20 (13.03 percent in CY19). Marked rise in the assets was largely driven by increase in mutual funds mainly in the money market and income funds category. However, a slowdown in economic activity led to contraction in asset base and deterioration in asset quality of NBFIs involved in the financing business. The risks of interconnectedness between the banks and NBFIs continued to emanate from mutual fund segment's dependence on banks for ownership support. **(See Chapter 5.2).**

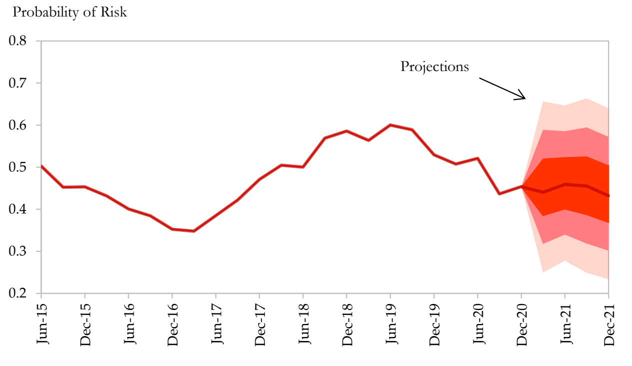
The **Insurance and Takaful industry** maintained its performance as the asset base expanded by 13.03 percent during CY20. Both, the life and non-life sectors demonstrated risk-averse behavior by increasing their exposure in government securities. Nonetheless, growth in premium of insurance industry remained subdued due to the pandemic-induced downturn. Conversely, while Claims for the Life sector increased, Claims for the Non-Life sector decreased due to the marked slowdown in economic activity. **(See Chapter 5.3)**.

The Non-Financial Corporate Sector, performance was boosted on the back of lower financial cost due to significant monetary easing. The top corporate firms witnessed improvements in profitability, liquidity and solvency indicators, though sales and business turnover indicators slackened due to weakened demand. In particular, automobiles, energy and oil & petroleum sectors faced notable contractions in sales. Encouragingly, the probability of default for large corporates slightly declined owing to improved operating performance. (**See Chapter 6**).

Although the pandemic triggered some operational constraints, the performance and resilience of **Financial Market Infrastructures (FMIs)** remained intact during CY20**.** Pakistan Real Time Interbank Settlement Mechanism (**PRISM**)—with uninterrupted availability—handled an increased volume of transactions, although the value of transactions declined. The customer's increased preference for digitization in the wake of the pandemic and policy measures of SBP gave a strong push to E-banking transactions. To realize the objective of a modern and efficient national payment system, SBP launched 'Raast'—an instant payment system for retail transactions—as a major step towards implementation of National Payment Systems Strategy (**see Chapter 7)**.

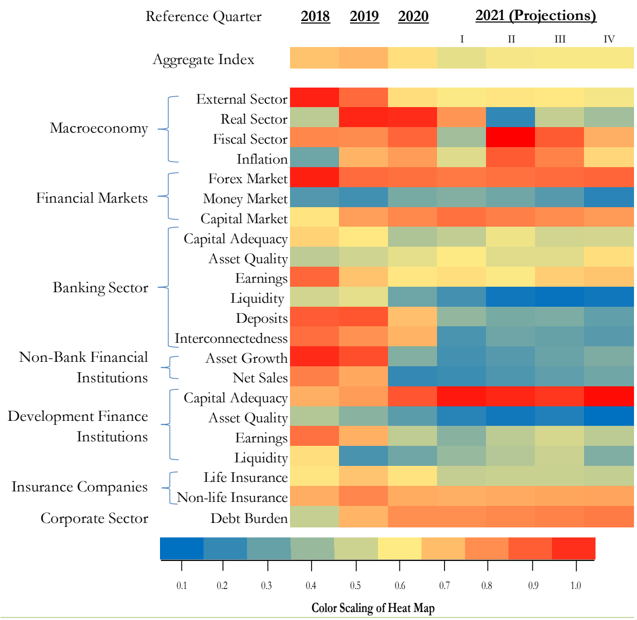
The consolidated picture of the state of financial stability indicates that vulnerabilities increased during Q2CY20 due to the COVID-19 shock. However, the risks subsided afterwards owing to swift and robust policy measures, contained impact of COVID-19, and economic recovery as reflected in estimated GDP growth of 3.94 percent for FY21 (**Chart 1A & 1B**). SBP, in particular, enacted a range of measures to support the economic activity and stability of the banking system (**see Appendix-A**). This view is also corroborated by the results of stress tests, which reveal that the banking sector remains resilient even under assumed adverse economic conditions over a projection horizon of three years. Reassuringly, the capital adequacy ratio of the banking sector in general and of large systemically important banks in particular, remains well above the regulatory benchmark even under severe stress scenarios (**see Chapter 4**).

Chart 1A: Financial Ssector Vulnerability Index (FSVI)



Source: Staff Estimates

Chapter 1B: Financial Sector Heat Map



Source: SBP

Looking ahead, the 7th wave of SBP **Systemic Risk Survey** (conducted in Jan-2021), revealed that besides global risks (e.g., slowdown in global output and volatility in commodity prices), rise in inflation, economic slowdown, and cyber security risks would be key concerns for financial system stability over the next six months (**see Box 1**). Cyber security and money laundering/ terrorist financing remain the key operational risks to the financial sector. SBP continues to engage with the banks for enhancing their readiness to ward off cyber security threats. Though level of standing varies across the institutions, banks in Pakistan continue to focus on improving their cyber resilience. Moreover, the compliance with FATF standards is essential to enhance integrity and stability of the sector. In this regard, the country has made considerable progress across all action plan items agreed with the FATF, largely addressing 24 out of the 27 action items.[6]

Going forward, risks to financial stability will largely be driven by the dynamics of COVID-19 pandemic and concomitant economic implications. A speedy vaccination drive across the world including effectiveness against emerging virus strains and contained outbreak may bolster global economic momentum and create a favorable external environment. However, normalcy in social conditions and increased aggregate demand may push-up oil and commodity prices, exerting pressures on current account. Also, monetary policy normalization in AEs may raise external funding costs.

On the local front, Pakistan's financial sector has withstood economic adversities. The policy support measures, thus far, have avoided delinquencies of borrowers and augmented the solvency of banks. Available data suggest that the borrowers allowed deferments and restructuring/rescheduling in general are regularly servicing their financial obligations.

Further, the third wave of COVID-19 in Pakistan seems to have peaked out, the pace of inoculation drive is picking up and will get an additional boost due to local production of vaccines in collaboration with China. Furthermore, the twin balances have started to improve, with the external balance turning positive and the fiscal deficit shrinking. These positive developments are increasing the probability of a full scale and sustainable revival of economic sectors. With encouraging developments on the pandemic front and improvements in the macroeconomic situation, residual risks to financial stability are expected to subside, with the sector anticipating better prospects for the year ahead.

However, the sustainability of such a revival is largely contingent upon the likelihood of the resurgence or emergence of new virus variants and success of vaccination campaigns. Further, any delays in the global and domestic recovery may affect the repayment capacity of borrowers, which could lead to solvency issues. As such, banks need to continuously assess the situation, particularly the repayment capacity of borrowers, and if required, carry out necessary adjustments in their business models in consultation with relevant stakeholders. The SBP, on its part, continues to closely watch the unfolding situation and remains ready to take whatever actions are necessary to safeguard financial stability.

[6] Documents - Financial Action Task Force (FATF) (fatf-gafi.org)

Box 1: SBP's Systemic Risk Survey - 7th Wave (January 2021)

(Disclaimer: The results represent the opinion of the respondents of the survey and do not reflect the views of the State Bank of Pakistan.)

SBP completed the 7th wave of its biannual Systemic Risk Survey (**SRS**) in January 2021 to capture the risk perceptions of the market participants and evaluate their confidence in the stability of the financial system. As was the case in previous iterations, the core survey questions remained unchanged. However, to gauge the perceptions of the participants about the stability implications of ongoing COVID-19 pandemic, the survey questionnaire has been supplemented with a set of questions since the last conducted wave (sixth wave).

Besides risks emanating from the pandemic, the survey gauged the present and future (over the next six months) perceptions of the respondents related to five broad categories of risk i.e. global, macroeconomic, financial markets, institutional and general. The respondents for the current iteration included a broad spectrum of stakeholders[7]. One hundred and fifteen participants took part in the current wave yielding 53% response rate.

Summary of Results:

1. At present, on the aggregate level, respondents rank the "Domestic Macroeconomic Risks" category as the most vital, followed by "Global Risks". Their perception about importance of risks to the financial system are exogenous to the system, and does not change for the next six months. **(Chart A & B)**

2. In terms of specific risks at present, highest rated are "deterioration in household income", "slowdown in domestic growth", and "volatility in commodity prices". For the next six months, the respondents substitute the risk sources with "increase in domestic inflation", "volatility in commodity prices" and "cyber security risks". Apparently, in the near future, respondents are hopeful for the recovery in the domestic economy but remain cautious regarding rise in inflation. **(Chart C)**

3. Comparison of previous three waves indicates that the risk perception has slightly improved towards domestic inflation and slowdown in domestic growth. **(Chart E)**

4. The confidence on the stability of the financial and banking system has improved in comparison to previous waves. It manifests the effective handling of the economic and financial risks—in the wake of timely policy measures taken by the government and the State Bank of Pakistan—associated with the COVID-19. **(Chart D)**

5. It is encouraging to note that the respondents' views—in the pandemic's perspective—remain strongly positive about the efficacy of the SBP's overall policy measures. **(Chart F1 & F2)**

6. Regarding COVID 19's impact on financial industry, the survey results indicate that major adverse impact could be observed on advances growth followed by profitability and business operations. **(Chart G)**

7. In respondents' views, the impact of COVID-19 on financial stability would gradually fade out from immediate term to medium term as the pandemic eases **(Chart H)**. Further, respondents' perceptions have slightly improved in comparison to previous wave (6th wave).

[7] The respondents included executives from commercial banks, insurance companies, exchange companies, MFBs, DFIs, major financial market infrastructures, financial journalists, members of academia, SECP officials and think tanks.

Chart A: Perception on sources of systemic risk- present

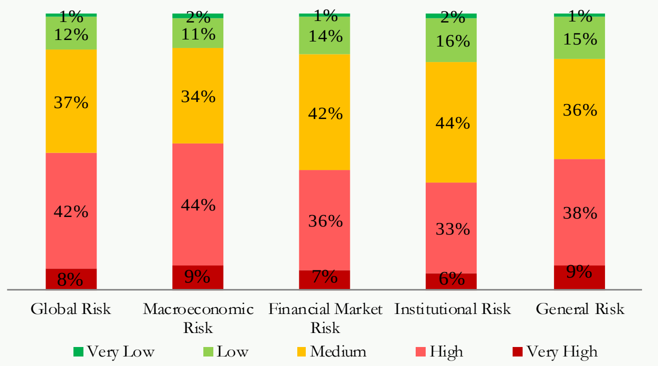


Chart B: Perception on sources of systemic risk- 6 months

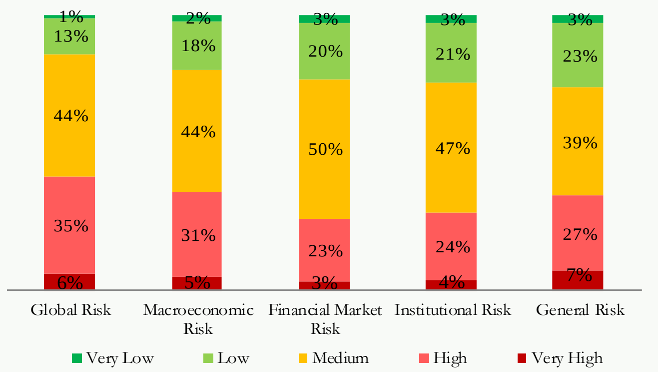


Chart C: Top 10 Risks Identified

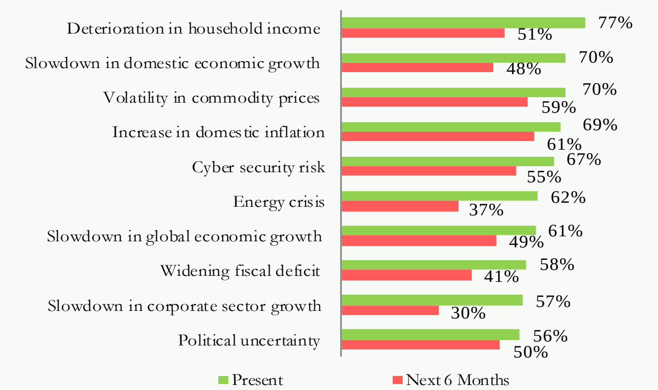


Chart D: Confidence in Financial Stability

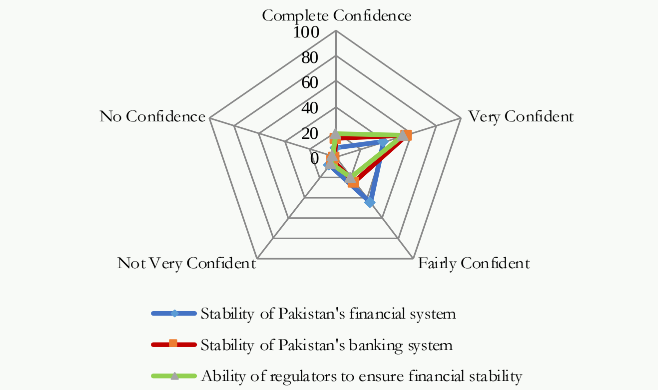


Chart E: Comparison of SBP's Systemic Risk Survey (SRS) Results (5th, 6th and 7th waves)

		5th Wave (Jan-20) Present (Average)	6th Wave (Aug-20) Present (Average)	7th Wave (Jan-21) Present (Average)
Global Risks	Slowdown in global growth	2.65	2.27	2.42
	Sovereign default risk	2.99	2.96	3.03
	Lack of funding from abroad	2.43	2.38	2.61
	Volatility in commodity prices	2.07	2.09	2.25
Macroeconomic Risks	Slowdown in domestic growth	2.10	2.16	2.26
	Increase in domestic inflation	1.79	2.26	2.19
	Widening fiscal deficit	2.24	2.32	2.40
	Deterioration of BoP	2.43	2.47	2.58
	Sovereign rating downgrade	2.68	2.81	2.77
	Slowdown in corporate sector growth	2.21	2.43	2.53
	Slowdown in infrastructure development	2.56	2.91	2.88
	Deterioration in household savings	2.26	2.26	2.12
	Volatility in real estate prices	2.96	2.86	2.97
	Energy crisis	2.50	2.49	2.39
	Political uncertainty	2.29	2.74	2.43
Financial Market risks	Foreign exchange rate risk	2.19	2.18	2.39
	Equity price risk	2.67	2.69	2.79
	Interest rate risk	2.32	2.72	2.62
	Liquidity risk	2.66	2.72	2.79

		5th Wave (Jan-20) Present (Average)	6th Wave (Aug-20) Present (Average)	7th Wave (Jan-21) Present (Average)
Institutional Risks	Regulatory risk	2.62	2.73	2.63
	Legal risk	2.85	2.98	2.89
	Asset quality deterioration	2.41	2.39	2.54
	Shortfall in capital requirement	2.57	2.63	2.72
	Access to funding (deposit mobilization & borrowings)	2.72	2.77	2.92
	Excessive private sector credit	3.03	2.80	2.98
	Concentration risk in PSC	2.97	2.78	2.94
	Concentration risk in mutual fund	3.28	3.33	3.11
	Operational risk	2.78	2.65	2.77
	Cyber security risk	2.28	2.23	2.18
	Disruption in financial market	2.78	2.66	2.84
General Risks	Terrorism	2.67	2.74	2.58
	Geopolitical risk for Pakistan	2.25	2.48	2.44
	Natural disasters/ Increasing threat of climate change	2.68	2.59	2.88
	Social unrest	2.82	2.75	2.71

Very High Medium Very Low

Chart F1: Respondents confidence on the SBP's measures to mitigate the implications of Covid-19 Shock

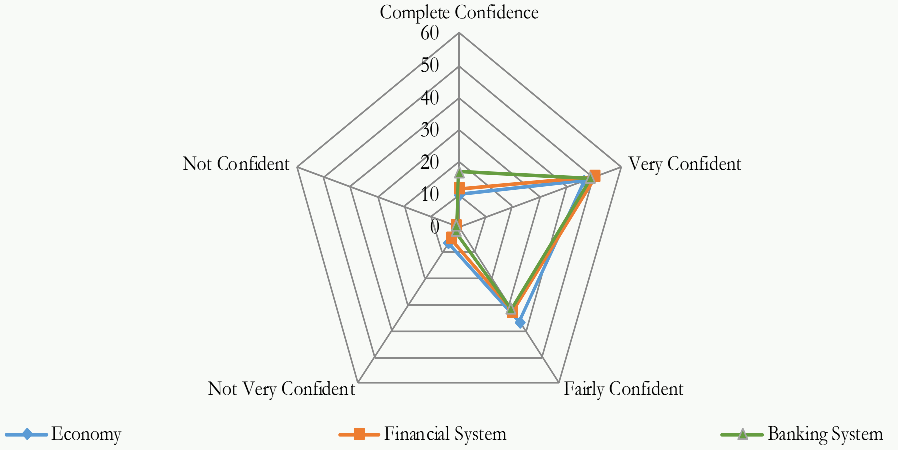


Chart F2: Respondents' views about the efficacy of SBP measures for the economy

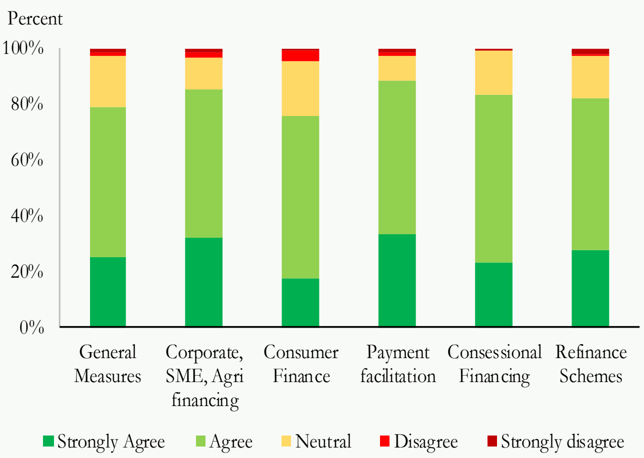


Chart G: Respondents views about the likely impact of COVID-19 on key areas of the financial industry

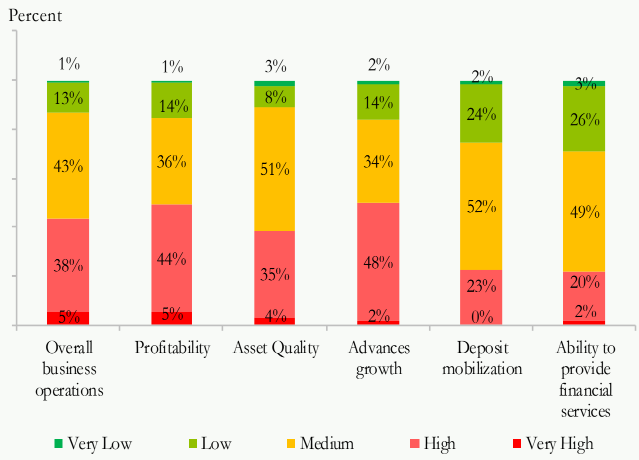
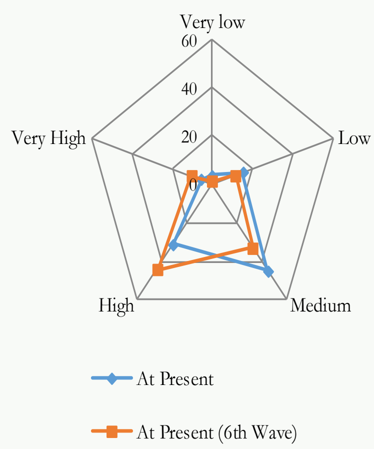
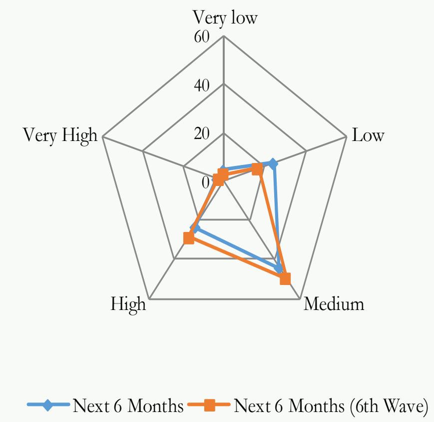


Chart H: Likelihood of COVID-19 pandemic undermining the stability of Pakistan's financial system - Comparison with SRS 6th wave

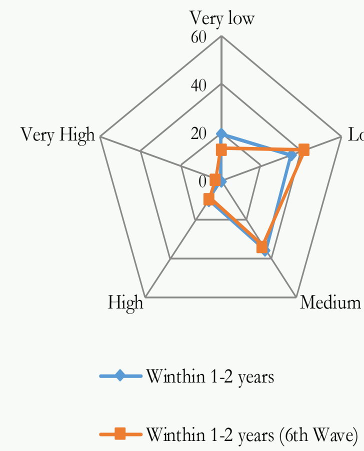
i) At Present



ii) Next Six Months



iii) Within 1-2 years



Chapter 1: Global and Domestic Macro Financial Environment

After experiencing historic losses in CY20, global economy continues to face uncertainties and divergent recovery prospects in the wake of COVID-19 pandemic. With acceleration in immunization, growth is likely to rebound strongly in advanced economies while the pandemic may continue to disrupt economic activity in emerging market economies for some time. Although commodity prices have recovered to their pre-pandemic levels yet, inflationary pressures remain muted in advanced as well as most of the emerging economies. Aggressive use of counter cyclical monetary and fiscal policies has supported response to the crisis and economic recovery, while central banks' measures helped in both containing the negative economic effects and preserving the financial stability. However, a sharp rise in fiscal deficits and public debt has been observed in both advanced and emerging markets.

Domestically, the impact of outbreak and the associated containment measures led to substantial losses to the economic activity and prompted a policy recalibration of the ongoing stabilization program to minimize the economic fallout. As a result of prudent and well-targeted relief measures, economic activity rebounded, the fiscal deficit remained in check despite counter-cyclical expenditures, the current account and FX reserves showed marked improvements, exchange rate continued to follow stable trajectory and the banking sector remained profitable as well as resilient. However, inflation remained elevated primarily due to food supply shocks while private sector credit growth remained subdued owing to demand and supply factors.

Global Developments

Global community faced enormous human and economic losses due to COVID-19 pandemic…

Global community continues to face historic humanitarian, economic and social losses owing to Global Health Crisis (**GHC**) caused by the Corona virus (**COVID-19**) which emerged at the start of CY20. More than 3.9 million people have already died; whereas despite enormous counter cyclical economic relief measures undertaken by the authorities to dampen the economic fallout, world economy *contracted* by 3.3 percent due to mobility restrictions, lockdowns and closure of business activities to combat the pandemic (**Table 1.1**).[8] The contraction turned out to be 6.6 percentage points below the estimated growth rate of 3.3 percent projected for CY20 before the onset of the pandemic.[9]

Table 1.1: Global Economy: Real GDP Growth (percent)

	2019	2020	2021*	2022*
World	2.80	-3.30	6.00	4.40
Advanced Economies	1.60	-4.70	5.10	3.60
EMDEs	3.60	-2.20	6.70	5.00
EMDEs - Asia	5.30	-1.00	8.60	6.00
USA	2.20	-3.50	6.40	3.50
Euro Area	1.30	-6.60	4.40	3.80
U.K	1.40	-9.90	5.30	5.10
Japan	0.30	-4.80	3.30	2.50
Argentina	-2.10	-10.00	5.80	2.50
China	5.80	2.30	8.40	5.60
Turkey	0.90	1.80	6.00	3.50
India	4.00	–8.0	12.50	6.90
Russia	2.00	-3.10	3.80	3.80
Saudi Arabia	0.30	-4.10	2.90	4.00
United Arab Emirates	1.70	-5.90	3.10	2.60
Pakistan	1.90	-0.40	1.50	4.00

Source: IMF World Economic Outlook, April 2021
*Projections

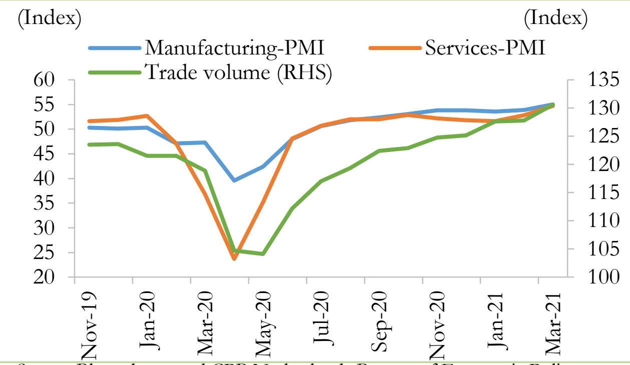
[8] Absent these counter cyclical relief measures, output losses could have been three times higher. International Monetary Fund. (2021). World Economic Outlook: Managing Divergent Recoveries. *Washington, April.*

[9] International Monetary Fund. (2021). World Economic Outlook Update: Tentative Stabilization, Sluggish Recovery? *Washington, January.*

…accompanied by economic losses, income disparity widened within-country and across-countries

Owing to unique nature of the crisis that puts the contact intensive sectors at disadvantage, incomes and employment prospects of daily wagers, informal sector and migrant workers have been affected disproportionately. Resultantly, around 95 million more people are estimated to have fallen below the extreme poverty benchmark of daily earning of two dollars during CY20, while income inequality has risen.[10] Apart from increasing within-country income inequality, the pandemic is likely to disrupt the pace of convergence between advanced economies (**AEs**), and emerging markets and developing economies (**EMDEs**) owing to disparity in the availability of vaccines and consequent divergent impacts on human health and economic activities.

Chart 1.1: Global High Frequency Economic Indicators

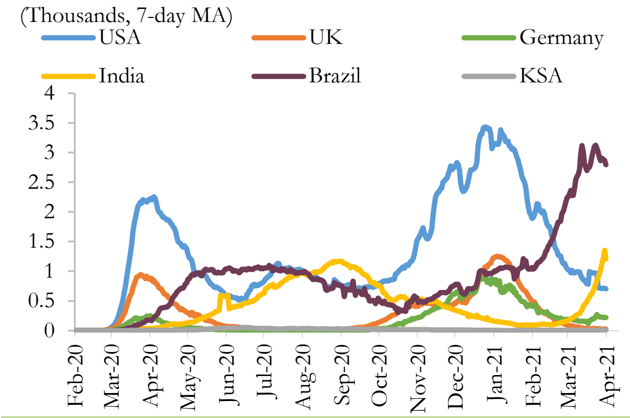


Source:Bloomberg and CPB Netherlands Bureau of Economic Policy Analysis
Note: PMI= Purchasing Manager Index

Economic recovery in second half of CY20 was followed by a second wave of the virus

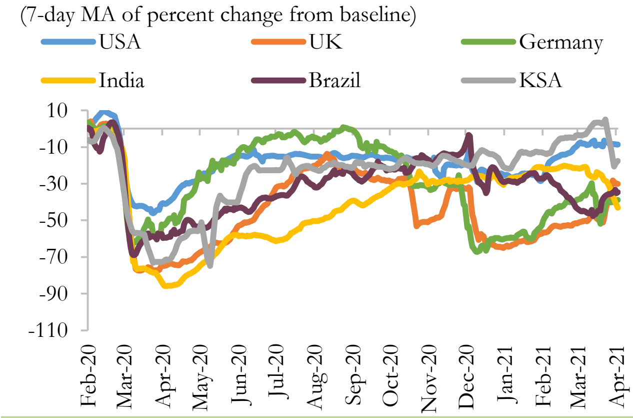
Almost all countries across the globe administered necessary containment measures after declaration of COVID-19 a pandemic in March 2020. At their peak level in April 2020, these restrictions substantially affected manufacturing, services and trade sectors. A gradual easing of the restrictions was observed in Q2CY20, which led to revival of economic activity in second half of CY20 (**Chart 1.1**).[11] However, the gradual lifting of lockdowns was followed by new waves of the pandemic towards the end of CY20, leading to re-imposition of containment measures in many countries (**Charts 1.2 a & b**).

Chart 1.2 - a: Daily New Deaths



Source: Datahub

Chart 1.2 - b: Change in Retail and Recreation Mobility



Source: Google COVID-19 Community Mobility Reports

COVID-19 vaccines boost sentiments in AEs while most of the EMDEs continue to face high uncertainty…

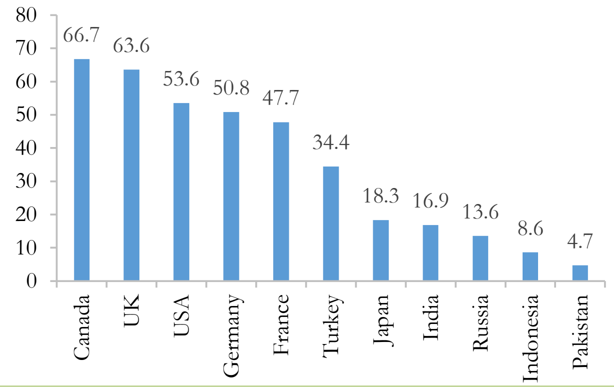
With a breakthrough in COVID-19 vaccine in late CY20, the level of uncertainty reduced, which boosted the prospects of economic recovery. However, the materialization of recovery

[10] International Monetary Fund. (2021). World Economic Outlook: Managing Divergent Recoveries. *Washington, April.*
[11] The revival of activity was primarily attributed to a pent-up demand for consumer durables, increased demand for cars and electronic devices related to work-from-home arrangements.

prospects strongly hinges upon availability of inoculations, where a considerable variation between rich and developing countries is clearly visible (**Chart 1.3**). COVID-19 vaccine procurement data shows that AEs are likely to achieve a complete vaccination of population by June 2021 while most of the EMDEs may take longer to achieve the same level of inoculation.[12]

Chart 1.3: Share of Population Vaccinated - June 21, 2021

(Percent of total population)



Source: ourworldindata.org

The pace of vaccination programs in developing world is likely to be key in addressing the spread, duration, and consequent normalization of economic activity. The Indian experience with the second wave sheds light upon the scale of risk posed by COVID-19 and importance of sufficient inoculation to mitigate the risk. Amid monetary and fiscal support measures coupled with the mass vaccination campaigns, the AEs are likely to grow by 5.10 percent and 3.60 percent during CY21 and CY22 while EMDEs are expected to grow by 6.70 percent and 5.00 percent (**Table 1.1**).

GCC countries show bright recovery prospects

Gulf Cooperation Council (**GCC**) countries are the key source of home remittances and important trade partners of Pakistan. GDP in these countries recorded a contraction of 4.80 percent during CY20; mainly on account of historic dip in oil prices coupled with disruptions caused by the pandemic. However, because of early start of vaccination drives, recovery prospects remain strong in GCC countries. Rebound in oil prices, primarily attributed to recovery in AEs and China and, production cuts by OPEC+,[13] are likely to help control pandemic-induced elevated levels of fiscal and current account deficits during CY21 and CY22 (**Table 1.2**).

Table 1.2: Gulf Cooperation Council (GCC) Macroeconomic Performance

	2018	2019	2020	2021*	2022*
Real GDP (annual growth rate)	1.90	0.70	-4.80	2.70	3.80
Current Account Balance (percent of GD	8.60	5.80	-1.30	4.20	3.80
Fiscal Balance (percent of GDP)	-1.60	-1.60	-9.20	-3.00	-1.40
Oil Price (US$ per barrel)**	68.5	61.5	41.6	58.5	54.8
Inflation (annual average, percent)	2.20	-1.50	1.20	2.70	1.90

Source: Regional Economic Outlook, Middle East and Central Asia, IMF, April 2021

*IMF-Projections

**Average of UK Brent, Dubai Fateh and West Texas Intermedital crude oil prices.

Commodities prices depicted persistent rise since April 2020

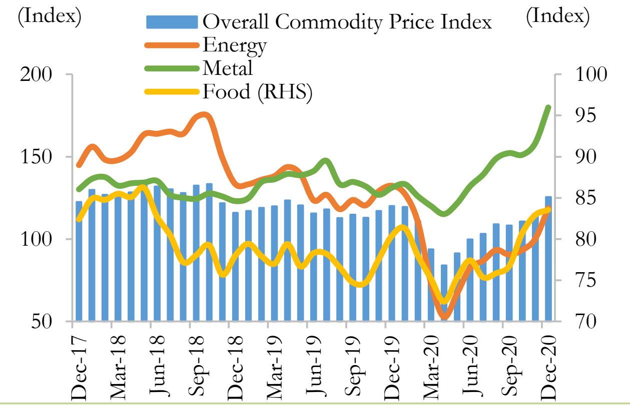
Commodity prices, including oil, metals and food, observed substantial softening during February to April 2020, mainly in response to weak demand conditions. For instance, at the peak of crisis in April 2020, world oil prices touched the historic low of USD 21.04[14] per barrel. However, with easing in lockdowns, commodity prices exhibited a broad recovery after April 2020 (**Chart 1.4**). Oil prices rebounded strongly on account of improved demand conditions after relaxations in lockdowns and production cuts administered by OPEC+. Based on future markets, average oil prices are projected to remain in the range of USD 55-59 per barrel until CY22.

[12] At the end of March 2021, fractions of people vaccinated for G20 advanced economies (16 percent), G20 emerging economies (2 percent), non-G20 emerging economies (1 percent) and low-income developing countries (0.5 percent) depicted wide gaps in inoculation levels with respect to income level of countries. IMF WEO, April 2021

[13] Organization of Petroleum Exporting Countries and Russia.

[14] Monthly average of Brent, Dubai and West Texas Intermediate.

Chart 1.4: Commodity Prices



Source: Bloomberg and IMF

The global food price index also rose considerably by 20.90 percent, during March 2020 to February 2021. Substantial rise in prices of wheat, corn, soybeans and palm oil was observed during H2CY20. Soybeans and corn prices surged because of relatively poor production in USA and South America while wheat prices increased due to weak crop performance in USA and EU and, introduction of export tax by Russia. Strong demand conditions for the purpose of stockpiling; especially by China, also contributed to surge of wheat and overall food prices.

Inflation, though, remained contained in advanced and emerging economies

Weak demand conditions and substantial reduction in commodity prices before April 2020 lowered inflation rates in AEs that approached zero percent in USA, EU and Japan. After revival of economic activity amid massive support and relief measures, inflation exhibited some recovery in USA. However, inflation rates have remained negative in EU and Japan and, lower than long-term average in UK. In case of emerging economies, inflation remained stable as well except for China, where a deceleration was observed (**Chart 1.5**).

Chart 1.5 - a: Inflation in Selected AEs

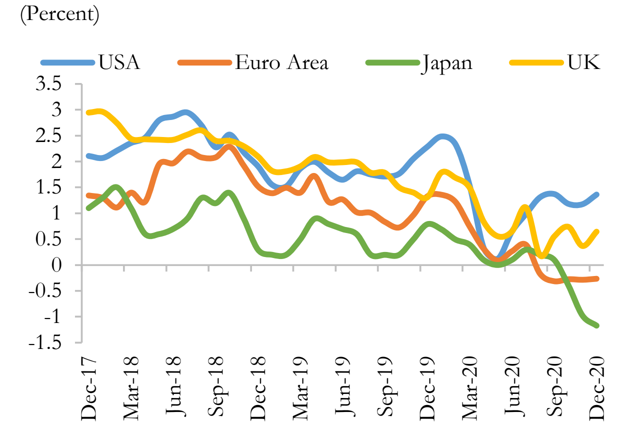
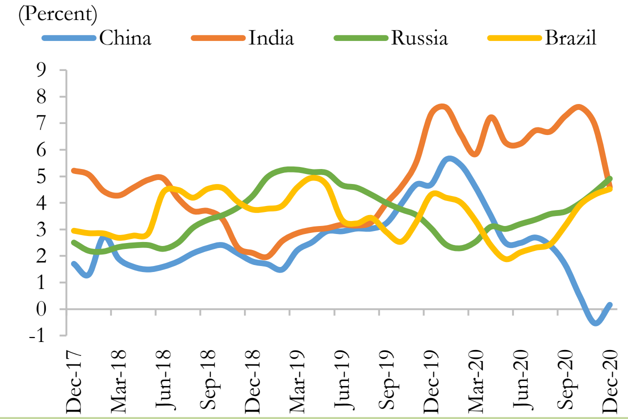


Chart 1.5 - b: Inflation in Selected EMDEs



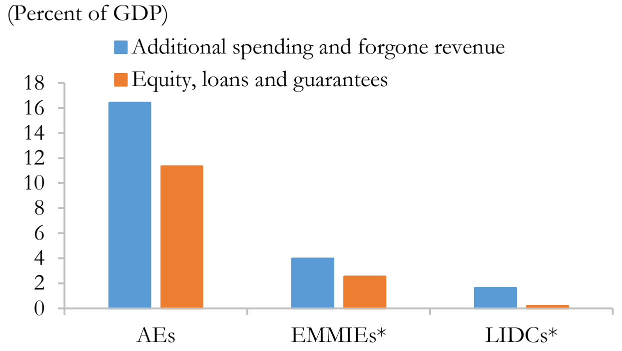
Source: Haver Analytics

Aggressive counter cyclical fiscal policies were introduced by AEs and EMDEs to contain economic fallout…

Considering the scale of economic fallout brought about by stringent lockdowns, fiscal authorities made efforts to provide a comprehensive policy response. The authorities, especially in AEs, adopted aggressive counter cyclical expansionary policies including revenue cutting and expenditures boosting measures to support vulnerable households as well as firms, which were facing severe impairment in their cash generation capacity and income. Estimated amount of global fiscal response to the crisis reached USD 16 trillion by March 2021. Relative to GDP, relief measures provided by advanced, emerging and low-income countries are 16.42 percent, 3.98

percent and 1.62 percent, respectively (**Chart 1.6**).[15]

Chart 1.6: Fiscal Policy Reponse to COVID-19

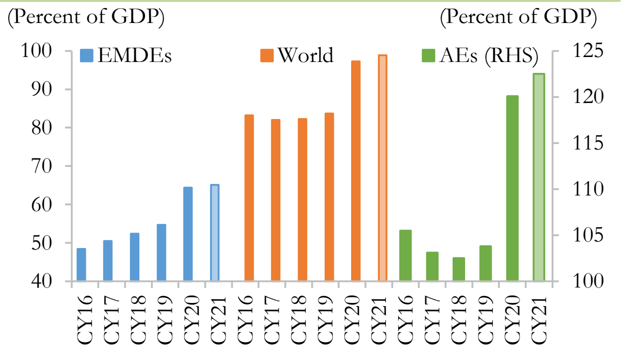


Source: IMF
* EMMIEs: Emerging Markets and Middle-Income Economies
LIDCs: Low-Income Developing Countries

…leading to a surge in deficits and debt levels…

The support measures correspondingly worsened the fiscal deficits and debt levels. This rise in deficits and loss of revenues owing to lockdowns led to a substantial rise in the public debt across the globe (**Chart 1.7**).[16]

Chart 1.7: Public Debt in AEs and EMDEs



Source: IMF
Note: Data for 2021 represents IMF forecast

Divergence in vaccine access and recovery could lead to varied fiscal performance in medium term

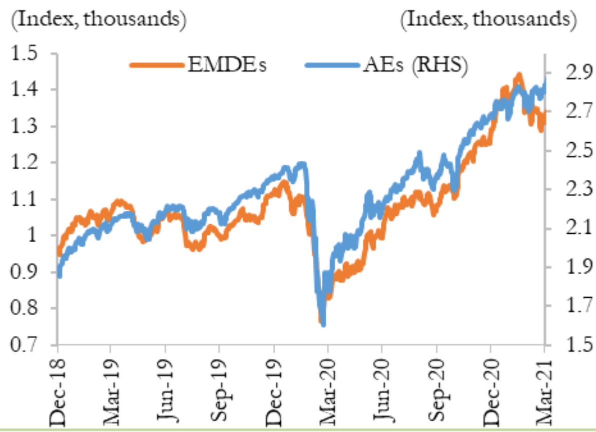
On account of vaccine-driven recovery leading to relatively low requirement of support measures, fiscal deficits in AEs are likely to recede. Resultantly, government debt-to-GDP ratio is likely to remain stable at around 121 percent in the medium term. However, owing to divergent recovery prospects, primarily attributed to lower access to vaccines, the debt levels in the emerging economies may observe gradual uptick from 64.4 at the end of CY20 percent to 73.2 percent in the medium term.[17]

Financial markets observed surge in volatility at the start of the crisis…

Starting from March 2020, rising infections across the globe caused a significant dent to investors' sentiments, leading to crash of markets in AEs, and EMDEs (**Charts 1.8 a & b**). Market liquidity conditions, as reflected in financial conditions index, tightened swiftly, leading to serious concerns about financial stability. In particular, EMDEs experienced sudden capital outflows due to shift in global investors' risk appetite in favor of financial assets based in AEs. This flight to safety led to tightening of financial conditions and pressure on the currencies of emerging market economies.[18]

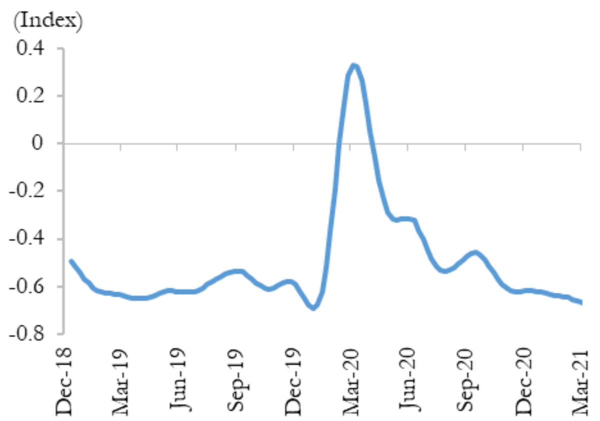
[15] IMF Fiscal Monitor, April 2021
[16] IMF Fiscal Monitor, April 2021
[17] IMF Fiscal Monitor, April 2021
[18] IMF Global Financial Stability Report, April 2021

Chart 1.8-a: Equity Prices in AEs and EMDEs



Source:Bloomberg

Chart 1.8-b: Financial Conditions Index

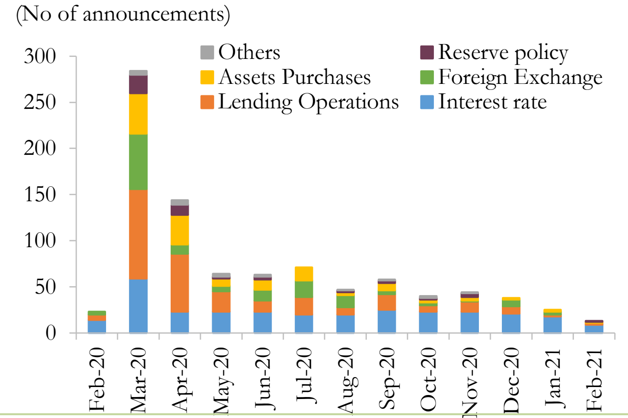


Source: fred.stlouisfed.org

…pushing central banks to use conventional and unconventional policy tools to support recovery and protect financial stability …

Under such precarious and unprecedented situation, central banks aggressively used both conventional and unconventional tools to support liquidity, flow of credit, and solvency conditions of the financial institutions. Policy tools utilized by the central banks can be categorized in five general types: interest rate measures, lending operations, FX operations, asset purchases and variations in reserves requirements. At the start of the crisis, central banks ensured viability of financial system against the backdrop of unprecedented levels of uncertainty through interest rate cuts.[19] These policy rate measures were augmented by lending operations to ensure supply of credit to liquidity constrained households and firms. Moreover, FX operations were used to ease pressure on exchange rates, especially in emerging markets. To ease domestic liquidity conditions via unconventional tools, asset purchases were also utilized abundantly by advanced economies, though less frequently by emerging economies (**Charts 1.9**).[20]

Chart 1.9: Monetary Policy Responses to the Pandemic



Source: Bank for International settlements (BIS)

Resulting easy financial conditions started to nurture vulnerabilities…

Impact of pandemic control measures on world GDP growth is estimated to be 6.6 percentage points.[21] However, abundant use of expansionary fiscal and monetary policies to support the economic activities, has led to extremely easy financial conditions giving rise to a number of vulnerabilities. First, a persistent rise in equity prices in advanced economies since April 2020 led to overvaluations.[22] Second, divergence in economic recovery between AEs and developing economies, mainly attributed to vaccine availability and policy response to COVID-19, has strong

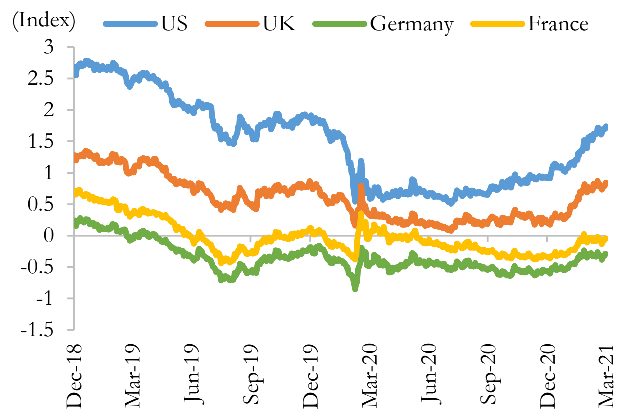
[19] Carlos Cantú, Paolo Cavallino, Fiorella De Fiore and James Yetman (2021), "A global database on central banks' monetary responses to Covid-19", BIS Working Paper 934.
[20] By March 2021, central banks have made USD 10 trillion worth of asset purchases. IMF (2021), Global Financial Stability Report, April

[21] Estimated CY20 world GDP growth is -3.3 percent. In absence of support measures, output contraction could have been three times larger. IMF WEO, April 2021.
[22] IMF Global Financial Stability Report, April 2021.

implications for developing countries. An improvement in advanced economies' growth and inflation expectations has already started to reflect as an uptick in long-term interest rates (**Chart 1.10**). This rise in interest rates may tighten the financial conditions for developing countries. Finally, combination of weak economic conditions and easy financial conditions has escalated corporate leverage and risk levels in both AEs and EMDEs. Under uncertainty, banks and investors may adopt a cautious approach in extending credit to vulnerable firms, which may prolong the economic recovery process.

Going forward, global economic recovery hinges upon various factors related to the pandemic, financial conditions and commodity prices. Importantly, contained pandemic outcomes, global access to vaccination and breakthrough in medical treatment of the COVID-19 and effectiveness of existing vaccines against new variants may boost recovery prospects.

Chart 1.10: Ten-Year Government Bond Yields



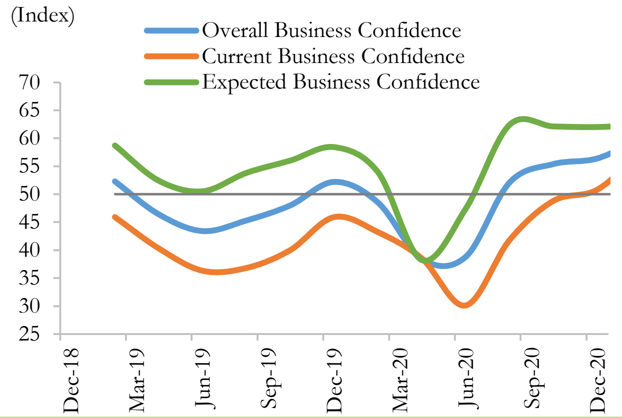
Source: Bloomberg

Domestic Developments

Early achievements of stabilization program marked bright prospects at the start of CY20…

The domestic economy entered CY20 in a situation when stabilization measures undertaken under the umbrella of IMF Extended Fund Facility (**EFF**) had just started bearing desired results. Cautious fiscal and monetary policies, market-based exchange rate and elimination of some preferential tax treatments had largely controlled the menace of twin deficits. These early achievements boosted domestic as well as foreign investors' sentiments. Optimism of domestic businesses was reflected in consistent improvement in Business Confidence Index since July 2019 (**Chart 1.11**), while foreign investors' confidence was manifested by portfolio investment inflows into local currency government debt securities.

Chart 1.11: Business Confidence Indices



Source: SBP

…but the advent of Global Health Crisis led to huge losses of economic activity

However, at the start of CY20, domestic as well as global economy was hit by Global Health Crisis brought about by COVID-19. In Pakistan, initial cases started to appear at the end of February 2020 while strict lockdowns to contain the spread of the pandemic were implemented in March 2020. Lockdown restrictions included closure of markets and manufacturing units except for essential services, ban on intercity and interprovincial transport, closure of educational institutes and ban on mass gatherings. These restrictions, which were gradually eased from May 2020, though shielded the country from massive spread of the pandemic yet proved to be costly in terms of loss of economic activity. Transport, trade, manufacturing, education and hospitality services sectors were affected badly leading to a contraction of overall economy by 0.47 percent during FY20 (**Table 1.3**). At the peak of the crisis in April 2020, the large scale manufacturing (**LSM**) contracted by a massive 41.90 percent on YoY basis. Exchange rate and FX reserves also temporarily came under pressure as foreign investors rebalanced portfolio investments in quest for flight to safety.

Table 1.3: Key Economic Indicators of Pakistan*

	2017	2018	2019	2020
Real Sector		(Percent)		
Real GDP Growth (FY)	5.22	5.53	2.08	(0.47)
LSM Growth (Average YoY)	7.10	1.32	(2.62)	(4.58)
Inflation (Average YoY)	5.04	5.32	9.35	9.53
External Sector		(USD Billion)		
SBP Reserves (End-of-Period)	14.11	7.20	11.34	13.42
Current Account Balance	(16.18)	(18.86)	(8.56)	0.25
Exports (Goods)	21.51	23.42	23.30	21.98
Imports (Goods)	57.31	60.05	50.01	45.81
Trade Balance	(35.80)	(36.64)	(26.70)	(23.83)
Remittances	19.71	21.04	22.12	25.96
PKR/USD Rate (Year Average)	105.45	121.73	150.04	161.87
Fiscal Sector		(Percent)		
Fiscal Deficit (as % of GDP, FY)	(5.84)	(6.53)	(9.07)	(8.09)
Total Revenue Growth	20.26	(3.01)	12.28	10.09
Total Expenditure Growth	17.00	6.05	18.90	9.43
Monetary Sector		(Percent and PKR Trillion)		
Credit to Private Sector Growth (Average YoY)	16.12	16.76	12.08	3.88
Government Budgetary Borrowing	8.60	10.04	11.78	14.19
Borrowing from Schedule Banks	6.25	5.17	5.83	8.23
Borrowing from SBP	2.35	4.87	5.95	5.95

*All data are on Calendar Year unless stated otherwise.

Source: Ministry of Finance, Pakistan Bureau of Statistics and State Bank of Pakistan

Early achievements of stabilization program allowed a prudent, proactive and comprehensive response to the crisis…

Policy space offered by initial achievements of stabilization program enabled the government and SBP to undertake a relief agenda that was commensurate with the scale of the pandemic-induced economic fallout. Government and SBP took several measures to contain the pandemic-induced recession. For example, to protect the most vulnerable segments of the society, emergency one-time cash transfers of PKR 12,000 were made to 16.9 million households. Measures taken by SBP included reversal of erstwhile consolidating monetary policy stance, supporting health sector to fight the pandemic (RFCC), concessionary financings for business to promote investment activities (TERF) and prevention of job losses (Rozgar Scheme), deferment of principal repayment and rationalization of prudential regulations to facilitate restructuring of pandemic-stricken loans of banks.[23] Cumulative estimated impact of these SBP measures was around five percent of GDP at the end of CY20. Timely receipt of IMF funding worth USD 1.39 billion in April 2020 under Rapid Financing Instrument (**RFI**) also helped stabilize external account and exchange rate.

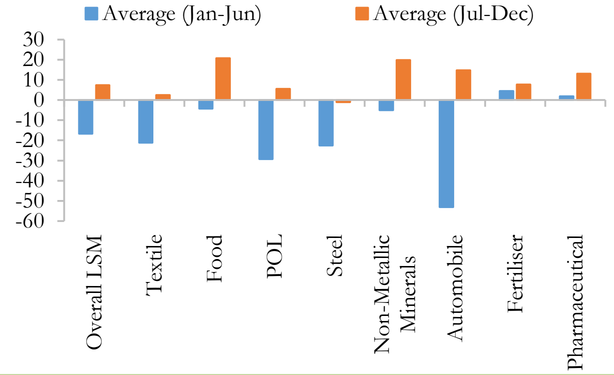
…which helped maintain, external and fiscal stability while economic activity rebounded strongly

As a result of the well targeted relief measures and careful execution of (smart) lockdowns, domestic economy was able to navigate through the pandemic without losing pre-COVID stability gains. The LSM indices reflected the revival of economic activity in the second half of CY20 after gradual phase out of lockdowns (**Chart 1.12**). Business Confidence Index has also been on the rise since June 2020 (**Chart 1.11**). Fiscal deficit, despite counter-cyclical expenditures due to COVID-19, reduced from 9.07 percent of GDP in FY19 to 8.09 percent of GDP in FY20. The current account balance displayed a remarkable improvement and turned to a surplus of USD 0.25 billion in CY20 from a deficit of USD 8.56 billion in CY19 (**Table 1.3**). Exchange rate remained broadly stable while SBP's liquid FX reserves showed a net improvement of USD 2.08 billion, reaching USD 13.42 billion at the end of CY20. These positive developments indicate that the domestic economy adequately managed first and second waves of COVID-19 crisis.

23 For details of these relief measures, please see https://www.sbp.org.pk/covid/index.html.

Chart 1.12: LSM YoY Growth in CY20

(Percent)



Source: Pakistan Bureau of Statistics

Despite low aggregate demand, increase in food prices kept inflation at an elevated level…

Average YoY inflation for CY20 was recorded at 9.53 percent, slightly higher than 9.35 percent for CY19 (**Table 1.3**). In both urban and rural markets, food prices turned out to be the key factor behind the elevated level of inflation (**Chart 1.13** & **1.14**). For instance, in January 2020, headline and food national CPI inflation rates reached 14.57 percent and 23.68 percent, respectively. Following factors explained substantial rise in food inflation during initial months of CY20: (i) supply disruptions in major food items, (ii) elimination of preferential tax treatments for sugar, cigarettes, edible oil and ghee in FY20, and (iii) pass-through of rising energy prices into food prices. Apart from food items, energy prices also contributed to the headline inflation.

Postponement of an increase in energy tariffs till June 2020, import of non-perishable food items (wheat and sugar), administrative measures to ensure smooth supplies[24], and a fall in world oil prices coupled with its immediate pass-through to the domestic oil prices were the key factors that helped ease inflationary pressure after Q1CY20. Owing to weak demand conditions and spare capacity due to lockdowns, core inflation depicted slight deceleration after Q1CY20 and for last three quarters of CY20 it averaged 5.82 percent and 7.96 percent in urban and rural markets, respectively (**Chart 1.13**).

Chart 1.13 - a: Urban Inflation Trends

(Percent)

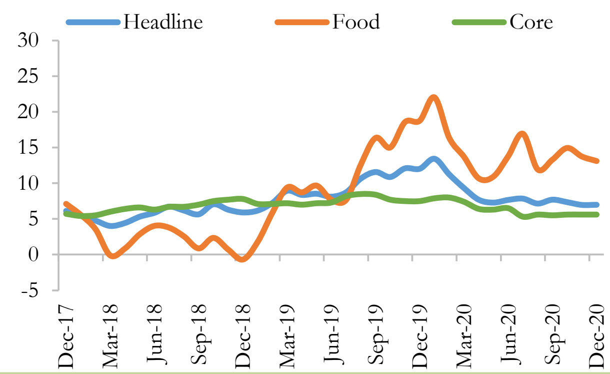


Chart 1.13 - b: Rural Inflation Trends

(Percent)

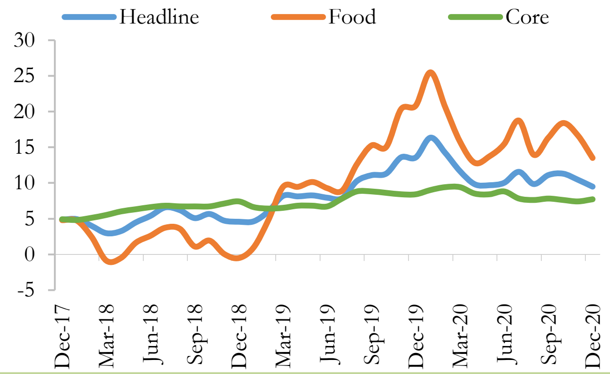
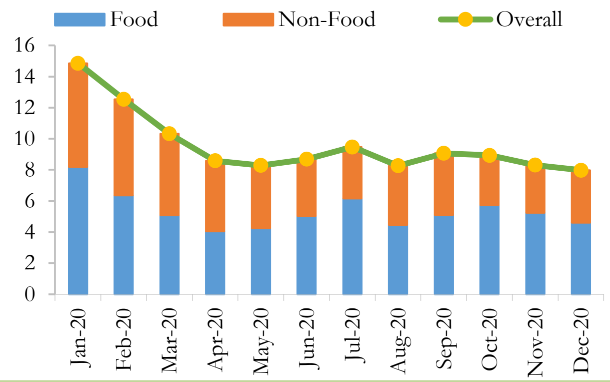


Chart 1.14: Overall, Food and Non-Food National CPI

(Percent)



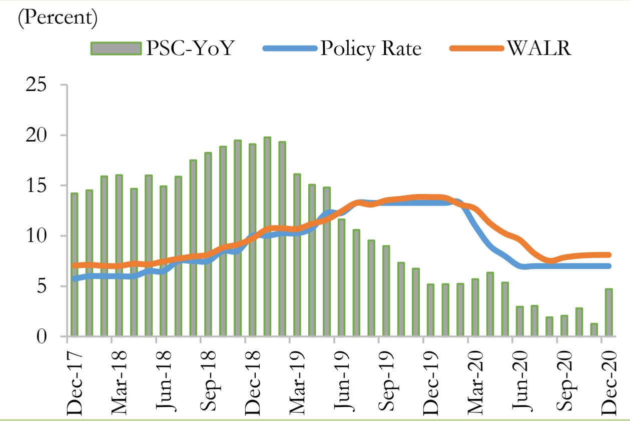
Source:Pakistan Bureau of Statistics

[24] See Annual Report 2019-20; The State of Pakistan's Economy; https://www.sbp.org.pk/reports/annual/arFY20/Complete.pdf

Monetary policy was recalibrated to cushion the slowdown in growth, ease out repayment capacity and maintain financial stability …

Monetary policy target rate was operating at 13.25 percent in March 2020 when COVID-19 hit the domestic economy. Monetary Policy Committee in its various regular and emergency meetings held between March and June 2020 gradually reduced the policy rate by 625 basis points to 7 percent. The healthy trickle down of monetary policy rate to weighted average lending rates coupled with other support measures preserved the flow of private sector credit (**PSC**). (**Chart 1.15**).

Chart 1.15: Interest Rate and Deceleration in Private Credit



Source: SBP

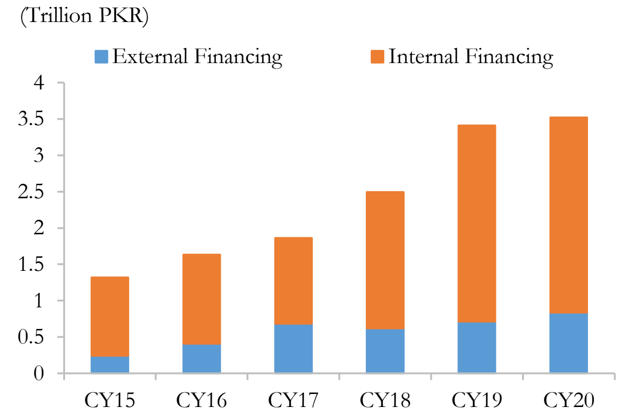
…but private sector credit growth remained weak due to credit demand factors…

Although SBP refinance schemes initiated after COVID-19 supported private sector credit growth to some extent, yet overall decelerating trend persisted as average growth fell from 12.08 percent in CY19 to 3.88 percent in CY20. The substantial deceleration in PSC can be explained by following factors. First, at the start of CY20, tighter monetary and fiscal conditions in the wake of ongoing stabilization program contained the demand for private sector credit. Second, closures of production and economic activities due to lockdowns adversely affected credit demand. Third, increase in exports in second half of CY20 and higher sales tax refunds particularly improved textile firms' liquidity position, thereby containing demand for additional borrowing. Finally, uncertainty caused by fresh waves and new variants of COVID-19 may have led to a risk averse behavior by the firms.

…and credit supply factors

With a 3.22 percent rise over CY19, government budget deficit for CY20 was recorded at PKR 3.52 trillion. Owing to unfavorable external financing conditions, major portion of budget deficit (76.24%, PKR 2.68 trillion) was financed through internal sources. The mix of internal financing was heavily skewed towards banking sector (91.31 percent of total internal financing). Amid heightened uncertainty and increased government budgetary needs, banks deployed a key portion of their liquidity into treasury securities (**Chart 1.16** & **1.17**). The banks' risk aversion was clearly visible in the rising share of investments and declining share of advances relative to total assets (**Chart 1.18**); moreover, within their loan portfolios, banks prefer borrowers with better credit worthiness. Major component of rise in investments (90 percent) was parked in government securities (for details on banking sector performance, please **see Chapter 03**).

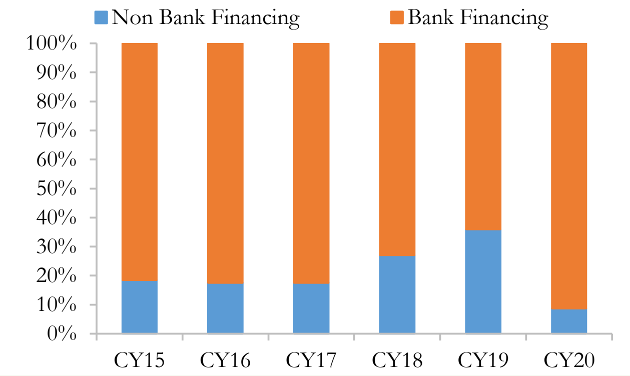
Chart 1.16: Financing of Budget Deficit



Source: MoF

Chart 1.17: Bifurcation of Internal Financing

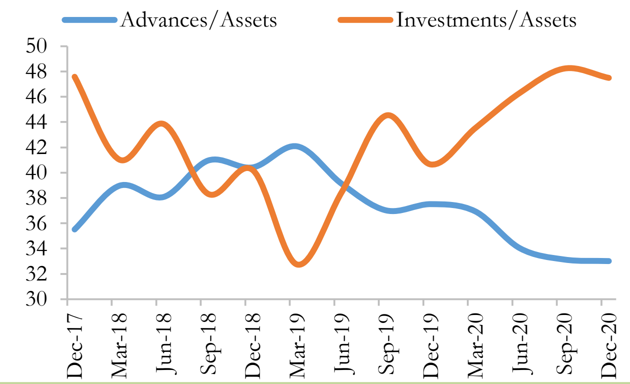
(Percent)



Source: MoF

Chart 1.18: Asset Mix of Banking Sector

(Percent Share)



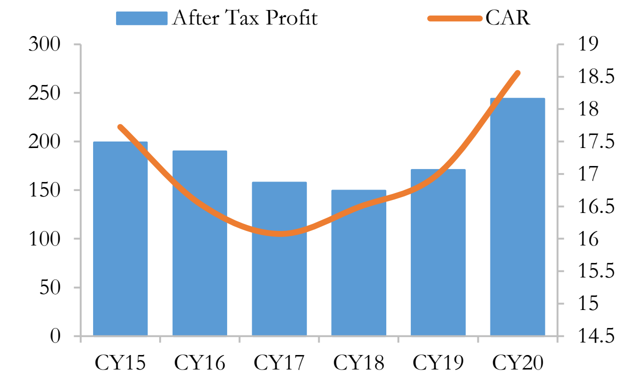
Source: SBP

Yet, banking sector profitability and resilience improved…

Banking sector enjoyed a substantial rise in profitability as after-tax profit grew from PKR 171 billion in CY19 to PKR 244 billion in CY20; registering a 42.92 percent increment (**Chart 1.19**). This phenomenal rise in profitability can be explained by reversal of monetary policy stance leading to relatively early repricing of deposits vis-à-vis variable-rate loans and healthy revaluation gains on the sale of securities. Rise in profitability led to a marked improvement in capital adequacy ratio (CAR) which increased from 17.00 percent at the end of CY19 to 18.55 percent at the end of CY20 (**Chart 1.19**).

Chart 1.19: Profitability and Resilience of Banking Sector

(Billion PKR) (Percent)



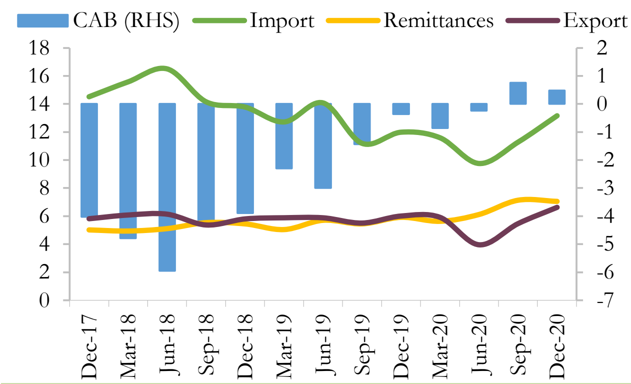
Source: SBP

Current account balance turned into surplus after 2003…

Current account balance (on full year basis) turned into surplus in CY20 for the first time after CY03, which was attributed to subdued imports, buoyant remittances and a strong recovery in exports after COVID-19 shock (**Chart 1.20**). A significant reduction in imports (i.e., by 9.4 percent) during CY20 can be attributed to the impact of stabilization policies which had been successfully implemented before COVID-19, low domestic demand during lockdowns and historic low oil prices. Although imports contracted in CY20, yet the trend reversed in second half of CY20, mainly attributable to a rise in domestic demand after opening up of economic activities. Further, weak performance of cotton crop and soaring prices of wheat and sugar in domestic market necessitated the import of these commodities.

Chart 1.20: Current Account Balance

(Billion USD) (Billion USD)



Source: SBP

…as remittances continued to play critical role in supporting current account…

Remittances grew by 17.35 percent during CY20. This strong performance of remittances, which compensated for the loss of exports due to COVID-19, may be attributed to a number of factors. First, restrictions on air travel created frictions in informal channels of cross-border funds transfer and indirectly promoted flow of remittances through formal channels. Second, fiscal and monetary support measures taken in the western hemisphere and the Middle East might have boosted expatriates' incomes leading to a rise in remittances. Finally, regulatory measures taken by SBP to boost remittances e.g., doubling the rate of telegraphic transfer (**TT**), introduction of a tier-based system, digitization of inflows and exemption from withholding tax have also promoted remittances.

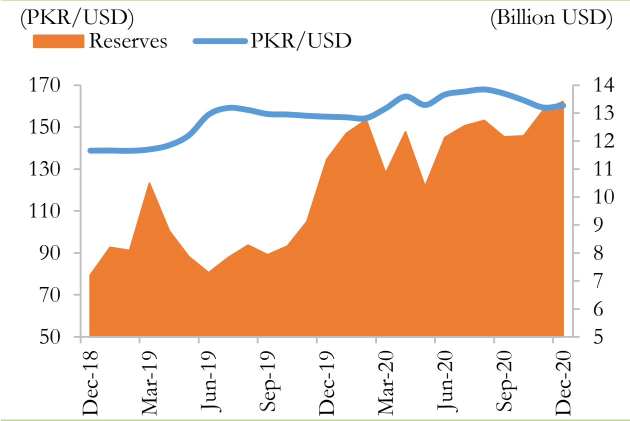
…and exports showed healthy recovery

Exports, which were showing voluminous gains at the start of CY20 owing to adoption of market based exchange rate, contracted by 31.7 percent on QoQ basis during second quarter of CY20, as the demand across the globe faltered due to lockdowns. However, with a growth rate of 10.56 percent during H2CY20, exports exhibited strong recovery. This quick recovery after first wave of COVID-19 crisis was attributable to government's conducive policies to support the industry.

Improvement in current account and external financing stabilized reserves and exchange rate…

On the back of positive outcome in current account, availability of multilateral and commercial financing, including the Rapid Financing Instrument, and rescheduling of external debt through G20's Debt Service Suspension Initiative (**DSSI**)[25], position of SBP foreign exchange reserves improved by USD 2.08 billion. While PKR/USD parity observed a slight depreciation in the first half of CY20 in line with market dynamics, the parity recovered as the situation improved on external front in the second half. Specifically, PKR/USD exchange rate appreciated by 3.18 percent from June 2020 to December 2020 with a further appreciation of 4.43 percent from December 2020 to April 2021 **(Chart 1.21)**.

Chart 1.21: Exchange Rate and Reserves



Source: SBP

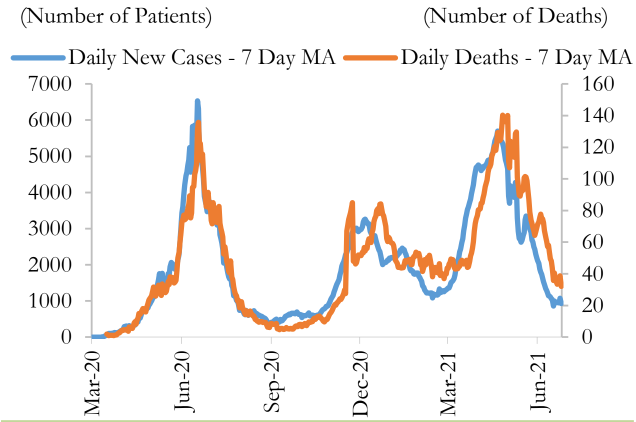
Going forward, path of domestic economy hinges upon the pandemic outcome

Going forward, domestic macroeconomic performance critically hinges upon a host of factors. First, Pakistan remained relatively safe during first and second waves of the pandemic, as the disease spread has been short-lived and contained when compared against many other countries. If the same pattern persists during the third wave, a stable recovery may be expected (**Chart 1.22**). Second, despite emergence of new variants of the virus, COVID-19 vaccination programs are saving lives and supporting economic recovery worldwide. However, any lax approach towards a domestic vaccination program may expand the pandemic duration and constrain economic recovery. Third, monetary policy normalization in advanced economies may lead to a rise in financing costs (**Chart 1.10**). Fourth, upward spiral in commodity prices and recovery in

[25] https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative

domestic aggregate demand may lead to a surge in import bill and a corresponding deterioration in the current account balance. Finally, after resumption of IMF EFF, striking the right balance between stability and growth in the face of evolving pandemic outcomes is also critical for domestic economic performance and financial stability.

Chart 1.22: COVID-19 in Pakistan



Source: ourworldindata.org

Box 1.1: A Comparison between COVID-19 Crisis and Global Financial Crisis

The last global financial crisis (**GFC**) of 2008-09 and ongoing GHC of COVID-19 have had significant impact and implications on the economic and financial systems of world. However, these crises have some unique and idiosyncratic features. Unlike the GFC, which was mainly caused by endogenous economic and financial imbalances, the ongoing pandemic is purely exogenous in nature. The pandemic has had far more intense and wider economic impacts, especially in terms of output, fiscal spending and public debt, and economic uncertainties. In fact, the GFC-driven regulatory reforms and experiences learnt about the cross-sectoral feedback effects as well as the use of different tools to address systemic issues have greatly helped policy makers to weather these shocks.

Importantly, banks were at the epicenter of the financial crisis both in terms of causes and its propagation during GFC, but in the current health crisis, they have turned into part of the solution. Moreover, the policy responses of the central banks and national authorities around the world have been swift and aggressive against the pandemic, and the scale and scope of these measures exceed the ones used to contain GFC. A brief comparative analysis can be seen in the table below:

Sr. No	GFC	COVID-19
1	Originated in the financial sector	Originated in the health sector
2	Global output loss = 0.6 percent	Estimated global output loss = 3.3 percent
3	Less than 60% economies of the world experienced sub-zero growth	More than 80% economies of the world are likely to experience sub-zero growth
4	Value of Global Economic Policy Uncertainty Index was around 200	Value of Global Economic Policy Uncertainty Index was above 400
5	Transmission of crisis to other countries took considerable time	Immediate transmission of health crisis into economic shocks around the globe
6	Banks were the epicenter of financial crisis both in terms of causes and its propagation	Banks have turned into part of the solution in current crisis unlike part of the problem previously
7	Tightening in financial conditions was more pronounced	Tightening in financial conditions has been less pronounced
8	Central banks responded aggressively to contain GFC	This time, central banks' actions were extraordinary in speed, size, and scope. Particularly, in emerging markets, several central banks introduced asset purchase program for the first time
9	During GFC, AEs and EMEs ran fiscal deficits of 8.9 percent and 4.8 percent (as percent of GDP), respectively	AEs and EMEs experienced fiscal deficits of 11.7 percent and 9.8 percent, respectively, in 2020
10	In AEs, general government debt as percent of GDP) reached to 91 percent in 2009 from 79 percent in 2008	General government debt, with 16-percentage points rise, is projected to reach at 120 percent (as percent of GDP) in 2020
11	In EMEs, general government debt increased to 38 percent in 2009 from 35 percent in 2008	Debt level is estimated to reach at 64 percent from 55 percent in 2019.
12	EMEs experienced capital outflows	Portfolio capital outflows were 50 percent larger

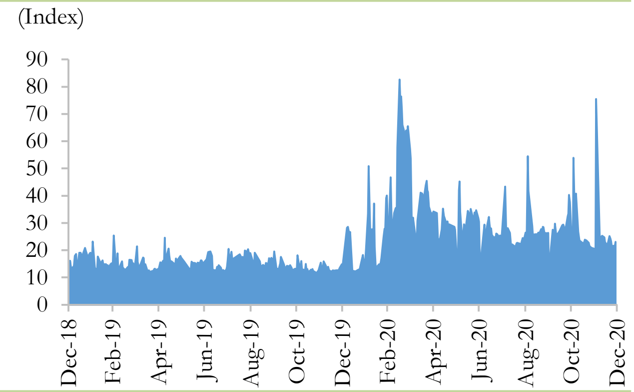
Chapter 2: Financial Markets' Behavior

The COVID-19 related uncertainties induced a short-lived stress in domestic financial markets in early CY20. The equity market observed a V-shape recovery and the momentum continued afterwards. With better economic fundamentals and the market based exchange rate mechanism, the exchange rate stabilized over the year. Investors' interest in long-term instruments remained high in H1CY20 due to a fall in the benchmark rates. However, interest rate expectations reversed in the second half of the year, which resulted in a decline in appetite for longer-tenor securities. Nonetheless, the introduction of new variants of floating rate PIBs and issuance of Ijarah Sukuk helped the government to lengthen maturity profile of its domestic borrowing thus hedging the rollover risk.

The extraordinary policy measures adopted after the onset of pandemic eased the stress in the global financial markets…

The COVID-19 pandemic brought the global economic activity to a standstill and induced panic selling in equity markets. Share prices fell sharply and volatility in the equity markets touched historic highs with the VIX surpassing even the levels observed during the GFC of 2008 (**Chart 2.1**).[26]

Chart 2.1: Trend in Chicago Board Options Exchange's (CBOE) Volatility Index (VIX)

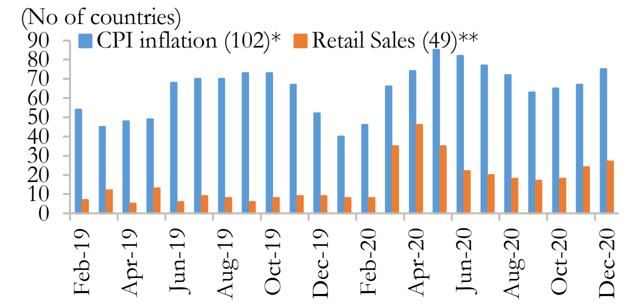


Source: FRED

Moreover, growing uncertainties fueled expectations of a prolonged recession, triggering downward pressures on the yields on long-term government bonds in AEs. Except for the US and the UK, yields even touched negative zone in other AEs.[27]

Side by side, the investors started de-risking their portfolios in Emerging and Frontier Markets, leading to pressures on currencies across a number of countries. At the same time, due to a fall in sales and a rise in layoffs across various jurisdictions, the businesses and households faced cash flow problems causing a significantly depressed demand. As a result, despite supply disruptions, the headline inflation fell across many countries (**Chart 2.2 & 2.3**). Moreover, concerns about global growth pushed down the commodity prices, particularly oil prices.[28]

Chart 2.2: Retail Sales and CPI inflation fell across a number of countries



*No of countries with decline in YoY rate relative to last year's YoY value
**No of countries with contraction in Sales on YoY basis
Note: Parenthesis represent number of total countries for which data is available, Source: Bloomberg

As the economic activity sharply weakened and the future prospects looked bleak, authorities swiftly resorted to strong counter cyclical fiscal, monetary and macro-prudential policy measures. Particularly, the central banks across the globe introduced accommodative monetary policies,

26 Chicago Board Options Exchange Volatility Index (**VIX**) represents the market's expectations of volatility over next one month. The index was at 82.7 on March 16, 2020, 5 days after WHO's warning about COVID-19 converting into a pandemic, whereas in GFC its highest level was 80.9 on November 20, 2008.

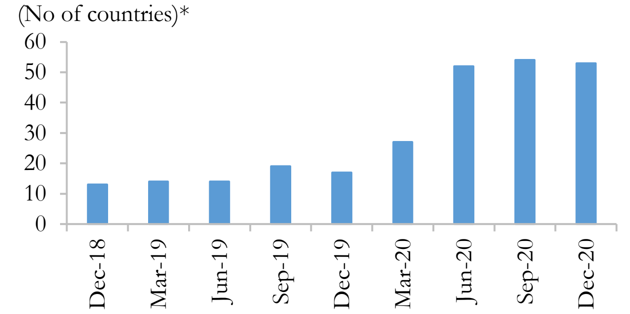
27 These include: Austria, Belgium, Denmark, France, Germany, Netherlands, Sweden, Switzerland, and Finland

28 WTI was at USD -37.0 per barrel on April 20, 2020

among other measures, to save the financial system, the economy and livelihoods. Because of these extraordinary measures, the global financial conditions in most of the advanced and emerging economies became accommodative, particularly in AEs, during CY20.

Consequently, firms were able to restore their cash flows by tapping various sources of funding such as bonds, bank credit and government credit guarantee schemes. With the revival in confidence and gradual reopening of economies, economic optimism started to return. The stock markets rebounded from their low levels during the pandemic, as investors again started to search for better returns.

Chart 2.3: Unemployment rate surged across a number of countries



*No of countries with rise in YoY rate relative to last year's YoY value
Note: Data was available for 58 countries.
Source: Bloomberg

Calibrated implementation and tapering of support measures would be vital in reducing potential risks…

The extraordinary policy measures helped in preventing the financial crisis. However, as the pandemic is extant, the vulnerabilities continue to exist and the uncertainties could reemerge due to virus mutations and repeated waves. Further, a premature exit or a delayed tapering of support measures could aggravate the risks to the economic and financial stability. It is, therefore, essential to manage the support measures in well-calibrated manners.

Though the global financial conditions eased further starting June 2020,[29] the EMDEs found it difficult to attract inflows and mobilize external resources because the investors demanded higher risk premiums.[30] Resultantly, the local currency bond issuance (for example, to fund fiscal deficits) became common in most of the EMDEs. Though portfolio flows recovered partially in the second half of CY20, investors preferred investment in jurisdictions with relatively better economic fundamentals and policy environment.[31]

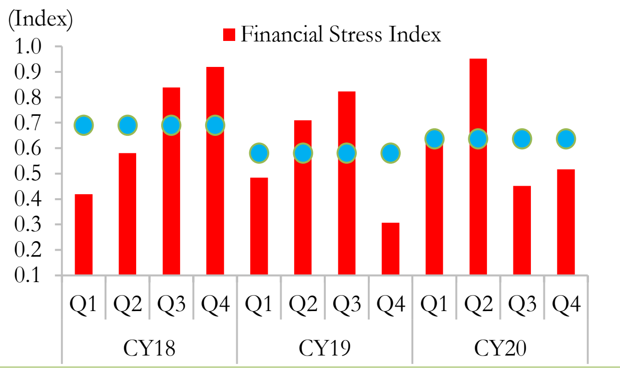
The unprecedented fiscal push during the pandemic further raised the already elevated levels of public debt, which might become problematic for many jurisdictions, especially EMDEs. Debt servicing concerns could burden the public debt management, generate solvency issues and limit the capacity of sovereigns for further policy intervention.

Domestically, financial markets witnessed relatively higher stress during the first half …

After falling in CY19, the stress level in Pakistan's domestic financial markets again rose during CY20, but on average remained lower than the level witnessed in CY18 (**Chart 2.4**). A detailed review of the developments showed that the stress level was particularly higher in second quarter of CY20 when the pandemic quickly spread globally and the country too reported the highest level of infections. However, the extraordinary policy measures and early abatement in the impact of the outbreak played a key role in reducing the stress in markets.

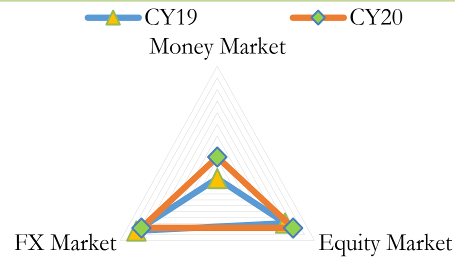
[29] GFSR October 2020, IMF
[30] GFSR October 2020 highlighted that financial conditions have generally eased in emerging markets (excluding China) since June 2020 but external costs for many EM countries were still above pre–COVID-19 levels.
[31] GFSR October 2020, IMF

Chart 2.4: Stress in financial markets rose in H1CY20



Note: The dots represent yearly average of the index.
Source: SBP

Chart 2.5: Volatility subsided in FX market while increased in Equity and Money market



Note: Volatility in the respective markets is calculated using Exponential Weighted Moving Average (EWMA) formulation as described in RiskMetrics (1996), J. P. Morgan Technical Document, 4th Edition, New York, J.P. Morgan. Daily Overnight repo rate, KSE-100 index and Interbank PKR/USD Exchange Rate are used as indicators for the money, equity and foreign exchange markets, respectively.
Source: SBP

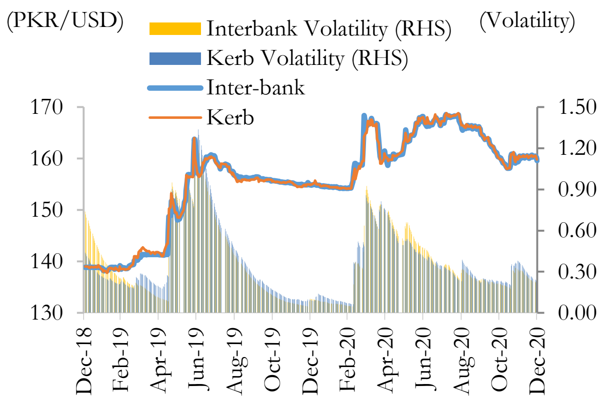
While it took a while for the real sector of the economy to recover, the equity market (KSE-100 index) recorded a quick V-shaped recovery from the effects of the pandemic. The FX market also witnessed another episode of significant volatility during the pandemic, though the magnitude of volatility was lower than last year. However, better fundamentals, improving external sector along with better liquidity and market-based exchange rate helped the market to withstand the shock and normalize the volatility in H2CY20. Amid a sharp reduction in SBP policy rate, volatility in overnight repo rate rose and the pandemic related increase in fiscal deficit contributed to tightening liquidity conditions in money market (**Chart 2.5**). However, SBP's proactive liquidity management helped the smooth functioning of the money market and contained the deviation of overnight interest rate from policy rate during CY20.

FX Market

Uncertainties sparked volatility in FX market for a short period …

The domestic FX market witnessed a brief spike in volatility during the first quarter of CY20 (**Chart 2.6**). On the one hand, changing risk sentiments led global investors to rebalance their portfolios; while on the other hand, weakened economic prospects due to lockdowns triggered balance of payment concerns. Meanwhile, the exchange rate, in a short span of 3-weeks, depreciated by 8.4 percent between March 06, 2020 and March 27, 2020 **(Chart 2.7)**.

Chart 2.6: The Exchange rate exhibited volatility in CY20

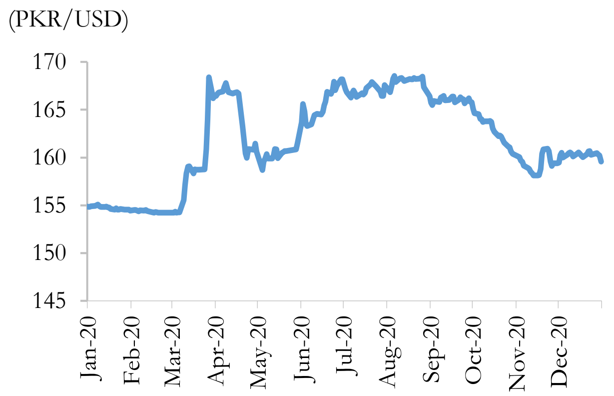


Source: SBP

The market, however, withstood the shock and stabilized soon after the initial wave of the pandemic …

The stress in the FX market proved to be short lived as the volatility gradually tapered off during the remaining year. This was because the fundamentals of the economy (e.g. FX Reserves, current account balance) were in a better position to handle the pandemic shock and the market-based exchange rate mechanism was in place. Moreover, contrary to initial expectations, favorable trade dynamics were observed (e.g. fall in imports and some revival in exports) that helped improve FX liquidity in the market. At the same time, growing workers' remittances, financing under RFI of the IMF, and relief under DSSI provided further comfort on the external front.

Chart 2.7: The two way movement of exchange rate in CY20



Source: SBP

… as the country entered the pandemic with a strong position in terms of improved macroeconomic fundamentals and better cushions…

The county had largely addressed the external account deficit before the inception of the pandemic. SBP's FX reserves along with the net swap position improved substantially since June 2019. By February 2020, the gross SBP reserves reached to the level of USD 12.8 billion; an improvement of 75.1 percent when compared to June 2019 level. Similarly, the SBP's forward liabilities had reduced to USD 2.8 billion by February 2020, reflecting an improvement of 64.7 percent from their June 2019 level. Thus, sufficient cushions were available to absorb the pandemic shock.

… and the market based exchange rate mechanism supported the confidence…

Despite the challenges posed by the pandemic, the exchange rate, on average, depreciated only by 7.4 percent against the greenback in CY20 compared to 18.8 percent in CY19. SBP's adoption of market-based exchange rate could, inter alia, be a reason as the parity responded to the market dynamics. In fact, it exhibited two-way movements during CY20 **(Chart 2.7)**. For instance, PKR depreciated by 8.4 percent against USD between March 06 and March 27, 2020 in the interbank but appreciated by 5.5 percent between March 27 and May 5, 2020. Similar episodes also happened in H2CY20.[32] As a result, the confidence of market participants as well as the market functioning improved.[33] Hence, the adoption of the market-based exchange rate system proved to be an important shock absorber during the pandemic.

…accompanied by the favorable developments on the external front

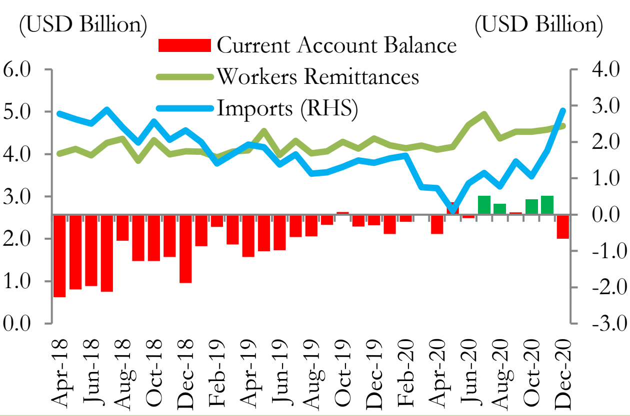
Moreover, other developments in the external sector more than compensated the stress created from the portfolio rebalancing. First, the country received USD 1.39 billion under RFI from the IMF in April 2020 to address immediate balance of payment concerns. Second, it also obtained debt-servicing relief under DSSI, which abated repayment pressures.[34] Further lower benchmark rates (e.g. LIBOR), also helped reduce debt

[32] A depreciation between May 05 and Aug 26, 2020, and an appreciation between Aug 26, 2020 and November 16, 2020.
[33] Also, the average spread between interbank and KERB remained lower this year (-0.005 in CY20 versus -0.009 in CY19).
[34] World Bank estimates that under DSSI Pakistan is expected to save USD 3.7 billion from this relief between May and December 2020 and USD 2.5 billion between January to June 2021. Source: https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative

servicing costs during CY20. Resultantly, the growth in external debt servicing reduced substantially to 7.0 percent in CY20 from 55.8 percent in CY19[35].

Third, at a more fundamental level, the current account balance improved, particularly during H2CY20. After an initial dip till May 2020, the exports recovered to their pre-COVID-19 levels from September 2020 onwards. Encouragingly, beating expectations, the workers' remittances remained upbeat at an average of USD 2.16 billion per month during CY20 compared to USD 1.84 billion per month in CY19. Moreover, the imports of USD 43.5 billion in CY20 were lower than USD 47.7 billion in CY19. Consequently, the current account balance recorded a surplus of USD 0.25 billion in CY20—the first since CY03 (**Chart 2.8**). The net outcome of these developments was that the FX market stress abated as the year progressed.

Chart 2.8: The current account balance improved during CY20

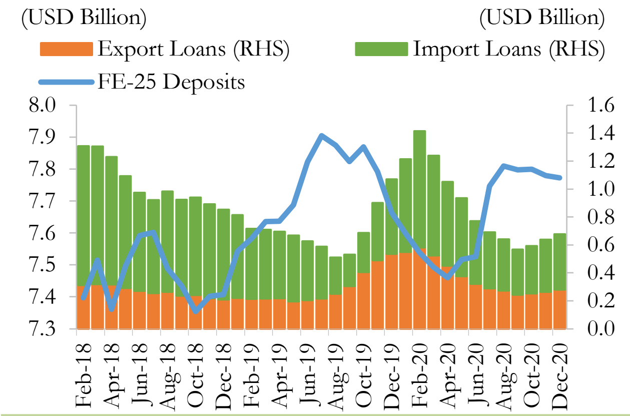


Source: SBP

Easy liquidity conditions prevailed in the FX market as demand for FE-25 loans subsided during pandemic…

To meet the funding needs, both importers and exporters increasingly used FE-25 loans from Jul-2019 to Feb-2020. The attractiveness of these loans stemmed from borrowers' perceived minimal exchange rate risk and (rising) interest rate differential between the local and foreign currency loans. Further, some of the exporters could not avail SBP's concessionary financing (e.g. EFS) due to some supply-side constraints especially in case of those banks that had exhausted most of the limit assigned for EFS.[36] However, with the imposition of COVID-19 related lockdowns, globally and domestically, the economic activity virtually came to a halt and the demand for FX loans plummeted. Furthermore, the sudden exchange rate depreciation in March 2020 and ensuing uncertainties also made FE-25 loans unattractive. Consequently, borrowers started repaying their FE-25 loans (**Chart 2.9**).

Chart 2.9: FCY loans fell Feb-20 onwards during CY20



Source: SBP

…and deposits continued to grow

Contrary to the situation of FX loans, FE-25 deposits maintained their rising trend from March-2020 onwards contributing to the dollar liquidity in the interbank market.

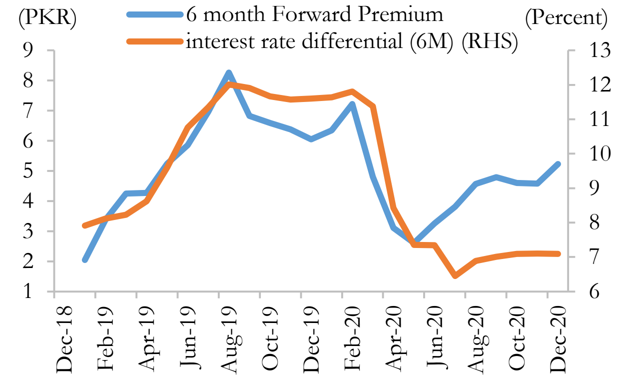
With ample liquidity, forward premiums started rising from June 2020 onwards…

Forward premium that had falling since August 2019, mainly due to declining interest rate

[35] External Debt servicing include principal repayment (short term and long term) and interest payments.
[36] From January 2020 onwards, SBP enhanced the overall limit for the EFS by PKR 100 billion.

differential (6M KIBOR-6M LIBOR), changed direction in May 2020 (**Chart 2.10**).[37] Abundant liquidity in the spot market coupled with steady interest rate differential, helped the exchange rate to appreciate and pushed forward premium upwards since June 2020.[38]

Chart 2.10: Trend in Forward Premium and Interest rate differential

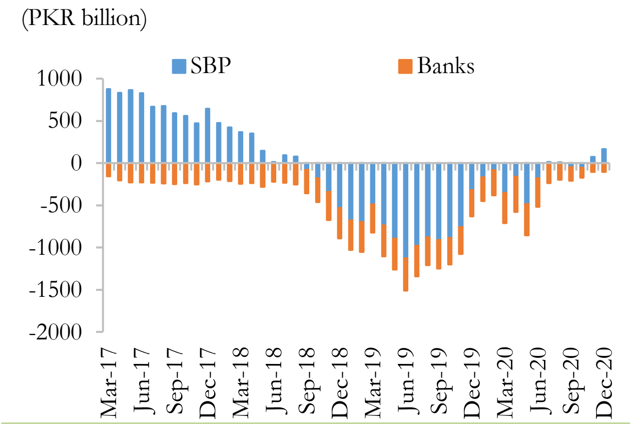


Source: SBP and FRED

…and banks were able to accumulate more foreign assets

Besides an improvement in the Net Foreign Assets (**NFA**) of SBP, the NFA of the banks also recorded a continuous improvement in CY20 (**Chart 2.11**). The NFA of the banks recovered from PKR -307.04 billion at end December 2019 to PKR -101.55 billion by end December 2020, an improvement of 66.9 percent. The growing FX liquidity in the market allowed banks to not only reduce their borrowings from abroad (a drop of 19.7 percent YoY) but also increase their balances held abroad (a rise of 122.4 percent YoY) during CY20. With these positive trends in NFA of both SBP and banks, the overall stock of NFA turned positive in December 2020—the first time since April 2018.

Chart 2.11: NFA of the banking system improved in CY20



Source: SBP

Besides, SBP's trade facilitation measures also contributed to the stability of the market

At the beginning of the year, SBP took several measures to facilitate the international trade. (**Appendix A: Supervisory initiatives**). During the pandemic, SBP provided further relief by allowing authorized dealers to make advance payment of up to 100 percent of the value of import of medical equipment, medicines and ancillary items etc.[39] Such measures not only complemented government's efforts against COVID-19, but also provided a sense of stability in the FX market during the pandemic.

[37] Here, the forward premium is difference between Spot rate and Six month forward rate.

[38] For instance, the current account balance was in surplus for consecutive five months (from July to November 2020)

[39] EPD Circular Letter No. 09 of 2020 dated March 24, 2020

Money Market

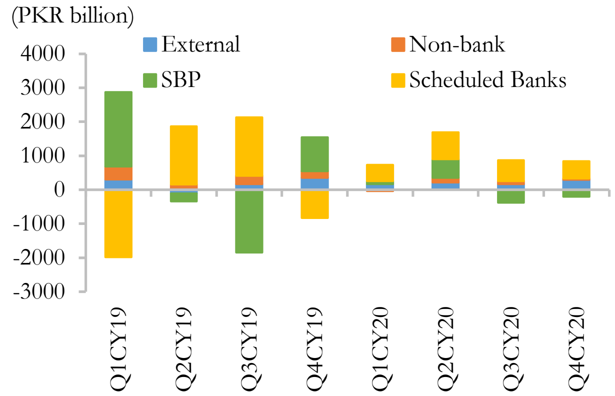
In the wake of the pandemic, SBP responded with a sharp fall in policy rate…

The sharp and significant fall in the policy rate was among the major economic support measures taken during CY20. In a short span of 97 days (between March 17, 2020 and June 24, 2020), SBP reduced the policy rate from 13.25 percent to 7.0 percent. Moreover, with the initiation of interest rate easing cycle, SBP also introduced symmetry in Interest Rate Corridor (**IRC**) on March 17, 2020—in line with international best practices.[40] The purpose was to increase the effectiveness of monetary policy and improve market functioning.[41]

Pandemic also induced higher than expected borrowing needs of the government…

Further, in the aftermath of the pandemic government's financing needs increased as it made sizeable social security and other expenditures to protect lives and livelihoods. The fiscal deficit doubled during Q2CY20 as compared to the expected position in pre-COVID scenario.[42] Facing a difficult situation, the government tried to utilize all possible avenues to mobilize additional resources. Among the domestic avenues, bank financing shared almost half (47 percent) of the borrowing burden during Q2CY20 (**Chart 2.12**).

Chart 2.12: Financing of Budget Deficit was tilted towards banks in CY20

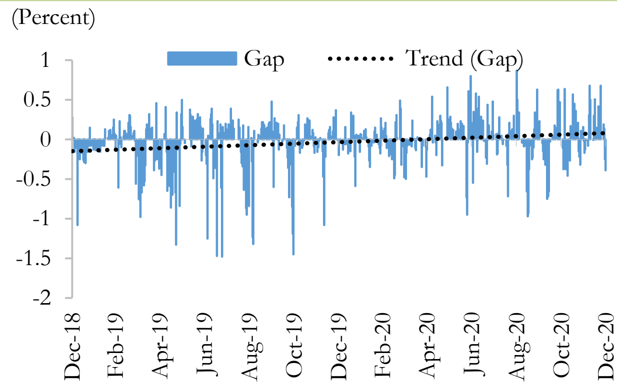


Source: SBP

…leading to a temporary hike in the volatility of overnight repo rate (ONR) and somewhat tighter liquidity conditions

The sharp fall in policy rate and the unexpected rise in government borrowing from the domestic market were reflected in key money market rates. Moreover, the deviations of ONR from policy rate, which on average remained negative during Q1CY20, turned positive afterwards—reflecting tighter liquidity conditions (**Chart 2.13**).

Chart 2.13: Trend in gap between O/N repo rate and policy rate



Source: SBP

40 Earlier, the ceiling rate was 50 bps above the policy rate and the floor rate was 150 bps below SBP Policy rate. The 50 bps positive gap above SBP policy rate was less penal in case banks were short of funds on required reserves compared with the gap for floor rate (150 bps below SBP policy rate) in case of placing surplus liquidity with SBP.

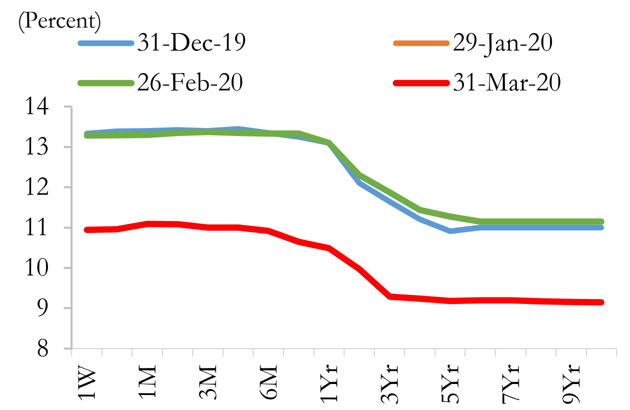
41 The revised width of floor and ceiling rates would encourage banks to improve their liquidity management through bringing more efficiency in the market by discouraging banks' use of ceiling and floor facilities. For details see Chapter 1: Enhancing Effectiveness of Monetary Policy in Annual Performance Review 2019 – 2020, of SBP

42 SBP Annual Report on the State of the Economy, FY20

Moreover, the emerging uncertainty resulted in downward shift in the yield curve…

The inverted yield curve at the end of December 2019, showed a notable downward shift by end Q1CY20 (**Chart 2.14**). With the emergence of the pandemic, market's expectations towards a prolonged fall in economic activity were reflected in the yield curve. Following the 75 bps and 150 bps declines in SBP policy rates on March 17, 2020 and March 24, 2020, respectively, the yield curve exhibited a parallel downward shift by end March 2020.

Chart 2.14: The downward shift in Yield Curve in Mar-20

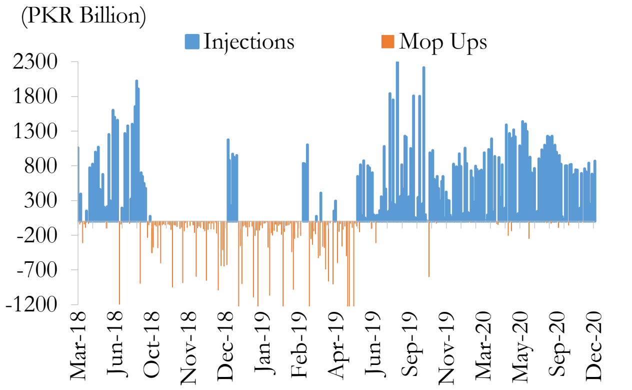


Source: MUFAP

Given the tighter conditions, SBP proactively managed liquidity to reduce the stress in the money market

In the wake of sudden change in market conditions, SBP responded through frequent and sizeable market interventions to maintain ONR closer to policy rate. Not only the frequency of injections more than doubled to 42 in H1CY20 from 18 in the same period last year, but the average OMOs injection size also went up significantly to PKR 682.0 billion in H1CY20 from an average of only PKR 492.0 billion during H1CY19 (**Chart 2.15**).

Chart 2.15: OMOs injections increased significantly in H1CY20



Source: SBP

Encouragingly, higher deposit growth also augmented the supply of funds…

The increase in deposits also provided much-needed support to the supply of funds in the interbank market. Total deposits increased by PKR 1.5 trillion by end H1CY20 from their Dec-2019 level—a rise of 9.1 percent (for details see **chapter 2**). In the absence of this healthy deposit mobilization, the average OMO injections could have been higher than the actual one during H1CY20.

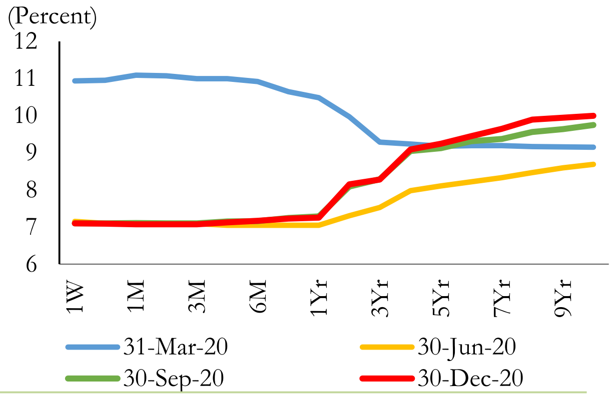
…and gradual implementation of Treasury Single Account also did not add additional pressures

The implementation of Treasury Single Account (**TSA**), though imperative for government's liquidity management, could potentially generate funding pressures for some banks (especially for the ones with higher share of government deposits). Consequently, the gradual implementation strategy helped abate additional pressures in the money market. However, banks heavily relying on government deposits need to diversify their funding sources by focusing on non-government deposits to compensate for any steady loss of government deposits due to TSA.

As economic recovery revitalized in H2CY20, interest rate expectations reversed…

Following the declining trend in COVID-19 positivity rate, the government partially relaxed the lockdown measures during May 2020, which helped in restoring economic activity as well as business confidence. Macroeconomic indicators such as LSM also recorded 2.38 percent YoY growth in Q3CY20 compared to a sharp decline of 24.67 percent in the preceding pandemic-stricken quarter. The CPI inflation also inched up marginally to 8.85 percent in Q3CY20 from 8.45 percent in Q2CY20, which led to rising inflation expectations of market participants. This, among other factors, changed the perceptions of the market participants. As a result, the yield curve normalized from end June 2020 onwards (**Chart 2.16**).

Chart 2.16: Upward shift in the Yield Curve at longer tenors from June 2020 onwards



Source: MUFAP

…and market participants' interest in longer tenor government securities gradually waned

As the expectations of a rise in longer-term rates strengthened from end June 2020 onwards, market's interest in the long-term instruments started waning despite government offering a variety of choices (such as, Ijarah Sukuk and new versions of PIB i.e. floating-rate bonds) (**Chart 2.17**). This view was evidenced by falling offer-to-target ratio for long-term instruments by the end of the year. Instead, the market tilted towards the shorter horizon.

On part of the government, it made considerable efforts to lengthen maturity profile of its borrowing. However, banks' behavior to bid at higher rates compelled the government to accept lower than targeted amounts of longer tenor instruments during H2CY20.

Chart 2.17a: Trend in Offer to Target Ratio

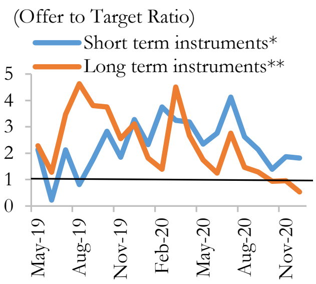
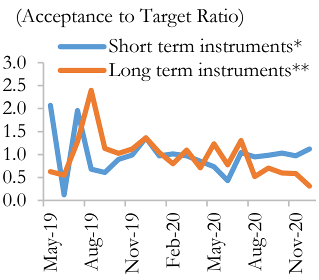


Chart 2.17b: Trend in Acceptance to Target Ratio



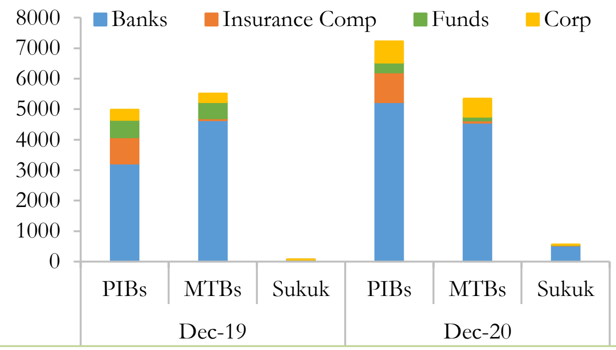
*includes 3, 6 and 12 month Treasury Bills
**includes PIBs (fixed and floating) and Ijara Sukuk, Source: SBP

However, introduction of floating-rate PIB helped reduce rollover risk for the government as well as revaluation risk for the investors…

Though market's interest in long-term securities declined by the end of CY20, the introduction of floating-rate categories of PIBs helped the government to lengthen maturity profile of its borrowing during CY20. Within the total acceptance of PKR 12.2 trillion during the year, the share of floating-rate PIBs rose to 13.9 percent—much higher than 2.9 percent last year Nevertheless, the floating-rate category also helped increase the share of long-term government securities in the balance sheet of banks—the largest investors in government securities (**Chart 2.18**). The share of PIBs in investment in government securities (on banks' balance sheet) went up to 49.9 percent as at end Dec-20 from 41.0 percent in CY19. In fact, since CY16 it was the first time that the share of PIBs was higher than MTBs. The issuance of floating PIBs will help minimize the rollover risk for government.

Chart 2.18: Banks hold a major part of Government securities

(Face Value PKR billion)



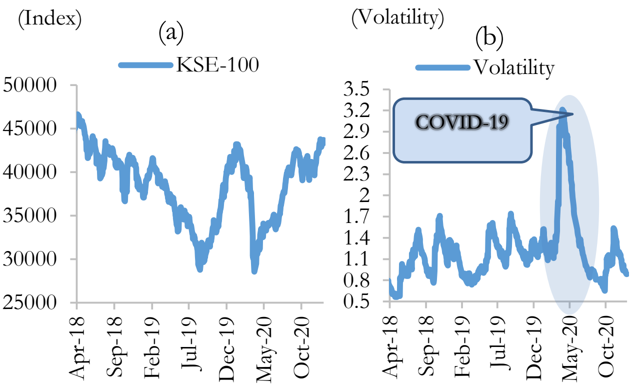
Source: SBP

Equity Market

Onset of pandemic brought considerable volatility in equity market during Q1CY20…

Amid the pandemic, the equity market witnessed significant volatility in the first quarter of CY20. The KSE-100 index was already under stress at the beginning of the year (January and February), reflecting the emerging uncertainties from the unfolding GHC. However, as the pandemic emerged in Pakistan, the index slid by around 31 percent within a few weeks to 27,267 by March 26, 2020; last time the index was lower than this level was on March 31, 2014 (**Chart 2.19**). [43]

Chart 2.19: KSE-100 index; exhibited temporary but significant volatility in Q1CY20

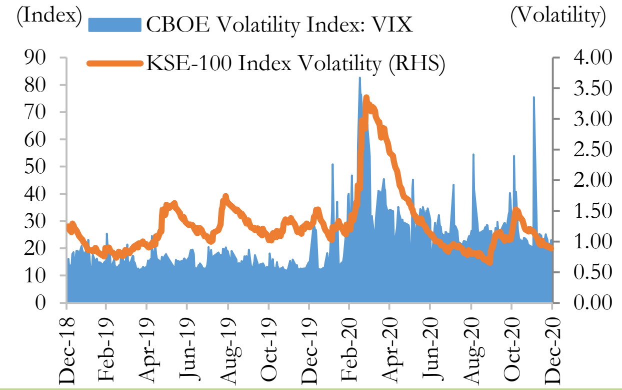


Source: PSX

…however, the decline in equity prices was in line with global trend

The heightened volatility in global equity markets during March also influenced domestic equity market. The VIX index, which is commonly used as an indicator of gauging stability in global equity markets, almost coincided with volatility in KSE-100 index during March (**Chart 2.20**).[44] The panic selling also triggered downward pressures that led to market halts on eight occasions during March-2020.

Chart 2.20: Volatility in VIX Index coincided with that of KSE-100 index during Q1CY20



Source: FRED and PSX

Risks in the equity market were significantly higher during Q1CY20…

Being a health crisis, the COVID-19 related uncertainty was quite unique for the market. However, the initial response was like previous crisis such as GFC of 2008 – i.e. flight to safety. As highlighted earlier, risks were significantly higher during Q1CY20. Not only the actual returns of KSE-100 index breached the Value at Risk (**VaR**) with higher frequency (20 times) in CY20 (18 times in CY19), the magnitude of breaches was also quite higher. Moreover, the returns also dipped below the Stressed VaR (**SVaR**) on five occasions (**Chart 2.21**); all in March 2020. However, thanks to the support from policy measures, these risks started to

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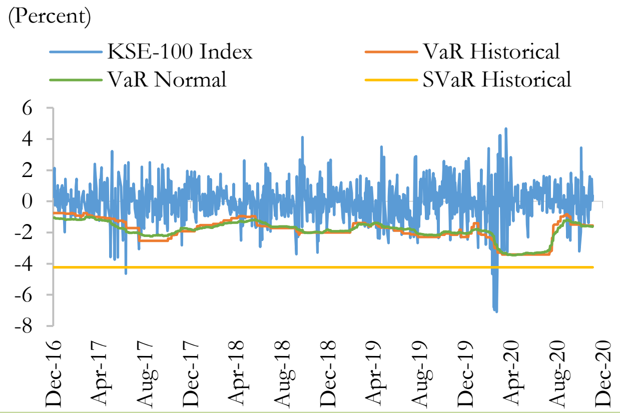
[43] The KSE-100 index previous fell to 27160 level on 31st March, 2014.

[44] The correlation between KSE-100 index and VIX is positive at 0.27 during CY00 and CY20 and is highly statistically significant, the value of coefficient increases to 0.39 and 0.51 when the sample is reduced to CY11 to CY20 and for CY20 (pandemic year only), respectively.

subside from April 2020 onwards.

Chart 2.21: VaR also showed high stress during H1CY20

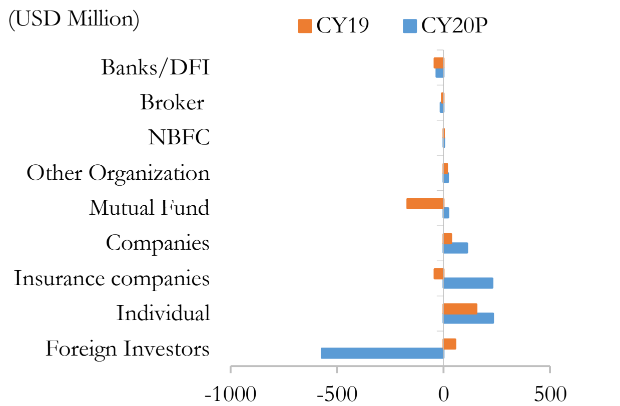


Source: SBP

...leading to 'flight to safety' among different investors....

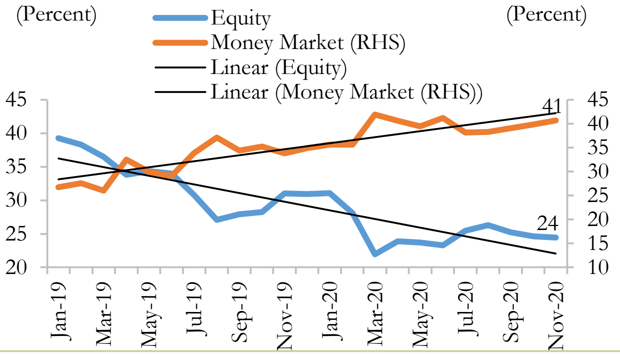
The initial responses from the investors seemed to be contingent upon the perspective of different type of investors. For instance, individuals, insurance firms and companies were net buyers during CY20 while banks and foreign investors were net sellers (**Chart 2.22**). Specifically, the net selling of USD 571.5 million in CY20 by foreign investors was worth noting and was contrary to net buying of USD 55.7 million in CY19. Among local investors, mutual funds also showed some risk averse behavior and remained tilted towards money market (**Chart 2.23,** data is till November 2020).

Chart 2.22: Foreign investors turned net seller in CY20



Source: NCCPL

Chart 2.23: Mutual Funds remained tilted towards Money Market avenues



Note: This chart presents share in total assets of mutual funds

Source: SECP

...SBP and SECP responded with timely actions...

Given the extent of the volatility, the timely policy support measures of SBP and SECP played a critical role in revival of investors' confidence. Both the regulators took various policy measures that helped normalize the impact of the pandemic shock.

...SBP support measures were vital in restoring investors' confidence...

First, SBP responded quickly to the emergence of the pandemic and lowered the policy rate by 75 bps on March 17, 2020 and then within a week by a further 150 bps on March 24, 2020. Furthermore, the central bank clearly communicated to the market that it stood ready to take whatever further actions become necessary in response to the evolving economic impact of the Coronavirus.

Second, SBP relaxed the margin requirement (from 30 percent to 20 percent) and margin calls (from 30 percent to 10 percent) for exposure against shares of listed companies due to prevailing volatility in the country's equity market.[45] Moreover, the central bank allowed Banks/DFIs to take exposure on any person against the shares issued by its group companies, provided the tenor

[45] BPRD Circular Letter No. 13 of 2020 dated March 26, 2020

of the financing facilities did not exceed one year (Financing against Shares/TFCs/Sukuk).

Third, the successive cuts in policy rate during Apr-Jun 2020 gave further impulse to the equity market.

Fourth, since continuity of business was a major concern, SBP took measures (facilitated by banks) to provide uninterrupted financial services to the general public and encouraged the use of alternative delivery channels (**ADCs**). The SBP also instructed banks to waive fee on digital transfers to minimize human contact in banking services. These initiatives helped in facilitating business transactions.

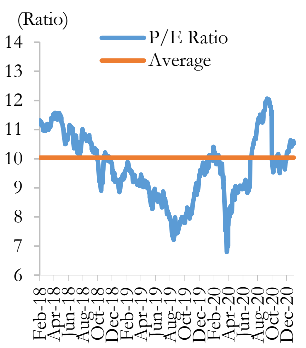
…SECP also took measures to manage the market volatility

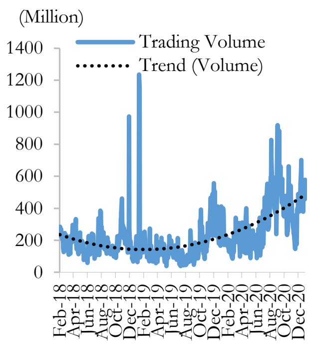
Like SBP, the SECP also took various measures that helped in controlling stress in the equity market. The regulations of National Clearing Company of Pakistan Limited (**NCCPL**) were amended to improve market liquidity.[46] As part of the risk management framework, SECP also enhanced the maximum limit of circuit breaker level to 7.5 percent from 5 percent (in a phased manner).[47] The index-based market halts proved to be a good risk management tool. The eight market halts during Q1CY20 were quite helpful in managing the market volatility as the halts increased the resilience and provided reasonable time to investors to better assess the market conditions and calm their sentiments.[48]

After initial set back, the market recovered quite quickly …

With the fall of KSE-100 index during Q1CY20, valuations (Price/Earnings ratio) got cheaper till end June 2020 and proved to be one of the major reasons in reviving the equity market besides attracting investors. Though the P/E ratio at 9.34 for the whole year was higher than 8.76 for CY19, some divergent phases were observed within year under review. The P/E ratio fell to 6.81 on March 26, 2020. However, as the trading activity recovered, the ratio rose to 10.53 by end of CY20 (**Chart 2.24**). Despite rising trend in valuations, KSE-100 index kept its growth momentum, as the economy showed a visible recovery and satisfactory corporate profitability helped in preserving the investors' interest in H2CY20.

Chart 2.24: Falling valuations helped the market to rebound





Source: Bloomberg and PSX

[46] These include: the discontinuing of 10 percent additional margins being collected from brokers and the 10 percent additional haircuts being applied by NCCPL on margin eligible securities (MES); revised slabs of liquidity margins and narrowing the scope to only large exposures of brokers; reduction in security deposit requirements; increase in pool of eligible collateral against margin requirements; revisions in methodology for calculating haircuts on PIBs for acceptance as margin eligible securities (MES); inclusion of GOP Ijarah Sukuk in the list of MES, and enhancing the list of eligible securities from 100 to top 200 for Margin Trading System (MTS).

[47] Source: Introduction of market halts and widening of circuit breakers, available at: https://www.psx.com.pk/psx/files/?file=141446-1.pdf

[48] With the objective to safeguard investors and market participants during volatile markets and collection of margin by the clearing company, market halt procedure has been introduced at PSX after it was approved by SECP in PSX regulations in December of 2019. The index-based market halt is applied in case KSE-30 index moves 4 percent either way from its opening index value. Once circuit breakers reach the level of 7.5 percent, whichever is higher, index based market halts shall only be applicable in case KSE-30 index moves 5 percent either way. In case KSE-30 index continues to trade 4 percent or 5 percent, as applicable, above or below its opening index value for consecutive 5 minutes (during market open state only), the trading in all securities shall be halted for 45 minutes. Source: PSX and SECP press release dated March 12, 2020 and March 13, 2020, respectively available at: https://www.psx.com.pk/psx/files/?file=144562-1.pdf and https://www.secp.gov.pk/wp-content/uploads/2020/03/Press-Release-March-13-SECP-Reviews-Stock-Market-Situation.pdf

…and the momentum of recovery was strong enough to beat the last year performance …

The fall in equities proved short lived and the KSE-100 index started quick recovery from the end of March-2020 onwards. The sustained recovery helped the index to reach 43,755 by end of CY20 (40,735 in CY19), which translated into a growth of 7.4 percent during CY20 compared to 9.9 percent last year. Total market capitalization, however, was higher than last year (**Table 2.1**).

Table 2.1: Progress of capital market in Pakistan during CY18-CY20

	Dec-18	Dec-19	Dec-20
Million PKR except companies, index and bond data			
Total No. of Listed Companies	546	534	531
Total Listed Capital - PKR	1,322,748	1,386,599	1,430,582
Total Market Capitalisation - PKR	7,692,787	7,811,812	8,035,363
KSE-100™ Index	37,067	40,735	43,755
Growth (KSE-100 Index)	-8.41%	9.9%	7.4%
KSE-30™ Index	17,174	18,656	18,180
KMI-30 Index	61,174	66,032	75,276
KSE All Share Index	28,043	29,012	30,780
PSX-KMI All Shares Index	18,185	19,387	21,718
New Companies Listed during the year	3	1	3
Listed Capital of New Companies - PKR	5,432	8,694	111,971
New Debt Instruments Listed during the year	6	7	7
Listed Capital of New Debt Instruments - PKR	28,820	240,624	246,967
Average Daily Turnover - Regular Market (Shares in Million)	194	164	324
Average Value of Daily Turnover - Regular Market (Rs in Mn) (YTD)	7,871	5,909	11,907
Average Daily Turnover - Future Market (Shares in Mn) (YTD)	68	74	99
Average Value of Daily Turnover - Future Market (Rs. In Mn) (YTD)	3,022	2,862	4,514

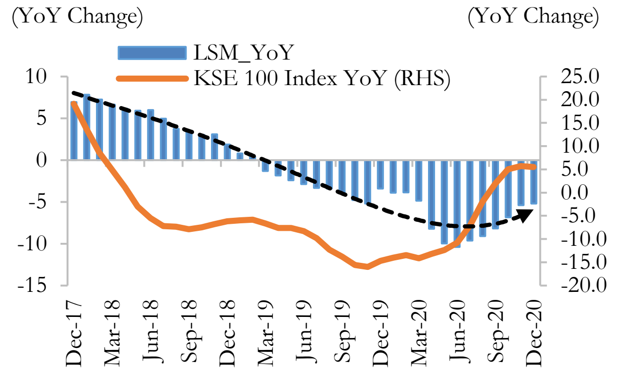
Source: PSX

EoP= End of Period

Recovery of the market preceded the revival in real sector of the economy…

The equity market seems to have gained optimism quite quickly as compared to recovery of the real sector (e.g. LSM) (**Chart 2.25**). While the lockdown restrictions such as business closures held back economic activity for most of the Q2CY20, the equity market continued its upward trend during the same time as the policy measures and attractive valuations fueled the optimism of the investors.[49]

Chart 2.25: 12MMA YoY Trend of LSM and KSE 100 Index



Source: PBS and PSX

…higher listing was also encouraging during CY20…

CY20 was also better in terms of Initial Public Offerings (**IPOs**) (**Table 2.1**).[50] Three firms raised PKR 5.44 billion of capital by issuing 226.2 million ordinary shares. Besides these IPOs, a chemical sector firm also issued 37.5 million preference shares for PKR 375.0 million during CY20. An increased use of e-IPO was also observed during the pandemic. Furthermore, SECP also simplified account opening process for low-risk investors and enhanced the maximum investment limit from PKR 500,000 to PKR 800,000.

…sector wise dynamics continued to influence investors' choices…

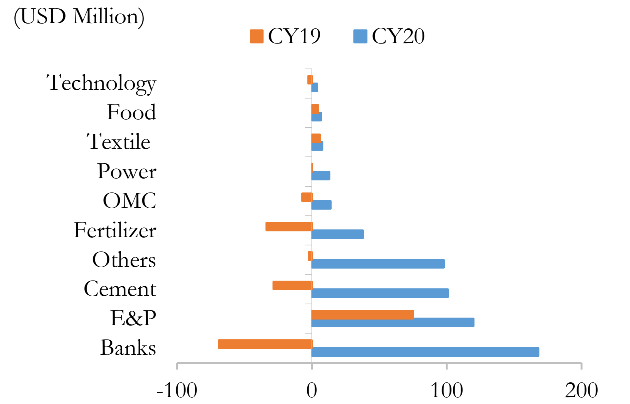
The sector wise investment pattern during CY20 was different from CY19 but almost similar to CY18 (**Chart 2.26**). Sector wise flows of portfolio (LIPI[51] data) show that banks' stocks were the top choice among local investors. Besides strong solvency, banks' profitability could be the main reason and buyers may have taken a strategic view on the future earnings as well as payout of suspended dividends.

[49] The market also continued working on June 29, 2020 during a terrorist attack on PSX, Karachi, as the law enforcement agencies were able to handle the situation.

[50] The IPOs were, i) The Organic Meat Company Limited (TOMCL) was listed on August 3, 2020, ii) TPL Tracker on August 10, 2020 and (iii) Agha Steel Company on November 02, 2020. Moreover, Engro Polymer and Chemicals issued Preference shares on December 31, 2020.

[51] LIPI stands for Local Investors Portfolio Investment

Chart 2.26: Banks and cement were the favorite sectors



Source: NCCPL

Exploration and Production (**E&P**) also performed well as the valuations were quite attractive due to depressed energy prices in global markets. Investors took positions to benefit from potential recovery amid the revival in demand as the economies gradually opened from pandemic and energy prices started rising during H2CY20.

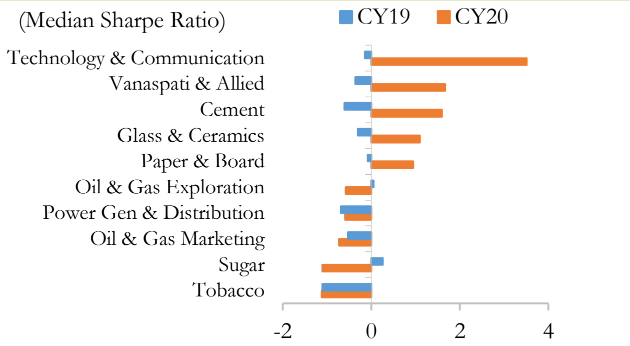
The other prominent sector was cement. As the sector leveraged heavily to finance capacity expansion in recent years, a significant reduction in finance costs during CY20, along with higher demand (dispatches) for cement, better prospects due to government construction package under Naya Pakistan housing scheme and higher future earnings may be the factors that caught local buyers' attention.

….COVID-19 and the associated policy support measures were also reflected in sector wise performance in KSE-100 index

The pandemic had a dual impact on various sectors of the economy – some severely hit while others got a boost. CY20 turned a good year for construction and allied sectors in domestic economy. The changing working patterns (e.g. remote working from home), enhanced use of technology to minimize human contact due to the virus and the policy support measures such as the construction package and Naya Pakistan housing scheme provided an opportunity of further growth to various businesses. Contrary to this, closure of factories (no use of electricity & gas) and restrictions on travel severely affected sectors that involved close human contacts and interaction such as transportation, tourism and hoteling, etc. and therefore reduced demand for energy and utilities businesses.

The sector wise median Sharpe ratios[52] suggest that firms in technology & communication (e.g. increased automation) and construction related sectors were among the top five performing stocks whereas tobacco, sugar and energy sectors could not perform well in CY20 – travel restrictions during the pandemic and subdued consumer demand may explain the subpar performances of these sectors (**Chart 2.27**).

Chart 2.27: Top and bottom 5 Performing sectors in KSE-100 Index



Note: Industrial Classification based on PSX
Source: Bloomberg

Going forward, stability in the financial markets will largely depends on (i) the changing situation of the pandemic (successive waves); (ii) the evolving policy environment and the timing of unwinding of the pandemic-related measures; (iii) the successful implementation of the IMF program, and (iv) the growth momentum of the economy.

52 Developed by Nobel laureate William F. Sharpe, the Sharpe ratio is used to help investors understand the return of an investment compared to its risk. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. Generally, the greater the value of the Sharpe ratio, the more attractive the risk-adjusted return. Risk free investments such as treasury bills has a Sharpe ratio of zero.

Section A: Performance and Risk Analysis of Banking Sector

Chapter 3.1: The Banking Sector

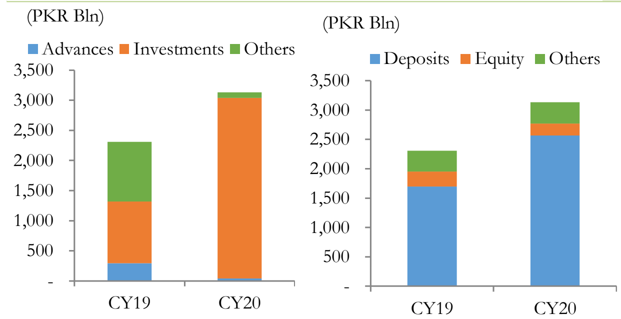
In CY20, banking sector has remained resilient despite pandemic induced vulnerabilities. The momentum of Advances — across various economic sectors — remained weak while banks' investments surged in the wake of higher government budgetary borrowing. Healthy flow of deposit provided the necessary funding to support the asset growth. Despite overall stresses in the macroeconomic environment, Non-Performing Loans observed a moderate rise partly supported by prudential relief measures. The earnings observed a marked improvement mainly attributed to lower interest and administrative expenses, and gains on sale of securities. The solvency continued to strengthen indicating elevated capacity of the banks to sustain stress from unexpected shocks. Given the uncertain environment, banks need to continuously assess the situation, particularly the repayment capacity of borrowers, and take necessary measures for ensuring institutional solvency.

Banking sector remained resilient during CY20…

Despite pandemic driven stress, banking sector's assets grew by 14.24 percent during CY20—higher than 11.73 percent growth observed in the previous year.

Growth in the asset base was almost entirely driven by investments which increased by 33.51 percent (**Chart 3.1.1**).[53] Marked rise in deposits—in a risk averse environment— enabled banks to finance investments of around PKR 3 trillion. Current accounts and saving deposits (**CASA**) contributed the lion's share in the growth of deposits, which mainly belonged to 'individuals' and 'businesses' categories of deposits. While advances recorded a paltry growth of 0.52 percent, this increase mainly resulted from SBP's policies to support the flow of credit. The credit decelerated across some economic sectors while made net retirements in others. Textile sector, however, availed highest financing during the reviewed year.

Chart 3.1.1: Assets and liabilities composition of the banking sector (flows)



Source: SBP

The credit risk of the banking sector, supported by SBP's macro-prudential interventions, moderately increased as Gross Non-Performing Loans Ratio (**GNPLR**) inched up to 9.19 percent by end Dec-20 (8.58 percent in Dec-19).

The after-tax earnings of the banking sector surged by 42.92 percent during CY20. Drastic cut in policy rate during March to June 2020 transmitted into lower funding costs on deposits due to immediate repricing of saving deposits.[54] On the other hand, interest earnings were supported by increase in the volume of investments in government securities as well as lag in the re-pricing of loans, which are repriced as per the frequency set in the loan agreement between the bank and the borrower.

The solvency of the banking sector remained robust, which further improved with, marked rise

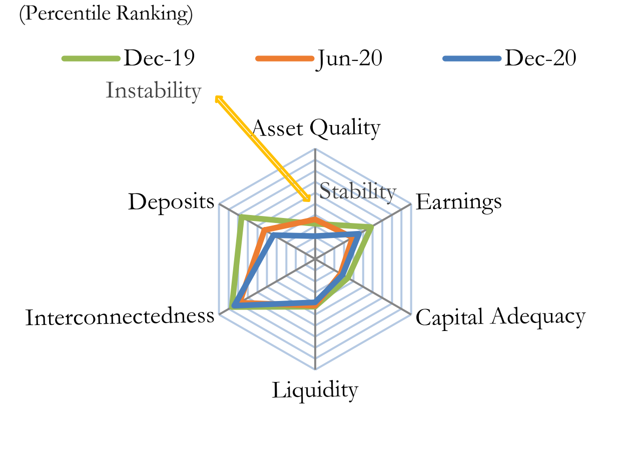
[53] Investments explain 96 percent rise in total assets flows during CY20.

[54] According to BPRD Circular No. 07 of 2013, in the wake of change in policy rate, re-pricing of saving deposits is applicable with effect from 1st day of the subsequent month. The circular can be accessed at: https://www.sbp.org.pk/bprd/2013/C7.htm

in earnings. The Capital Adequacy Ratio (**CAR**) increased to 18.56 percent by end Dec-20 from 17.0 percent in Dec-19. Similarly, the Basel liquidity ratio including Liquidity Coverage Ratio (**LCR**) and Net Stable Funding Ratio (**NFSR**) remained well above the required level during CY20.

Consolidated position of banks' stability along key risk dimensions has improved over the year as encompassed in Banking System Stability Map (**BSSM**) despite the elevated macroeconomic stress (**Chart 3.1.2**).

Chart 3.1.2: Banking Sector Stability Map



Source: SBP

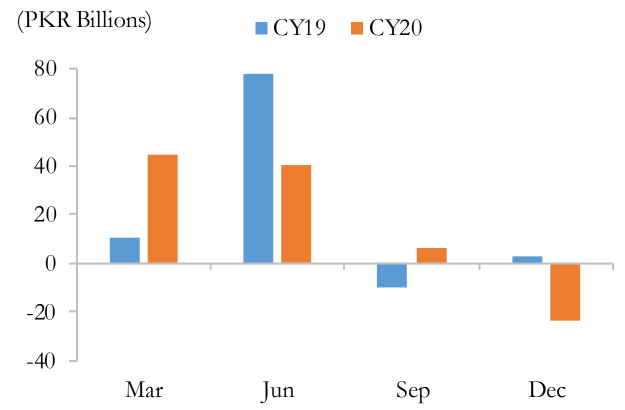
Credit risk increased somewhat …

The stock of banks' NPLs increased by 8.91 percent to PKR 829 billion during CY20. Positively, the current year growth in NPLs was lower than previous year's rise of 11.97 percent. However, GNLPR inched-up to 9.19 percent (8.58 percent in CY20) due to muted growth in loan portfolio. Importantly, the flow of NPLs increased by PKR 85 billion amid the height of uncertainties during H1CY20 which subsided to PKR 68 billion by the end of CY20.

…particularly in the first half, due to lockdown and other pandemic containment measures….

Rise in NPLs during H1CY20 manifested the impact of earlier macro-economic conditions especially higher interest rates which prevailed in Q1CY20 as well as lockdowns and social distancing measures enacted by the government during Q2CY20 (**Chart 3.1.3**).

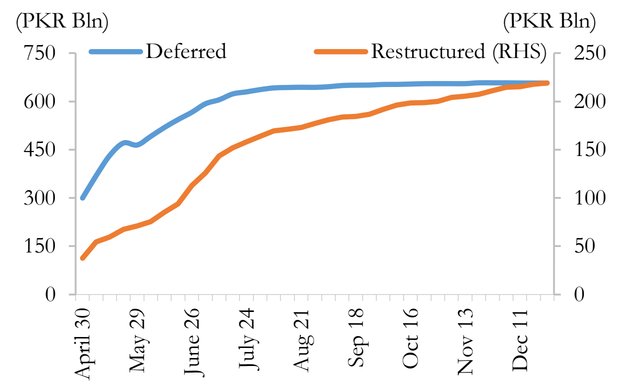
Chart 3.1.3: NPLs flows subsided in H2CY20



Source:SBP

With the impending cash flow constrains among economic agents due to pandemic containment measures, SBP acted proactively by providing relief through a host of measures, including 6.25 percent cut in policy rate between March to June 2020 and principal payment holidays and restructuring/ rescheduling of loans. From the start of the pandemic to end June 2020, loans worth of PKR 566 billion were deferred and PKR 113 billion allowed for restructuring/rescheduling (**Chart 3.1.4**).

Chart 3.1.4: Cumulative amount deferred and restructured/ rescheduled in CY20

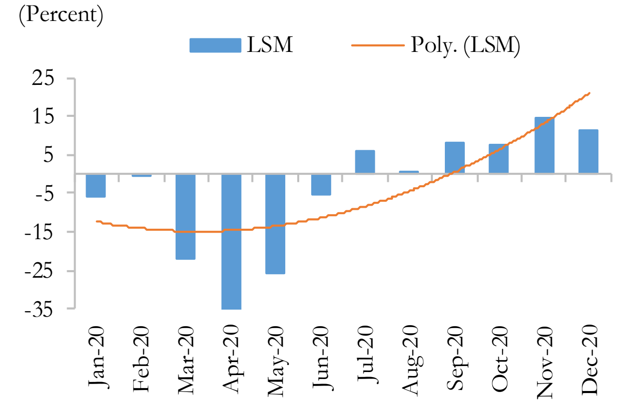


Source: SBP

… while credit risk subsided as support measures started to bear results

The contraction in NPLs during H2CY20 resulted from both the impact of SBP relief measures, gradual economic recovery, and increase in cash recoveries against NPLs. The support factors included upturn in manufacturing activity due to opening up of economic activity with SOPs, and combined impact of different policy measures, which were further augmented by government's package for the construction industry (**Chart 3.1.5**). Also, the lagged impact of monetary easing boosted re-payment capacity of the firms, which started to reflect in lower financial costs of borrowers **(see Chapter 6).**

Chart 3.1.5: YoY Growth in Large Scale Manufacturing Index



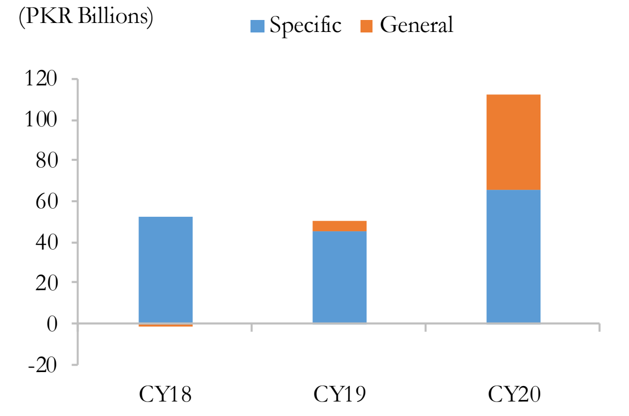
Source:SBP

Provisions increased substantially due to prudent approach of banks…

Provisions expense against NPLs grew by PKR 112 billion during CY20—considerably higher than previous year's rise of PKR 50 billion. Consequently, the stock of provisions reached to 88.33 percent of the value of outstanding NPLs by end CY20 (81.43 percent at end CY19). Higher level of provisioning translated into lower residual risk, with Net NPLR standing at 1.17 percent at the end of CY20 as compared to 1.71 percent a year ago. A proactively improved provisions coverage of credit risk suggests a lower risk to the solvency of banks.

It deserves emphasis that 41.96 percent of total provisioning made by the banks during CY20 were in the form of general provisioning which is kept as precautionary cushion under a forward-looking approach to address potential credit risks. This approach reflects banks prudent behavior in terms of both covering the anticipated risks post expiry of relief measures as well as a step to prepare for the implementation of IFRS 9[55] that was planned to be effective from January 1, 2021 (**Chart 3.1.6**).

Chart 3.1.6: Yearly provisions flows



Source:SBP

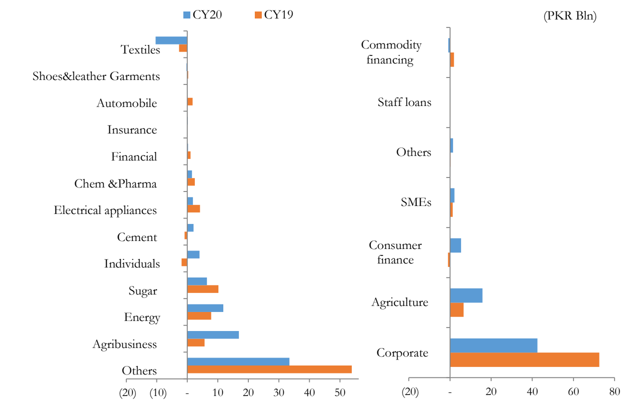
Rise in NPLs was concentrated in few economic sectors…

More than 50 percent rise in NPLs during CY20 was observed in Agribusiness, Energy, and Sugar sectors (**Chart 3.1.6**). The flow of NPLs in the Agribusiness amounted to PKR 17 billion against PKR 6 billion in CY19. Locust attacks on crops as well as pandemic driven problems (e.g., lack of public transportation and unavailability of labor

[55] IFRS 9 is an accounting standard published by the International Accounting Standards Board covering the measurement of financial instruments, asset impairment and hedge accounting.

The new standard introduces the concept of expected credit loss accounting, requiring banks to predict the future loss of all assets at the point of origination or purchase, and set aside provisions for these assets. Under the previous regime, IAS 39, banks provisioned for assets only at the point of impairment and other inputs) at the time of harvest drove-up NPLs of the sector.

Chart 3.1.7: Sector-wise and Segment-wise flow of NPLs



Source: SBP

Segment-wise analysis reveals that corporate witnessed deceleration in flow of NPLs during CY20 (**Chart 3.1.7**). Such a lower increase in quantum of NPLs despite pandemic stress demonstrates the effective role of SBP policies that facilitated banks to manage the credit risk as also risk averse approach in their lending strategies (**see Box 6.1 in Chapter 6**).

Among the sectors, Energy sector NPLs increased by PKR 12 billion during CY20—higher than PKR 8 billion recorded in previous year. The rise in NPLs was mainly driven by drop in international oil prices and softening domestic demand for petroleum products (owing to lockdowns) which translated into inventory losses[56] for Oil Marketing Companies (**OMCs**) and hence wakened their re-payment capacity. OMCs also experienced FX losses due to PKR depreciation at the onset of the pandemic. Besides, delay in receivables and non-finalization of Commercial Operations Date of certain energy firms resulted into delinquencies on their financial obligations during the reviewed year.

Sugar sector NPLs increased by PKR 6 billion during CY20 as compared to PKR 10 billion in previous year. Certain Sugar mills that experienced disruption in business operations in previous year—resumed operations in CY20 hence the sector was able to relatively better service the debt.

NPLs of the textile sector— one of the largest borrowers — contracted by PKR 10 billion in CY20. Quarterly analysis indicates that around 70 percent of the contraction in NPLs materialized during Q4CY20. Besides improved cash flows of textile sector due to export orders, improved cash recoveries by the banks contributed in the reduction of NPLs. Moreover, around 50 percent of the total NPLs during CY20 increased in "Others" category, a leading portion of which came from the overseas operations of some Pakistani banks.

Large and medium-sized banks' asset quality remained more or less stable …

Large and medium sized banks—holding more than 70 percent of the baking sector's NPLs—remained in a better shape during CY20 with contained infection ratio and an average provisioning coverage ratio (PCR) of 90.48 percent (**Table 3.1.1**). However, small and very small banks saw some increase in their infection ratio with average provisioning coverage of less than 70 percent at the end of CY20.

Table 3.1.1: Size-wise NPLs statistics

	Dec-19			Dec-20		
Bank-size	NPLs Ratio	PCR	% share in NPLs	NPLs Ratio	PCR	% share in NPLs
Large	6.11	102.82	51.57	6.85	115.54	52.46
Medium	6.40	69.62	21.83	6.67	73.92	20.48
Small	17.65	61.14	19.81	19.92	67.81	20.64
Very Small	21.50	65.56	6.79	23.59	67.80	6.43

Source: SBP

…though flow of private sector advances subsided...

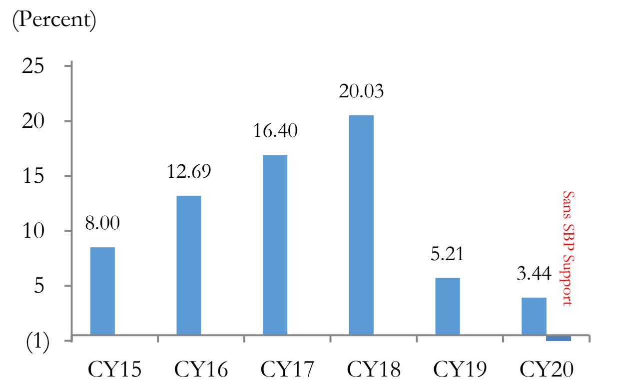
Total domestic advances increased by PKR 187 billion during CY20 against an increase of PKR 297 billion in the previous year. Advances to the private **sector** increased by PKR 217 billion while

56 Inventory losses occur when OMCs buy crude oil at a particular price, which falls by the time the oil is shipped to refineries and processed.

public sector advances witnessed contraction of PKR 30 billion in the reviewed year.

Importantly, growth in private sector advances—at 3.44 percent—was the lowest during the last five years (**Chart 3.1.8**). The slowdown in financing manifested the impact of economic downturn triggered by the pandemic.

Chart 3.1.8: Domestic private sector advances growth



Source: SBP

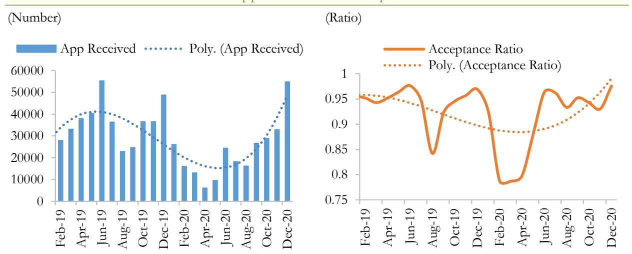
To mitigate the economic risks emanating from COVID-19, SBP enacted a number of concessionary refinance schemes to ensure easy access to liquidity including Rozgar Scheme[57], Temporary Economic Refinance Facility[58] (**TERF**), and Refinance Facility for Combating COVID-19 (**RFCC**).[59] Collectively under these schemes, banks disbursed PKR 247 billion during CY20, which kept the private sector advances growth positive during CY20.[60]

Weaker demand for advances mainly explains subdued growth of financing…

The analysis reveals that slowdown in private sector advances was primarily contributed by weaker demand conditions. In CY20, loan applications declined by 37.59 percent (273 thousand in CY20 vs. 437 thousand in CY19). From supply side perspective, banks accepted 92.76 percent application for financing in the reviewed year—slightly down from 94.97 percent in CY19, reflecting some degree of risk aversion on the part of banks in the wake of pandemic shock. Nonetheless, the mild impact of the pandemic, aggressive policy support by the SBP and the government and the subsequent early resumption of economic activities seem to explain revival in bank lending towards the end of the year.

Further, investigation shows that lowest loan applications were received during Q2CY20. Also in this period, banks' risk aversion peaked as acceptance ratio dipped to 88.01 percent (96.40 percent in Q2CY19)[61] (**Chart 3.1.9**). However, in subsequent quarters, loan applications consistently increased as well as the banks' willingness to lend improved.

Chart 3.1.9: Private Sector Loan Applications and Acceptance Ratio



Source: SBP

Except for textiles, other economic sectors availed moderate financing….

The **sector-wise** analysis indicates that textile sector availed highest level of financing among economic sectors (**Chart 3.1.10**). Most of the 11.75 percent growth in textile sector advances took place during the first and final quarter of CY20. Rise in financing during Q1CY20 was owing to

---

[57] The Scheme aimed to prevent layoff by financing wages and salaries of employees (permanent, contractual, daily wagers as well as outsourced) for six months (April 2020-Sep 2020) for all kind of businesses except for government entities, public sector enterprises, autonomous bodies and deposit taking financial institutions

[58] TERF is a concessionary refinance facility aimed at promoting investment both new and expansion and/or Balancing, Modernization and Replacement (**BMR**)

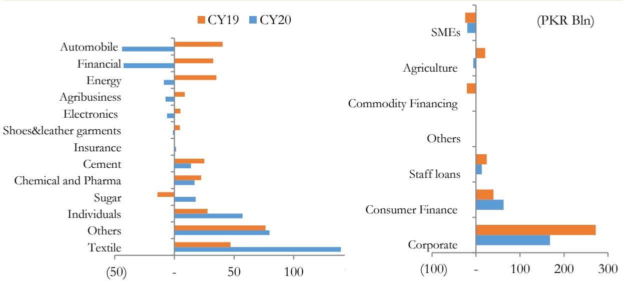
[59] RFCC aimed at enhancing the capacity of health sector of the country to deal with health emergency especially in the backdrop of COVID-19.

[60] The liquidity of PKR 213 billion, PKR 31 billion, and PKR 4 billion was provided to the private sector respectively under Rozgar Scheme, TERF, and RFCC.

[61] Monthly average of acceptance ratio during Q2CY20

enhancement of the aggregate limit for the Export Financing Scheme (**EFS**) by PKR 100 billion.[62,63] Increase in financing during Q4CY20 resulted from relatively early resumption of economic activity in Pakistan due to effective handling of the pandemic by the government that allowed textile sector to capture export orders ahead of its foreign competitors. Resultantly, textile sector demand for advances increased to scale-up exports.[64]

Chart 3.1.10: Sector-wise and Segment-wise flow of private sector advances



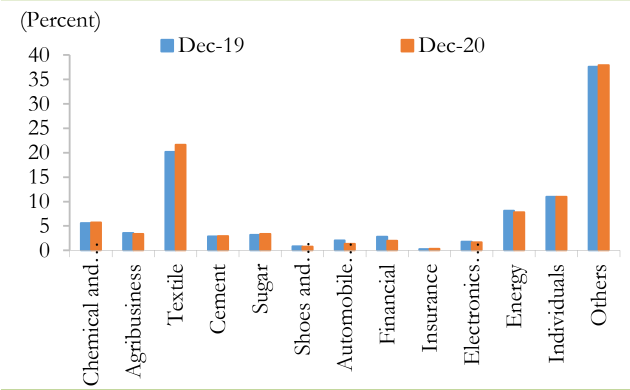
Source: SBP

Similarly, sugar sector advances grew by 8.11 percent in CY20. The growth in advances occurred during Q4CY20[65] due to an early start of sugarcane crushing. In the Cement sector, advances flows decelerated in CY20, due to improved cash flows of the cement sector on the back of higher sales[66] especially in H2CY20, when economic activities resumed and government announced a package for construction industry. Also, SBP's concessionary scheme for housing and construction finance also bode well for cement industry.[67] Similarly, higher sales of the Automobile sector during H2CY20[68] helped improve the liquidity of the sector, hence net retirement of 36.03 percent was observed during CY20 as compared to 49.84 percent growth in CY19. Financial sector made net retirement during CY20 as DFIs reduced borrowing from the banking sector.[69] Energy sector made net retirement as its cash flows improved owing to the issuance of energy Sukuk-II worth PKR 200 billion, which reduced the receivable of energy firms[70].

The composition of banks' loan portfolio remained unaltered …

The pandemic had no tangible effect on banks' distribution of advances to different sectors. The analysis indicates that sector-wise exposure of the banks remained almost stable during CY20 (**Chart 3.1.11**). This reflects that since the principal exposure of banks' advances was concentrated in manufacturing industry rather than high contact industries[71], loan structure of the banks remained unchanged despite pandemic shock.

Chart 3.1.11: Sector-wise percent share in private sector advances



Source: SBP

[62] Press release related to EFS is available at http://www.sbp.org.pk/press/2020/Pr2-28-Jan-20.pdf
[63] Higher financing coincided with higher exports of the textile sector, which stood at USD 3,378 million in Q1CY20 as compared to USD 3,327 million in Q1CY19.
[64] In Q4CY20, textiles exports amounted to USD 3.5 billion as compared to USD 3.4 billion in Q4CY19.
[65] Sugar advances showed higher contraction of PKR 20 billion during 9MCY20 against PKR 7 billion contraction in the comparable period of CY19.
[66] In CY20, cement sales increased by 2.0 percent. However, in H2CY20, sales were higher by 15.7 percent as compared to H2CY19.
[67] https://www.sbp.org.pk/smefd/circulars/2020/C10.htm
[68] Though total cars' sales were 35.8 percent lower in CY20 as compared to previous year, however, sales were up by 13.4 percent in H2CY20 against H2CY19.
[69] DFIs borrowings declined to just PKR 32 billion in CY20, from PKR 117 billion in CY19. As a result, investments during CY20 came down to PKR 47 billion from 117 billion in CY19.
[70] These Sukuk were issued by Power Holding Limited during Q2CY20.
[71] High contact-industries rely more on face-to-face interactions to conduct business operations e.g. hoteling, tourism, retail, etc.

Corporate segment significantly borrowed long-term advances…

The **segment-wise** analysis reveals that except for consumer segment, financing flows across segments were lower during CY20 as compared to CY19 (**Chart 3.1.10**). Further investigation indicates that a rise in financing of PKR 168 billion to **Corporate** segment during CY20 was almost entirely driven by fixed investment (**FI**) advances which increased by PKR 254 billion manifesting the impact of SBP refinance scheme including Rozgar Scheme and TERF.[72] The working capital (**WC**) advances, on the other hand, contracted by PKR 127 billion during CY20. In the final quarter of CY20, as the pace of economic momentum strengthened, financing demand for WC as well as trade financing (**TF**) also improved.

However, financing to SMEs subsided…

SMEs availed only a fraction of banks' lending portfolio, as their share in overall loans remained marginal. Unlike Corporate segment**, SMEs** made net retirement of 4.18 percent in CY20. Resultantly, the share of SMEs loans in total loans shrank to 5.32 percent from 5.68 percent in Dec-19. The historically lower share of SMEs in overall advances illustrates banks' abated risk appetite towards this segment.

…and the favorable lending rates triggered consumer financing

The **Consumer** segment grew by 11.13 percent during CY20, with most of this growth taking place in H2CY20. More than 60 percent contribution in consumer financing from auto loans and 33 percent from personal loans primarily indicating the impact of favorable lending rates due to significant monetary easing.

Public sector advances contracted by PKR 30 billion during CY20 (PKR -15 billion in CY19). Although there was an intake of PKR 35 billion for commodity financing, the retirements were driven by large public sector corporations in energy sector whose advances contracted by PKR 65 billion. This reflects maturity of long-term loans, issuance of Sukuk by a leading borrowing corporation, and improved cash flows of the public sector entities during CY20.

Unlike advances, banks investments in government securities surged during CY20…

Banks investments shot-up by 33.51 percent to PKR 12 trillion during the reviewed year (12.96 percent rise in CY19)-predominantly driven by investments in government securities. Weak financing demand, abundant liquidity, and high government budgetary borrowing needs accelerated banks' investments.

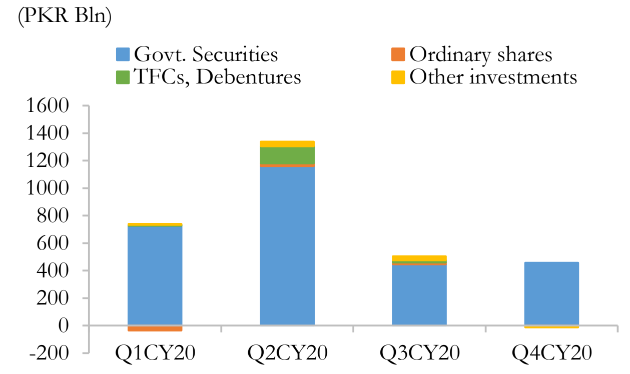
Further analysis indicates that most of the rise in investments occurred during second quarter of CY20 (**Chart 3.1.12**). In this period, domestic economy experienced economic shock driven by COVID-19, which not only weakened demand for financing (as business activity halted due to lockdowns and social distancing measures) but also pushed-up budgetary needs of the government to support the economy.[73] This combined with abundant liquidity due to healthy growth in deposits allowed banks to heavily invest in the risk-free government securities. Also during Q2CY20, banks investments in Term Finance Certificates (**TFCs**)/ Sukuk increased by PKR 124 billion, which primarily reflects Islamic Banking Institutions' (**IBIs**) investment in Energy Sukuk II (**see Chapter 3.2**).[74]

[72] Financing provided by SBP under Rozgar and TERF were of long-term nature that is why banks fixed investment advances accelerated.

[73] Budget deficit at -3.8 percent (of GDP) during Jul-Mar FY20 grossly widened to -8.1 percent during Jul-Jun FY20.

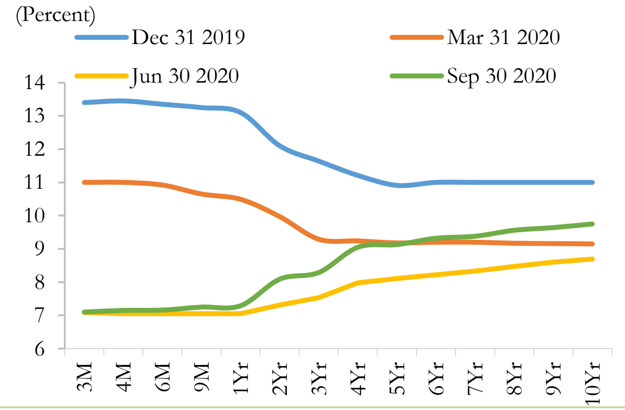
[74] These Sukuk—worth PKR 200 billion—were issued by Power Holding Limited during Q2CY20.

Chart 3.1.12: Break-up of Total Investments (Flows)



Source: SBP

Chart 3.1.13: Yield Curve



Source: SBP

In terms of composition, 91.86 percent of the investments in government securities were channeled into long-term bonds (PIBs). Consequently, share of PIBs in total government securities increased to 49.86 percent by end of CY20 (40.97 percent by end of CY19) while share of short-term securities (MTBs) declined to 42.07 percent (54.36 percent by end of CY19).

Interest rate dynamics as well as government debt strategy influenced investments composition…

The first half of CY20 observed a rise in both short-term as well as long-term investments by the banks. In the early months of CY20 (January and February) when there were no obvious expectations of decline in policy rate, banks preferred to invest in short-term i.e., 3 months treasury bills. However, as the expectations started to build for a cut in policy rate[75]during March-2020, banks bidding in 12M treasury bills auctions surged along with increased appetite for fixed rate PIBs in order to lock their funds at higher prevailing returns (**Chart 3.1.13**).

In Q2CY20, as policy rate moved down by 625 basis points to 7 percent, it became favorable for the government to improve its debt maturity profile and reduce its roll-over risk by increasing long-term debt. Accordingly, government reduced its target for MTBs to PKR 2.2 trillion in Q2CY20 from PKR 2.8 trillion in Q1CY20, while increased its auction target for PIBs to PKR 530 billion from PKR 450 billion. The government also introduced 3- and 5-years floating rate bonds during Q2CY20. Resultantly, long-tern borrowing of the government increased during Q2CY20.

In the second half of CY20, interest rate expectations (for 1 year to 10 years maturities) reversed owing to the anticipated rebound in aggregate demand pressures in the perspective of economic recovery. Interestingly, despite expectations that interest rates could rise in future, banks investments in MTBs declined during Q3CY20 while increased in PIBs, particularly in floating rate bonds.[76] Besides the change in government strategy on its debt profile, this increase was also supported by the reduced re-pricing risk[77] for banks in floating-rate PIBs.

[75] Change in interest rate expectations was largely driven by fall in global oil prices and anticipated softening in domestic economic activity due to rising COVID-19 cases.

[76] In Q3CY20, the government not only further reduced its target for MTBs to PKR 1.8 trillion but also retired its short-term debt (acceptance was less than maturing amount) leading to contraction in banks investments against MTBs. Contrarily, the government significantly raised its auction target for PIBs—particularly for floating rate PIBs —to PKR 1.3 trillion (auction target for PIBs fixed rate and floaters increased by 420 billion and PKR 830 billion, respectively). The banking sector also demonstrated increased interest in PIBs as banks bidding amount increased to PKR 2.4 trillion in Q3CY20 from PKR 1.0 trillion in Q2CY20.

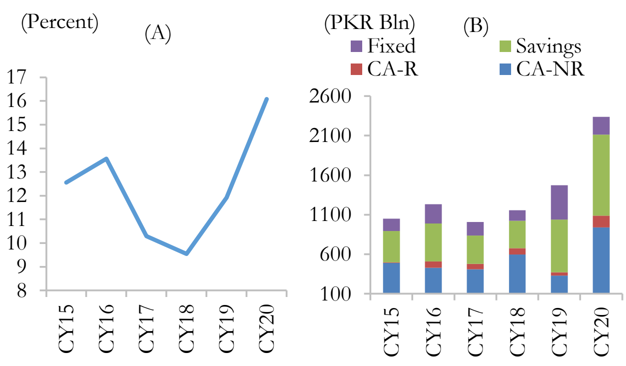
[77] When interest rates rise, banks experience mark to market revaluation losses on their funds locked in long-term bonds at fixed coupon rate because value/prices of the bonds move down.

Similarly, during the last quarter of CY20 banks investments declined in MTBs (because government acceptance was less than maturity amount) while increased in PIBs[78]. However, investments in PIBs came down to PKR 388 billion from PKR 853 billion in previous quarter.

Surge in investments was supported by an abundant inflow of deposits….

Deposits of the banking sector increased by 16.08 percent to PKR 19 trillion during CY20 (11.92 percent in CY19)—highest growth in previous 5 years (**Chart 3.1.14A**). Savings and current account deposits together contributed 88.89 percent rise in total customers' deposits during the reviewed year (**Chart 3.1.14B**).[79] It deserves emphasis that fixed deposits contribution in total deposits flows during CY20 came down to just 9.32 percent from 29.54 percent in previous year. This seems to be on account of reduced incentive for depositors as deep cut in policy rate transmitted into lower return on deposits.[80]

Chart 3.1.14: YoY growth in deposits and customers' desposits flows



Source: SBP

Analysis reveals that deposits increased by PKR 1.5 trillion in the first half of CY20, with the entire rise taking place in Q2CY20. This is a period when economic stress peaked due to elevated infections, lockdowns and social distancing measures. The following factors may have played a role in the phenomenal rise in deposits:

1. First, pandemic played vital role in deposits accumulation. Slack in economic activity and lockdowns drove-up deposits due to constraints on spending avenues (e.g., closures of restaurants, shopping malls etc.), "forced savings" drove-up deposits.[81]

2. The pandemic also drove-up the deposits via economic uncertainty channel. People remained cautious to utilize their savings to ward against uncertain income flows during the pandemic. This is evident by phenomenal rise in savings and CA deposits.

3. Policy measure to promote the use of ADC in the pandemic, including SBP's instructions to waive off banks charges on online fund transfers, promoted the cash-less transactions and helped in keeping the funds in bank deposits.

4. Strong inflow of workers' remittances also supported the rise in deposits.[82] Besides, these remittances might not have been fully utilized for consumption due to the lockdown.

5. Other investment avenues were limited in the pandemic because of which people preferred to keep their savings in the banks.

However, in case of floating rate PIBs, return on bonds moves along the changes in the interest rates. Therefore, banks increased investments in floating rate PIBs during Q3CY20 were focusing on short-term interest rate horizon while parking their liquidity for the longer-term bonds

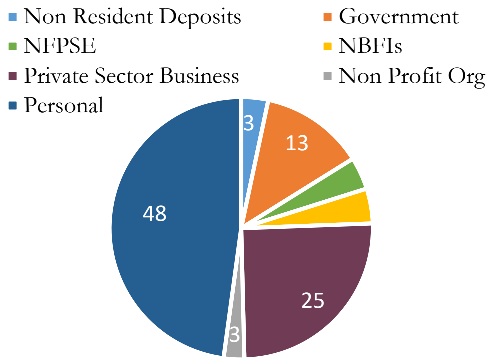
78 The government further introduced quarterly floating rate PIBs with tenors of 2 years, 3 years, 5 years and 10 years during Q4CY20.
79 Savings and CA-NR contributed by 43.08 percent and 39.47 percent, respectively.

80 Weightage Average Deposit Rates (WADR) on fresh deposits averaged at 4.78 percent during CY20—down from 7.57 percent in CY19.
81 Christine Lagarde (ECB President) explained the aspect of forced savings as one of the reasons behind rise in deposits in the euro area amid COVID-19. Her speech is available at BIS website (https://www.bis.org/review/r200615a.htm)
82 In Q2CY20, workers' remittances amounted to USD 6.1 billion against USD 5.7 billion in Q2CY19.

In the second half, deposits observed a rise of PKR 1 trillion (PKR 726 billion increase in H2CY19). The liquidity support provided to the banks by SBP in the wake of COVID-19 notably increased during this period, supporting the expansion in banks' deposits. Banks could also have attracted deposits from institutional investors as the government imposed restrictions on these investors to invest in National Savings Schemes (NSS).[83]

The category-wise analysis of deposit holders indicate that most of the rise in deposits was contributed by individuals followed by private sector businesses (**Chart 3.1.15**).

Chart 3.1.15: Category-wise percent share in total deposits flows during CY20

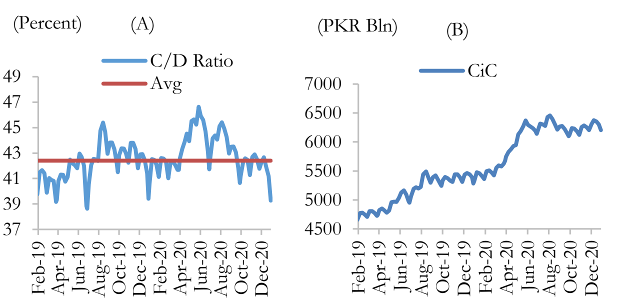


Source: SBP

Despite strong growth in deposits, currency to deposit ratio remained elevated in the economy…

Currency to deposit (**C/D**) ratio averaged at 42.98 percent in CY20—higher than the average of 41.84 percent recorded in previous year (**Chart 3.1.16A**). It was despite the fact that the banking sector received strong inflow of deposits during CY20 coupled with noticeable rise in mobile and internet transactions.[84] By looking at stock of currency in circulation (**CiC**), it can be observed that CiC sharply rose after March-2020 (**Chart 3.1.16B**).

Chart 3.1.16: Currency to deposit ratio and stock of currency in circulation



Source: SBP

One of the possible drivers of increase in CiC during this period seems to be Ehsaas Emergency Cash program launched by the government in order to mitigate the socioeconomic impacts of the outbreak.[85] Under this program, PKR 203 billion (USD 1.23 billion) were disbursed as one-time emergency cash assistance to 16.9 million families at risk of extreme poverty.[86,87] Moreover, wheat procurement by the government of PKR 190 billion during Q2CY20 may have led to higher currency in circulation on account of payments to farmers.[88]

Interconnectedness of the banking sector remained contained…

In the backdrop of ample flow of deposits and SBP refinancing schemes, banking sector interconnectedness, as exhibited in interbank borrowings, remained low during CY20. Moreover, persistent OMOs injections by SBP kept the market liquid reducing their dependence upon interbank money market for meeting the liquidity needs (**see Chapter 2**). Depending upon their business strategy and idiosyncratic dynamics, some medium banks engaged in significant

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[83] http//savings.gov.pk/ban-institutional-investment/:

[84] Volume of internet banking and mobile banking transactions increased by 52.9 percent and 112.8 percent, respectively during 9MCY20 (on YoY basis).

[85] https://www.pass.gov.pk/Detailf90ce1f7-083a-4d85-b3e8-60f75ba0d788

[86] The program was launched on April 1, 2020.

[87] Government of Pakistan (July 2020). Ehsaas Emergency Cash: A digital solution to protect the vulnerable in Pakistan during the COVID-19 crisis.

[88] Enhanced wheat procurement target of 8.25 million tons in 2020 (6.25 million tons in 2019) and rise in wheat support price to PKR 1,400 per 40 kg from PKR 1,300 per kg explain higher financing for wheat.

interbank activity, however, overall unsecured interbank borrowings of the banking sector contracted by PKR 126 billion during CY20 as compared to a rise of PKR 42 billion in CY19. Moreover, stock of banks' borrowings as percent of total assets slightly declined to 12.80 percent by end Dec-20 from 13.33 percent a year ago.

…as well as the liquidity buffers remained high

The liquidity buffers of the banking sector improved during CY20 as a result of huge investments in government securities. Liquid assets to total assets ratio of the banks enhanced to 54.76 percent in CY20 from 49.65 percent in previous year (**Table 3.1.2**).

Table 3.1.2: Liquid Assets to total assets by bank ownership

	CY17	CY18	CY19	CY20
	Percent			
Public sector banks	55.20	50.71	53.93	56.55
Local private banks	52.67	47.07	47.29	53.33
Foreign banks	89.33	84.85	85.40	88.33
Specialized banks	34.27	19.39	24.44	31.72
All banks	**53.97**	**48.69**	**49.65**	**54.76**

Source: SBP

Accordingly, liquid assets to total deposits ratio of the banking sector increased to 74.29 percent in CY20 from 68.44 percent in CY19.

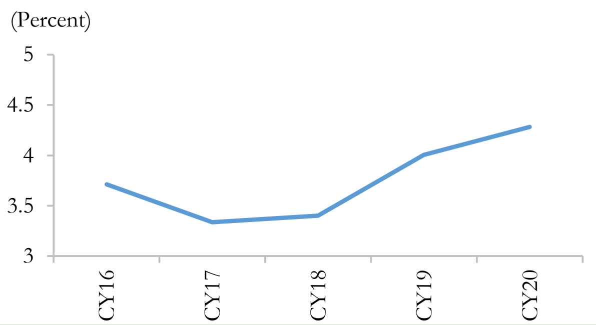
Similarly, banking sector continued to meet Basel III liquidity standards with wide margins. LCR improved to 226.0 percent (180 percent in CY19), while NFSR increased to 177.0 percent in CY20 (159.0 percent in CY19). [89]

Earnings of the banking sector accelerated during CY20…

Despite economic downturn and associated softening in advances, profit after tax (**PAT**) observed a healthy increase of 42.92 percent to PKR 244.04 billion in CY20 (14.34 percent growth in CY19). On the back of improved profitability, Return on Assets (**ROA**-after tax) and Return on Equity (**ROE**-after tax) rose to 1.05 percent (0.83 percent in CY19) and 13.78 percent (11.30 percent in CY19), respectively.

A number of factors drove-up banking sector's earnings. First, in the wake of pandemic, policy rate cut led to an immediate re-pricing of savings deposits due to Minimum Saving Rate policy.[90] This led to a decline in interest expenses by 7.28 percent during CY20 (90.05 percent rise in CY19). The impact of monetary easing also impacted the interest earnings which, however, managed to post an increase of 3.92 percent in CY20 as compared to robust rise of 60.55 percent in CY19. This growth in income was mainly attributable to sharp increase in volume of investment in relatively high-return longer-term government securities (**see Box 3.1**).[91] Resultantly, net interest income (NII) posted a healthy growth of 22.52 percent over the year, which led to increase in Net Interest Margin (**NIM**) to 4.28 percent in CY20 to 4.0 percent in CY19 (**Chart 3.1.17).**

Chart 3.1.17: Net Interest Margin



Source: SBP

[89] Banks are required to keep these ratios at least at 100 percent.
[90] According to BPRD Circular No. 07 of 2013, in the wake of change in policy rate, re-pricing of saving deposits is applicable with effect from 1st day of the subsequent month. The circular can be accessed at: https://www.sbp.org.pk/bprd/2013/C7.htm
[91] Quarterly interest earnings shot-up to PKR 516 billion in Q2CY20 then gradually declined to PKR 448 billion and PKR 417 billion, respectively, in subsequent quarters of CY20. This shows the lag impact of loans re-pricing in the wake of cut in policy rate, as the variable loans are repriced after a change in policy as per contractual frequencies, while minimum saving rate on saving deposits is immediately adjusted with effect from next month.

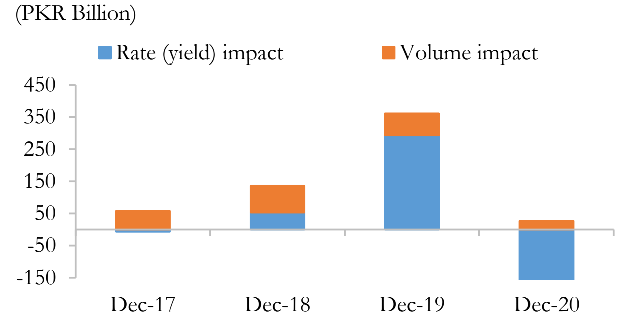
Second, non-interest income (**Non-II**) grew by 19.10 percent in CY20 as compared to marginal growth of 2.24 percent in previous year. Boost in non-interest income was entirely driven by gain on sale of government securities as the decline in interest rates generated revaluation surplus on securities, which was capitalized by banks during the year under review.[92] As interest rates moved down, banks capitalized this opportunity by selling their securities available for sale (**AFS**) to take advantage of higher bonds prices.[93] Banks' income from fee and commission, however, moderately declined by PKR 6 billion during CY20. This contraction reflects the impact of halt in economic activities and international trade during peak months of the pandemic besides SBP's policy to waive the charges of online Inter Bank Funds Transfer (**IBFT**).

Finally, banks' non-interest expenses (**Non-IE**) increased by just 5.82 percent in CY20—down from 16.10 percent growth observed in CY19. This was mainly due to the fact that the pandemic put a halt on banks' business expansion strategies and also accelerated the pace of digitization in their operations. This translated into lower branch expansion and allied expenses during CY20.[94] As a result, banks' administrative expense decelerated (5.30 percent growth in CY20 vs. 15.02 percent in CY19).

…Interest earnings were supported by volume effects of strong growth in investments, which made for huge cut in interest rates…

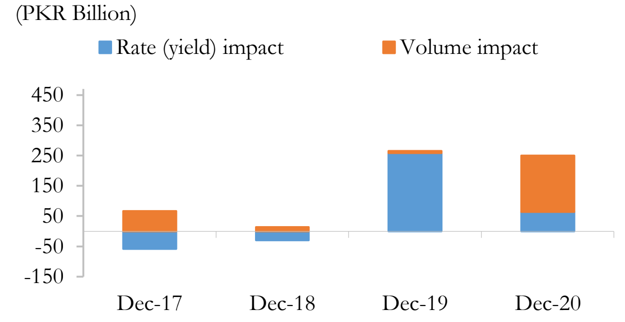
Unlike previous year[95], interest earnings from investments dominated banks total interest income during CY20. With considerable deceleration in advances and reduction in interest rates, share of income from advances declined to 41.16 percent during CY20 from 49.74 percent year earlier (**Chart 3.1.18A**).[96] On the other hand, rise in volume of investments in government securities drove the growth income as share of income from investment increased to 53.84 percent in CY20 from 42.42 percent in CY19. (**Chart 3.1.18B**). It deserves emphasis that as the banks have invested heavily in government securities over time, the income from increasing volume of risk-free securities mainly contributed towards total interest income **(See Box 3.1)**.

Chart 3.1.18 A: Earnings on advances - Rate vs. Volume Impact



Source: SBP

Chart 3.1.18 B: Earnings on investments - Rate vs. Volume Impact



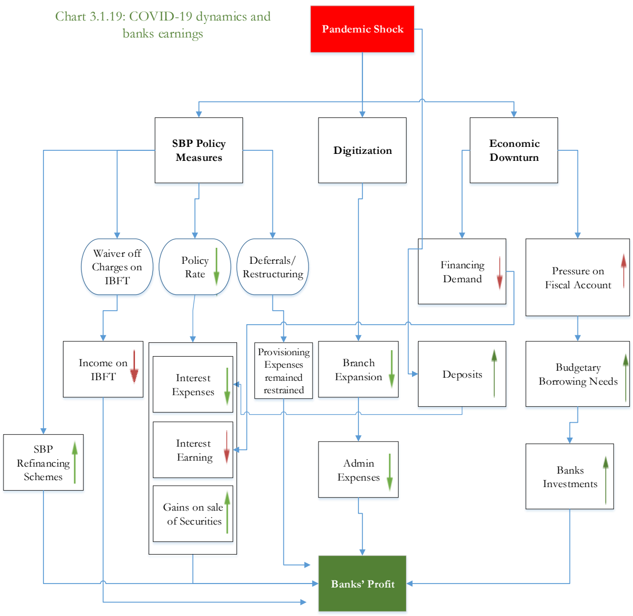
Source: SBP

[92] Non-II rose by PKR 217 billion in CY20 as compared to PKR 182 billion in CY19. Out of the additional rise in Non II of PKR 34 billion, banks' earned PKR 42 billion from sale of government securities.
[93] When interest rates decline, bonds prices go up leading to capital gains for bond holders.
[94] 230 branches were opened in CY20 as compared to 549 in CY19.
[95] In CY19, interest earnings from advances and investments amounted to PKR 931 billion and PKR 786 billion, respectively.
[96] The Charts 3.1.18A and 3.1.18B analyze the YoY changes in interest income and expense and trace these changes to two underlying factors i.e. changes in interest rate and the volume of earning assets and liabilities.

Interplay of different policy interventions and change in asset structure influenced banks' earnings …

Marked rise in banking sector earnings was supported by a robust growth in investments and different policy measures introduced to cope with the pandemic. An overall anatomy of the different pandemic related risks and policy measures and their impact on banking sector earnings is explained in the **Chart 3.1.19**.

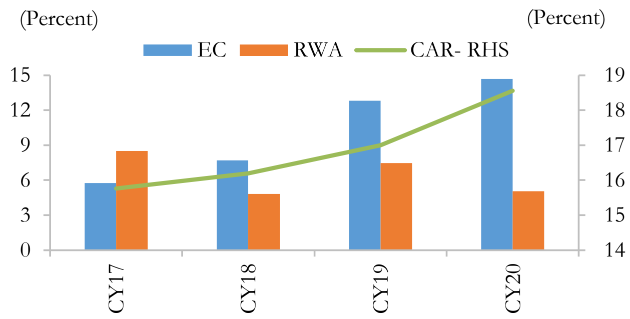
Chart 3.1.19: COVID-19 dynamics and banks earnings



Banking sector's solvency further improved during CY20…

Marked rise in earnings translated into improved eligible capital (**EC**) which strengthened by 14.67 percent (YoY) while banks' Risk Weighted Assets (**RWA**) increased at a relative lower pace of 5.06 percent. As a result, CAR increased to 18.56 percent by end Dec-20 from 17.0 percent a year earlier (**Chart 3.1.20**). The prevailing level of CAR was well above the minimum local requirement and global standard of 11.5 percent and 10.5 percent, respectively.

Chart 3.1.20: CAR level and yearly growth in eligible capital and risk weighted assets



Source: SBP

Improvement in EC of PKR 233 billion during CY20 was mainly contributed by Tier I capital which increased by PKR 148 billion reflecting 63.64 percent contribution in total EC. Further analysis reveals that the rise in Tier I capital was primarily driven by retained earnings, which contributed more than 80 percent in Tier I capital flows during the reviewed year. Remarkable increase in retained earnings largely came from healthy growth in profits, which were largely ploughed back, as the SBP imposed a suspension on dividend payouts for two quarters to conserve capital and enhance the lending and loss absorption capacity of the banks in the wake of uncertainties created by the pandemic.[97] Tier-II component of EC increased by PKR 85 billion during CY20. Around 50 percent rise in Tier II capital flows was contributed by revaluation reserves[98] followed by general provisions (38 percent contribution).

The RWA posted a muted growth of 5.06 percent in CY20 (7.46 percent rise in CY19). Slowdown in RWA was mainly driven by weak growth of Credit Risk Weighted Assets (**CRWA**) as banks mainly focused on investment in government securities while the growth in Market Risk Weighted Assets (**MRWA**) was also not that strong.

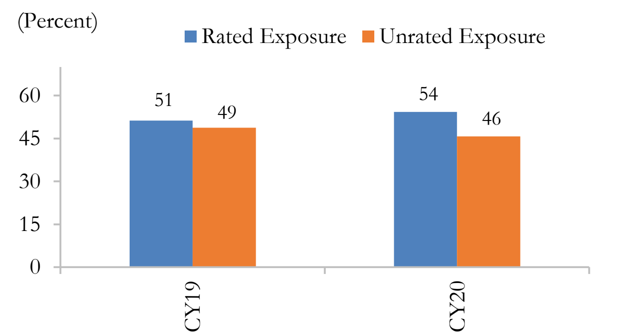
[97] https://www.sbp.org.pk/press/2020/Pr1-22-Apr-20.pdf

[98] Revaluation reserves increased by PKR 41 billion in CY20. Out of this, PKR 24 billion were contributed by unrealized gains on government securities held in Available for Sale (AFS).

MRWA grew by 8.56 percent in CY20 as compared to 33.76 percent expansion in previous year. Sharp deceleration in RWA despite huge investments in PIBs during CY20 (63.97 percent growth in PIBs stock in CY20 vs. 62.95 percent in CY19) manifests the increased investments in floating rate PIBs which carry low duration risk and lower capital charge. [99] Besides, equity and FX components of MRWA observed notable deceleration.

Similarly, expansion in CRWA remained muted during CY20 (2.62 percent growth in CY20 vs. 5.15 percent in CY19), as the banks' advances posted marginal growth. With most of this growth in advances to rated firms, the share of banks' lending exposure to rated corporate borrowers further increased (**Chart 3.1.21**). Incidentally, the banks have been following a conservative approach in their lending strategies. They focus more on large and better-rated firms as compared to unrated firms and SMEs, leading to lower capital charge over the period (**see Box 6.1 in Chapter 6**).

Chart 3.1.21: Banks' rated and unrated lending exposure



Source: SBP

On the contrary, banks' Operational Risk Weighted Assets (**ORWA**), accelerated by 16.87 percent in CY20 as compared to 10.9 percent in CY19. This was due to surge in gross income of the banks, which forms the basis of ORWA under Basic Indicator Approach of Basel rules.[100]

Pakistan's banking sector's soundness remained satisfactory in global perspective…

A cross-country analysis suggests that banks maintained higher level of CAR as compared to the average CAR of selective EMDEs while it was at par with some AEs (**Table 3.1.3**). In terms of domestic banks' asset quality, however, infection ratio was higher as compared to both groups of selective countries.

After-tax ROE of the Pakistan's banks was notably higher particularly in comparison to AEs. Also, domestic banks remained efficient in generating lower cost to income ratio as compared to EMDEs and AEs. In addition, the liquidity buffers maintained by domestic banking sector were significantly higher than the banks in EMDEs and AEs.

Table 3.1.3: Country-Wise Financial Soundness Indicators- As of September 2020

	CAR	Tier I CAR	Infection Ratio	ROA - after tax	ROE - after tax	Cost to Income Ratio	Liquid Asset Ratio	Liquid Assets to Short Term Liabilities
Pakistan	**19.5**	**15.5**	**9.9**	**1.1**	**14.8**	**47.1**	**54.6**	**110.6**
Argentina	23.7	21.8	4.5	3.6	24.6	49.4	48.9	69.3
Indonesia	23.4	21.7	2.9	1.7	11.3	46.5	20.1	29.0
Saudi Arabia	19.6	18.1	2.2	1.2	8.5	36.1	25.2	41.7
Turkey	19.4	16.1	3.9	1.5	13.7	34.1	45.6	60.6
Thailand	19.4	16.4	3.3	0.9	6.5	46.5	21.6	34.5
Malaysia	18.4	15.2	1.4	1.2	10.1	42.6	24.0	156.2
Brazil	16.7	14.3	2.4	1.3	13.0	58.6	17.5	274.5
Philippines	16.4	15.3	3.4	1.1	9.8	50.5	33.8	51.6
Peru	15.0	11.6	3.5	1.5	12.6	43.8	25.6	41.6
India	14.9	14.2	8.2	0.5	6.6	49.0	8.2	25.1
Chile	14.3	10.6	1.6	0.5	7.3	54.3	19.8	20.7
Russian Federation	12.7	10.4	9.3	2.0	17.2	96.3	22.3	119.7
China	14.2	11.6	1.9	0.8	10.3	26.9	24.4	58.2
Bangladesh	11.9	8.0	8.5	0.9	14.6	58.6	18.8	48.3
Average	**17.2**	**14.7**	**4.1**	**1.4**	**11.9**	**49.5**	**25.4**	**73.6**
Norway	23.1	20.2	0.8	0.7	7.5	43.9	12.5	25.7
Sweden	22.8	20.4	0.5	0.5	9.0	56.6	23.7	34.4
United Kingdom	21.0	17.6	1.0	0.4	6.5	63.8	23.5	50.0
Finland	20.1	17.6	1.5	0.4	5.6	62.0	20.3	39.2
Singapore	17.0	15.3	1.3	1.3	14.1	44.3	66.9	73.8
United States	16.2	14.4	1.0	0.3	2.7	61.2	16.7	157.1
Canada	15.7	13.5	0.6	0.7	14.8	67.5	15.7	75.2
Average	**19.4**	**17.0**	**1.0**	**0.6**	**8.6**	**57.1**	**25.6**	**65.1**

Source: IMF; SBP

[99] In case of increased investments in fixed rate PIBs, banks weighted average maturity rises leading to higher duration risk with respect to unfavorable changes in interest rates. However, since return on floating rate PIBs is tied to fresh weighted average yield recorded in MTBs auctions, there is a reduced risk of re-pricing.

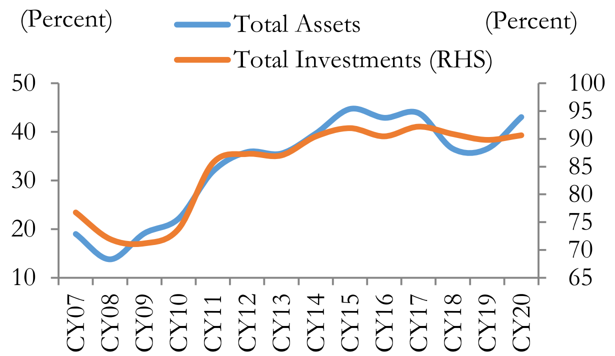
[100] As per BIA, the gross income of the bank for each of the past three financial years as per annual audited accounts is used in determining the operational risk charge. See Q91: http://www.sbp.org.pk/bprd/Basel/FAQs-Basel-IIMCR.pdf

Box 3.1: Impact of Investments in Government Securities on Banks' Earnings[101]

This analysis offers the impact of banks' investments in government securities from two perspectives. One, the growing volume of the securities portfolio and second, the returns from the investments.

Historical analysis of previous 14 years reveals that banks' exposure towards the government sector, especially in the form of investments, has steadily increased due to budgetary needs. As a result, there has been a structural shift in the balance sheet of the banking sector where the investments in government securities have become more prominent; their share in banks' asset increased from a low level of 18.99 percent in CY07 to 43.06 percent in CY20. Consequently, share of total investments in total assets has risen from 24.74 percent in CY07 to 47.50 percent in CY20.[102] The share of these securities in total investments increased to 90.65 percent in CY20 from 76.74 percent in CY07 (**Chart B3.1.1**). Besides government's fiscal needs, interest rate dynamics and lower demand for financing from the private sector also contributed to the portfolio build-up.

Chart B3.1.1: Percent share of investments in Government securities

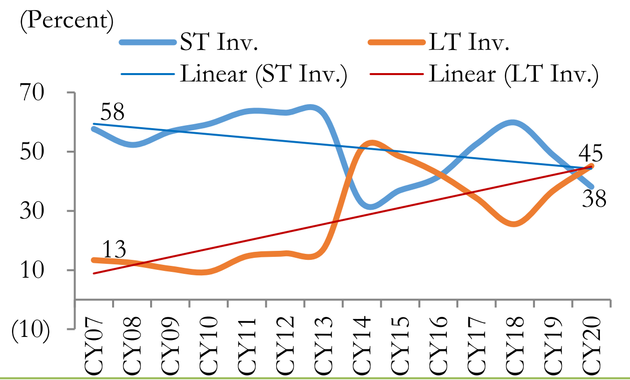


Source: SBP

As banks invested more of their funds in government securities over time, the income from these risk-free securities increasingly contributed towards total interest income. The share of interest income from government securities increased to 49.26 percent in CY20 from just 13.75 percent in CY07.[103] These statistics suggest growing importance of income from investments in government securities in banks' profitability.

Realizing the importance of returns from investments in government securities, banks attempted to have an optimal portfolio mix in which the higher income generating long-term bonds are sufficiently represented. Moreover, the Government strategy to improve the maturity profile of its debt also contributed to changes in the investment portfolio mix of the banks. Accordingly, the share of long-term (LT) investments in total government securities increased to 45.20 percent in CY20 (13.38 percent in CY07), while banks' exposure in short-term (ST) investments declined to 38.13 percent (57.68 percent in CY07) (**Chart B3.1.2**).

Chart B3.1.2: Percent share of short-term and long-term investment in total investments



Source: SBP

Besides, interest rate dynamics also affected the structure of the investment portfolio. The trend analysis of policy rate and growth of investments in government securities clearly suggest a positive

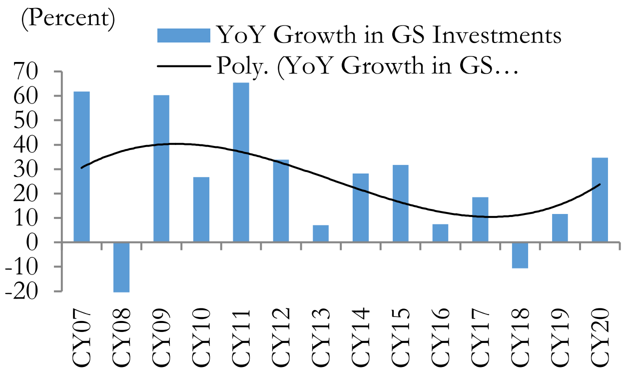
101 While this Box explores the impacts of investment in government securities on banks' earnings, please refer to Box 3.1 of FSR 2019 for comprehensive analysis on different implications of public sector exposure for banks.

102 If we include advances to the public sector, the exposure of the government sector has further risen from 20 percent in CY08 to 51 percent (in total assets) in CY20.

103 On average, interest income from risk-free securities contributed about 38 percent in total interest income in previous 14 years.

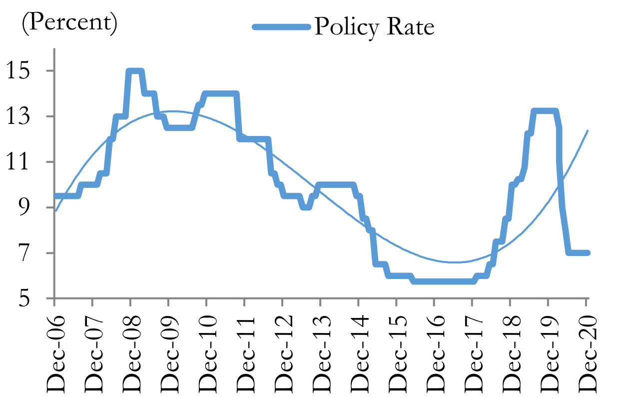
association between the two (**Chart B3.1.3 and Chart B3.1.4**). This phenomenon in fact also reflects the business cycles and underlying imbalances of Pakistan' economy, which is facing fiscal deficits and government's persistent demand for bank credit. Historically, the interest rate adjustment were made as a part of the stabilization programs to address the economic imbalances. This phase also mark the slowdown in economy and low demand for bank credit from the private sector. As the interest rates rise, while the aggregate demand—particularly the credit demand by the private sector—softens, it becomes more lucrative for the banks to invest in risk free securities. Accordingly, banks' portfolio of government securities accumulated over the years.

Chart B3.1.3: YoY growth in banks' holding of Government Securities



Source: SBP

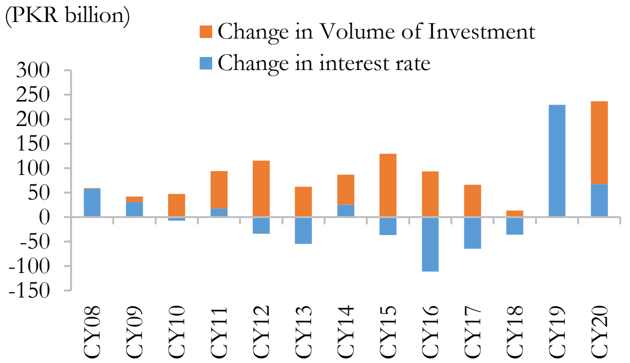
Chart B3.1.4: Policy rate



Source: SBP

As far as the interest income on investments in government securities is concerned, besides interest rates, the growing volume of investments has been a key driver (**Chart B3.1. 5**). In majority of the years since CY08, it is the volume factor, which contributed more to the income than the interest rates. This was also evident in CY20 in which despite drastic cut in policy rate, the income from investments increased. However, in CY08 and CY19, the returns were mainly driven by change in interest rates due to aggressive monetary tightening during these years.

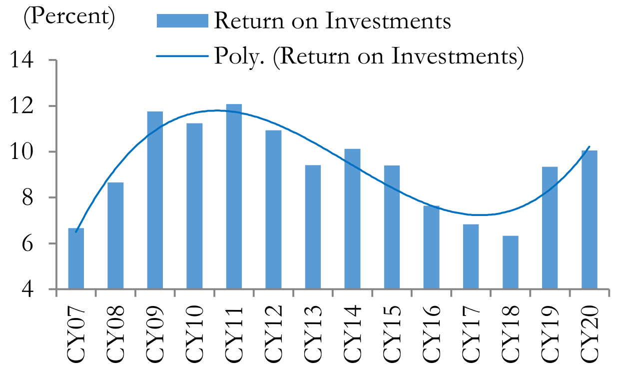
Chart B3.1.5: Change in Interest Earned on Investments in Government Securities due to ....



Source: SBP

In addition, the maturity profile of government securities also had an impact on the returns. Particularly, in CY20, return on investments (**ROI**) in government Securities have increased despite decrease in policy rate (**Chart B3.1.6**). As highlighted in Ch**art B3.1.2** above, portfolio mix of government securities reflects increased maturity due to higher investment in longer term PIBs. As a result, this change in portfolio mix led to improved return on government securities during CY20.

Chart B3.1.6: Return on investments in Government securities



Source: SBP

Conclusion

i. This brief analysis reveals that in the previous 14 years, Government's reliance on the banking sector has steadily increased for fiscal needs. Resultantly, it has influenced the balance sheet structure of the banking sector.

ii. With increased exposure in government securities, share of interest earnings from government securities in total interest income has reached to around 50 percent in CY20.

iii. The level of interest earnings on these securities mainly depends upon the volume of investments, which is determined by the financing needs of the government, and the prevailing policy rates. In CY20, the increase in the tenor of the securities led to higher return on government securities, though the policy rates were significantly cut during the year.

iv. It is critical to note that the persistence of fiscal deficits and high demand for bank credit might have affected the risk appetite of banks and weakened their true economic role of financial intermediation. This bears far reaching repercussions for the future economic growth of the country.

v. Also, the maintained solvency backed by higher exposure in risk-free securities manifests low risk-taking and inefficient allocation of the capital.

vi. On the positive side, high concentration of assets in government securities provided necessary support to banks' earnings against business cycles particularly in downturn times.

vii. However, there is a need to strike a balance between financial stability and due risk taking, which is essential for effective financial intermediation between general savers and private sector enterprises. For this purpose, a comprehensive approach is required from all the stakeholders. Banks need to enhance their role in the provision of credit to private sector, especially to private enterprises and high-potential sectors like SMEs, Agriculture and Mortgage Finance. Given the broad based and far-reaching implications of the construction industry for the economy, SBP is pursuing different initiatives in coordination with the government to promote housing finance. On the other hand, the government needs to broaden its revenue base and look for alternate sources of funding for its fiscal needs to reduce reliance on the banking sector. Moreover, collaboration between policy makers and the market participants is essential to promote savings in the economy and develop a vibrant capital market for effective intermediation.

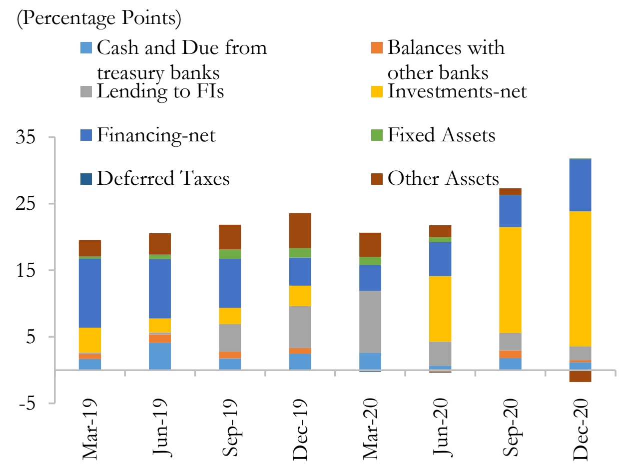
Chapter 3.2: Islamic Banking

Islamic Banking Institutions (IBIs) continued to outpace the conventional banks in growth of business. During CY20, their asset base recorded a 30 percent growth duly supported by a robust growth in deposits. As opposed to deceleration in advances of conventional-bank segment, IBIs recorded a healthy expansion in financing. The overall growth in asset base was however largely contributed by investments in new issue of Sukuk. The asset quality improved as infection ratios declined and provisioning against NPAs was prudently increased. Operating performance also improved with a significant increase in Profitability and related earning indicators. Consequently, solvency position improved further, thereby enhancing resilience of the IBIs to shocks.

Despite the Challenges of COVID 19, Islamic Banking continued to maintain its strong growth momentum during CY20…

Though COVID-19 posed various challenges for the banking industry, the Islamic Banking Institutions (**IBIs**)[104] maintained their growth momentum during CY20. Total assets grew by 30.0 percent that was well supported by growth in deposits. The major push in assets came from investments. However, unlike conventional counterparts whose loans portfolio contracted during the year[105], financing of IBIs marked a decent growth (**Chart 3.2.1 & Table 3.2.1**).

Chart 3.2.1: Contribution to Asset Growth of IBIs



Source: SBP

Table 3.2.1: Performance of Islamic Banking

	IBIs			Conventional Banks		
	CY18	CY19	CY20	CY18	CY19	CY20
PKR Billion						
Total Assets	2,658.5	3,283.7	4,269.4	17,023.6	18,707.6	20,854.4
Investments (net)	515.0	596.9	1,261.2	7,398.9	8,342.5	10,673.5
Financing (net)	1,510.8	1,622.5	1,881.0	6,444.4	6,626.4	6,410.5
Deposits	2,202.9	2,652.1	3,389.0	12,051.3	13,301.4	15,129.6
Percent Change						
Total Assets	17.0	23.5	30.0	5.9	9.9	11.5
Investments (net)	-3.6	15.9	111.3	-9.7	12.8	27.9
Financing (net)	25.2	7.4	15.9	21.5	2.8	-3.3
Deposits	16.9	20.4	27.8	8.3	10.4	13.7
Share in Total Assets (Percent)						
Investments (net)	19.4	18.2	29.5	43.5	44.6	51.2
Financing (net)	56.8	49.4	44.1	37.9	35.4	30.7
FDR/ADR (Percent)*	68.6	61.2	55.5	53.5	49.8	42.4

* FDR= Financing to Deposits and ADR=Advances to Deposits

Source: SBP

Partnership-based financing products got further traction…

The partnership-based partnership modes of financing, such as Musharaka and Diminishing Musharaka, continued to increase during CY20. The combined share of these financing types increased to 56.3 percent in CY20 from 53.8 percent in CY19, whereas the share of other modes such as Ijarah continued to fall (4.82 percent in CY20 compared to 5.75 percent in CY19) (**Table 3.2.2**). While the combined share of partnership based modes was already higher in recent year, a further increase in its share suggested that IBIs continued to target more banking products under risk sharing modes.[106]

[104] IBIs include both full-fledged Islamic Banks and Islamic banking branches of conventional banks.

[105] During CY20, advances (net) of conventional banks declined by 3.3 percent, while aggregate advances/financing of the entire banking sector posted a marginal growth of 0.5 percent.

[106] Profit and loss sharing modes include, Musharaka and Diminishing Musharaka. Other broader modes of financing are Trade based and Lease based financing.

Table 3.2.2: Islamic modes of financing

	CY18		CY19		CY20	
	Amount	Share	Amount	Share	Amount	Share
	amount in PKR billion, share in percent					
Murabaha	212.9	13.8	214.9	12.9	263.8	13.7
Salam	36.4	2.4	43.8	2.6	37.4	1.9
Istisna	140.0	9.1	158.5	9.5	160.4	8.3
Musharaka	306.0	19.9	329.3	19.8	437.8	22.7
Ijara	95.5	6.2	95.5	5.7	92.8	4.8
Car Ijara	61.2	4.0	58.3	3.5	58.0	3.0
Plant and machinery Ijara	19.6	1.3	25.0	1.5	17.1	0.9
Equipment Ijara	2.7	0.2	2.5	0.2	1.2	0.1
Others Ijara	12.1	0.8	9.6	0.6	16.5	0.9
Diminishing Musharaka	513.1	33.3	564.9	34.0	649.1	33.6
Other Islamic modes of finance	237.1	15.4	253.2	15.2	290.1	15.0
Mudarabah	-	-	-	-	-	-
Qard/Qard-e-Hasan	0.7	0.0	0.7	0.0	0.7	0.0
Total	**1,541.7**	**100.0**	**1,660.7**	**100.0**	**1,932.2**	**100.0**

Source: SBP

Amid challenging operating environment, financing growth was decent as new SBP schemes also proved enabling factor ….

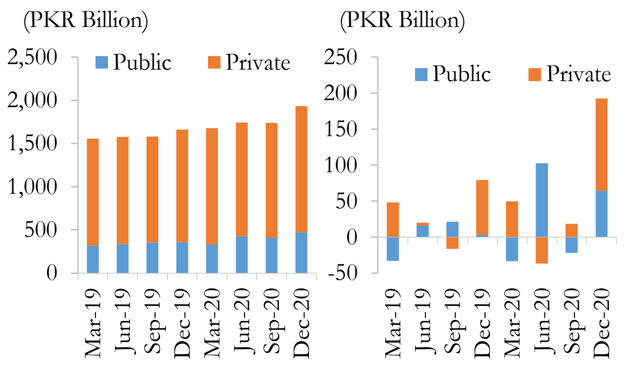
CY20 was a difficult year due to the challenges posed by the COVID-19 pandemic; however, IBI's performance in terms of financing was worth noting. In addition to the conventional modes of various SBP support measures such as Rozgar scheme (to prevent job losses in the economy), TERF (for BMR/new investment), and RFCC (for health sector), SBP (in collaboration with IBIs) also provided the Islamic versions of these schemes during CY20. These not only benefited businesses but also contributed in the revival of economic activity from the early H2CY20.

IBIs' total financing grew at 15.9 percent in CY20– more than double of the 7.4 percent growth in CY19. Moreover, the expansion in financing was encouraging and better than the conventional counterpart for the whole CY20. The flows were skewed towards public sector in first half of the year, as higher wheat financing[107] contributed to the rise in public financing during Q2CY20, and demand from private sector was subdued due to mobility restrictions and pandemic related uncertainties.

However, with the revival in business activities from June 2020 onwards, the pattern shifted towards private sector and its financing recorded healthy increase of PKR 128.1 billion during Q4CY20 **(Chart 3.2.2).** In addition to COVID-19 schemes, other refinance facilities such as Islamic Export Refinance Scheme (**IERS**) and Islamic Long Term Financing Facility (**ILTTF**) also helped IBIs to cater various needs of eligible borrowers.

Chart 3.2.2a: Trend in Outstanding Financing

Chart 3.2.2b: Trend in Flows



Source: SBP

…and growth in commodity financing and corporate segments was prominent …

IBIs financing for commodity operations and corporate segments, recorded a prominent increase during CY20. Disaggregated data revealed that the government procurement agencies enhanced financing for commodity operations from IBIs due to their relatively competitive pricing. (**Table 3.2.3**). With the PKR 121.3 billion increase, the share of commodity finance in total financing of IBIs went up to 15.0 percent in CY20 (10.1 percent in CY19).

The corporate segment also recorded healthy increase of PKR 114.8 billion in CY20 **(Table 3.2.3).**Within the corporate financing, the major rise was due to trade finance and fixed investment financing during the year.

[107] The government raised wheat procurement target to 8.25 million tons in 2020 from 6.25 million tons in 2019 and also increased support price to PKR 1,400 per 40 kg from PKR 1,300 per 40 kg, which contributed to rise in financing of the commodity.

Table 3.2.3: Segment-wise Islamic financing

	IBIs			Conv. Banks			IBIs		Conv. Banks	
	CY18	CY19	CY20	CY18	CY19	CY20	CY19	CY20	CY19	CY20
	PKR Billion						Flow PKR Billion			
Corporate Sector:	1144.8	1243.0	1357.8	4532.9	4736.4	4724.8	98.2	114.8	203.5	-11.6
Fixed Investment	541.2	586.6	636.3	1999.7	2106.0	2286.4	45.4	49.7	106.4	180.3
Working Capital	497.4	521.1	533.5	1533.0	1612.5	1428.7	23.7	12.3	79.5	-183.8
Trade Finance	106.2	135.3	188.1	1000.2	1017.9	1009.8	29.1	52.8	17.7	-8.1
SMEs:	57.2	57.5	57.6	439.0	414.2	394.5	0.4	0.0	-24.8	-19.7
Fixed Investment	23.1	25.8	27.5	94.7	79.4	77.0	2.7	1.7	-15.3	-2.4
Working Capital	31.5	28.7	26.6	299.4	295.7	281.0	-2.8	-2.2	-3.7	-14.7
Trade Finance	2.5	3.0	3.5	44.8	39.1	36.5	0.5	0.5	-5.8	-2.6
Agriculture	5.0	7.0	6.1	316.6	335.3	330.1	2.0	-0.9	18.8	-5.2
Consumer Finance	155.5	165.2	190.1	368.5	398.4	436.2	9.6	24.9	29.9	37.8
Commodity Financing	161.5	167.6	288.9	702.4	631.5	544.4	6.1	121.3	-70.9	-87.0
Staff Loans	14.6	19.0	23.1	111.9	131.6	140.4	4.3	4.1	19.7	8.8
Others	3.0	1.4	8.6	1.4	3.2	-4.5	-1.6	7.3	1.8	-7.7
Total	**1541.7**	**1660.7**	**1932.2**	**6472.7**	**6650.6**	**6566.0**	**119.0**	**271.5**	**178.0**	**-84.6**

Source: SBP

While the SBP refinance schemes such as IERS (to textile amid recovery in exports in H2CY20[108]) contributed to the rise in trade financing, the major increase in fixed investment financing could be traced in construction sector due to government package for this sector in CY20.[109] Supply side push to construction related financing also appeared, as in the mid of the year, SBP introduced mandatory targets for banks to achieve (by end December 2021) at least 5 percent of their domestic private credit to housing and construction of buildings.

Among other segments, the share of SMEs financing remained low and in fact further contracted during the year to 3.0 percent in CY20 from 3.5 percent last year. In this regard, SBP's pandemic-related support measures helped in preserving the credit flow to different sectors. In the absence of these policies, the significant stress and uncertainties created by the pandemic could have led to considerable decline in financing, especially to small and medium sized borrowers. A significant number of SMEs borrower availed financing under SBP's schemes[110].

The consumer finance segment of IBIs witnessed a healthy growth of 15.1 percent during CY20 (**Table 3.2.3**). Within consumer financing, auto financing was the major contributor with 56.7 percent share in overall growth in banking sector's auto finance. The increase could be attributed to several factors such as sharp fall in borrowing costs (amid significant reduction in Policy rate), the introduction of new car models during CY20 and revival in car sales in H2CY20, as the economy revived. In addition, SBP's regulatory polices e.g. temporary increase in Debt Burden Ratio from 50 percent to 60 percent along with reduction in SBP policy rate augmented the financing to households.[111]

Financing to agriculture fell by PKR 0.9 billion in CY20 (PKR 2.0 billion increase in CY19). Apart from the impact of cash flows constraints due to pandemic, other factors including disruptions e.g. scarcity of labor due to lockdown effect at the time of harvesting major crops like wheat and locust attacks also suppressed financing to the Agriculture.[112] Due to cash flows constraints, some of the borrowers delayed their loans repayments which led the IBIs to limit lending to segments such as Agriculture; its share in outstanding financing marginally fell to 0.3 percent in CY20 from 0.4 percent in CY19.[113]

108 Textile exports (USD terms) rose 5.1 percent YoY in H2CY20 compared to decline of 16.2 percent in H1CY20. In quantum terms, items such as hosiery and Yarn (other than cotton yarn) recorded double digit growth in H2CY20 compared to double digit decline in H1CY20, indicating recovery in exports of various textile's products. (Data source: PBS)

109 The government introduced a construction sector package in July 2020 to contain the economic impact of COVID-19. The package includes tax concessions for builders and developers on investment in Naya Pakistan housing schemes.

110 Share of approved applications was 61.5 percent for SMEs in the risk-sharing scheme (SBP Rozgar scheme). See SBP policies: https://www.sbp.org.pk/covid/index.html

111 BPRD Circular Letter No. 14 of 2020 dated March 26, 2020 available at: https://www.sbp.org.pk/bprd/2020/CL14.htm

112 Though farmers in Punjab did not report a major impact of the COVID lockdown on the wheat harvest, survey respondents (conducted by the Asian Development Bank (ADB) in lower Sindh in particular cited labor shortages and COVID disruption as a factor that delayed their wheat harvest and marketing efforts. (For details, see Chapter 2 of SBP's First Quarterly Report on the State of The Economy for FY21).

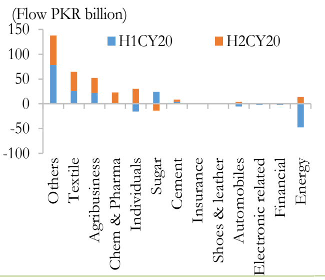
113 According to a recent survey by Pakistan Bureau of Statistics 12 percent of the households in the respondents delayed their loan repayment (of already taken) during the pandemic. Source: https://www.pbs.gov.pk/sites/default/files//other/covid/key_findings_presentation_covid_survey.pdf

The sector-wise flow of financing remained diversified…

Sector-wise flow suggested that the Islamic financing remained well diversified during CY20, though textile and Agribusinesses were prominent during CY20 **(Chart 3.2.3)**. With the revival of economic activity in H2CY20, a visible recovery in exports of several textile items was observed which contributed to the sector's financing needs. In the case of chemical and pharma sector, the increase was due to one of the pharma firms, which acquired 100 percent stake of a chemical manufacturer's business during CY20, leading to increase in the borrowing of the sector.

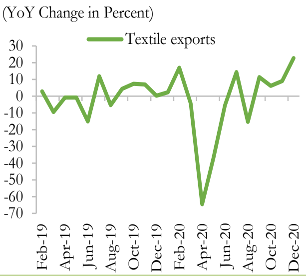
However, sectors such as automobile retired some of its financing during CY20. The recovery in the sales of cars in H2CY20 improved the liquidity position of the leading borrowers in the automobile sector, leading to decrease in financing during CY20.[114] It is important to highlight that the increase of PKR 21.7 billion in auto financing (by IBIs) played an important role in reviving car sales during CY20.

Chart 3.2.3a: Sector wise Change in Financing



Source: SBP

Chart 3.2.3b: V-shape Recovery in Textile



Source: PBS

Despite the COVID-19 pandemic, asset quality improved …

Despite a significant increase in financing, the asset quality of IBIs improved during CY20. The improvement was reflected on gross as well as net basis. Gross Non Performing Financing (**NPFs**) fell by PKR 8.5 billion to PKR 62.1 billion in CY20 compared to an increase of PKR 33.6 billion during CY19. Sector wise analysis shows that the fall in overall NPFs came from the decline in NPFs of real estate, textile and auto sectors.

Since gross financing posted strong growth, the infection ratio i.e. NPFs to Financing also fell to 3.22 percent in CY20, from 4.26 percent in CY19. Thus, as opposed to marginal deterioration in infection ratio for conventional counterparts (from 9.58 percent in CY19 to 10.81 percent in CY20), the asset quality of IBIs actually improved during CY20. However, disaggregated analysis shows that after rising to 5.0 percent in Mar-20, the infection ratio gradually came down to 3.22 percent by end of CY20 (**Chart 3.2.4**). This also suggests that the part of the improvement in NPFs was due to temporary regulatory measures of SBP (to dampen the impact of COVID-19) such as payment holiday on principal and rationalization of regulatory requirements on restructuring of financing.

Chart 3.2.4a: Asset quality indicators (IBIs)

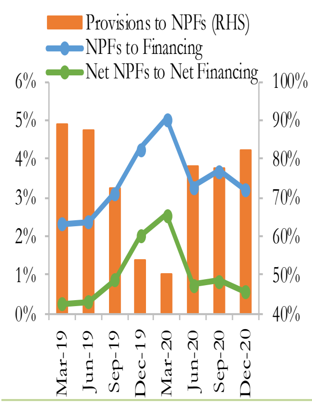
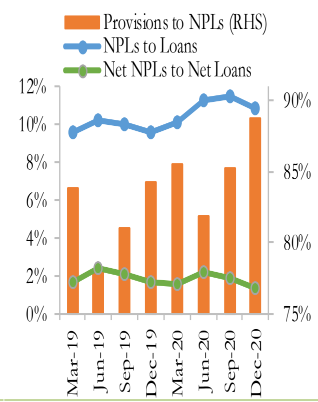


Chart 3.2.4b: Conventional banks



Source: SBP

Accordingly, IBIs also made increased provisioning from Q2 onwards totaling at PKR 13.0 billion in CY20 (PKR 7.3 billion in CY19) (**Chart 3.2.5**). The major increase in provisioning was of specific nature.[115] The provisioning coverage substantially improved to 82.37 percent

[114] Last year automobiles financing needs remained elevated due to lower sales and associated cash flow challenges. Sales of local assembled car fell by 25.2 percent in CY19.

[115] Banks are also targeting the implementation of IFRS-9 from January 01, 2021, which (among others) requires recognition of impairment charge based on "expected credit losses" (ECL) approach on assets rather than "incurred credit losses" approach. This also contributed to higher provisioning during CY20.

in CY20, resultantly, the Net NPFs to Net financing ratio fell to only 0.58 percent in CY20 from 2.01 percent in CY19; reflecting muted credit risk on net basis.

Chart 3.2.5a: Profile of NPFs of IBIs

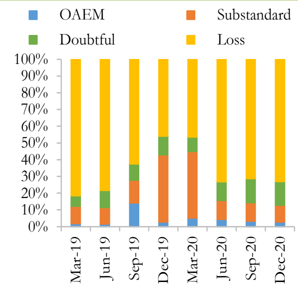
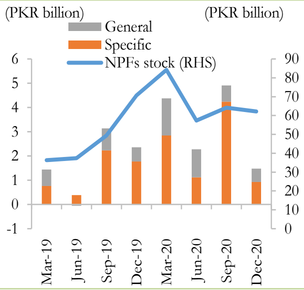


Chart 3.2.5b: Flows of Provisioing



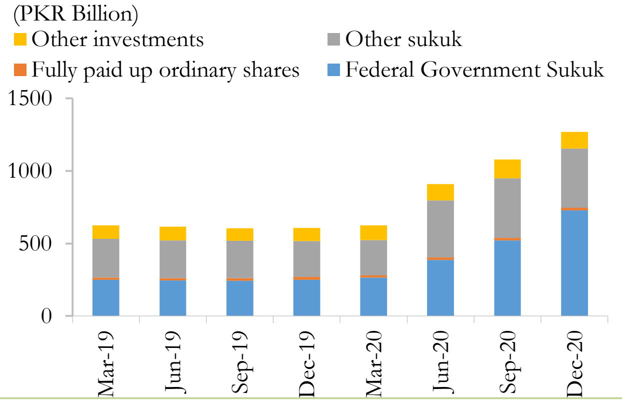
Source: SBP

Coupled with Fresh Ijarah Sukuk, another Issuance of energy Sukuk contributed in rise in investments…

IBIs' investments surged by 111.3 percent (or increase of PKR 664.3 billion) in CY20, compared to a 15.9 percent rise in CY19 (or increase of PKR 81.9 billion). The rise mainly comprised Federal government Ijarah Sukuk as well as Pakistan Energy Sukuk II (PES-II) **(Chart 3.2.6)**. A major part of the Ijarah Sukuk issuance was Variable Rate Rental (VRR) of 5 year tenor. The first auction of Sukuk during CY20 was held after a hiatus of almost 3 years; last time PKR 71.0 billion of 3 year Fixed Rental Rate (**FRR**) Sukuk were issued by the Federal Government on June 23, 2017. Within the year under review, H2CY20 witnessed higher increase in Federal Government Sukuk as the government aimed at better resource mobilization from Sukuk in federal budget of FY21.

Other Sukuk category mainly rose with the issuance of Pakistan Energy Sukuk-II (**PES-II**) of PKR 200 billion by Power Holding (Pvt.) Ltd. in H1CY20. IBIs financed a major part of this issue. This was the second consecutive year, when the government entity issued the energy Sukuk to inject liquidity in the energy supply chain. Furthermore, this was the first ever issuance of secured instrument through book building in Pakistan Stock Exchange's history as the Government of Pakistan aimed to ensure transparency and competitive bidding.[116]

Chart 3.2.6: Breakdown of IBIs' investments



Source: SBP

…better Shariah-compliant avenues improved liquidity management in IBIs….

Since IBIs were able to place their liquidity in Shariah-compliant investment and financing avenues during CY20, the combined increase in cash, placements in other financial institutions, and financing to other financial institutions was lower at PKR 118.6 billion in CY20 compared to PKR 256.1 billion last year, reflecting better liquidity management during CY20.

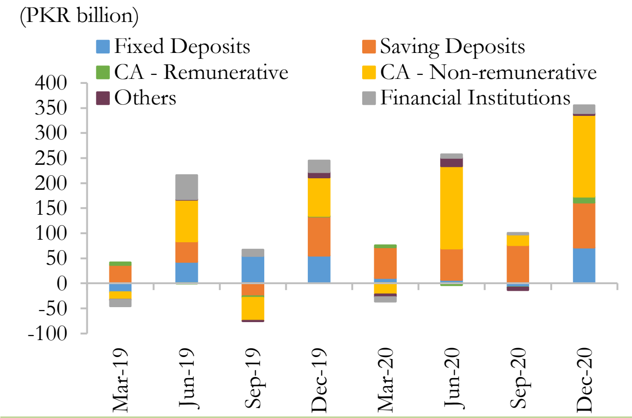
Deposits provided the necessary funding support for assets' growth…

IBIs' deposits rose by 27.8 percent during CY20—5-year high growth since CY15. The growth was also well above the 13.7 percent achieved by the conventional banks during CY20. Resultantly, IBIs' share in total banking deposits increased to 18.3 percent in CY20 from 16.6 percent in CY19.The rise in deposits mainly emanated from current-non remunerative deposits as well as saving and fixed deposits. Data suggested that IBIs' growth strategy was focused on mobilizing the low cost funding[117] **(Chart 3.2.7)**.

[116] Source: PSX press release dated May 19, 2020 available at: https://www.psx.com.pk/psx/files/?file=147951-1.pdf

[117] The combined share of non-remunerative deposits rose to 34.5 percent in CY20 form 31.7 percent in CY19.

Chart 3.2.7: Quarterly Flows of IBIs' Deposits



Source: SBP

Several factors such as COVID-19 related business closures and limited spending avenues during lockdowns, precautionary motives among economic agents, SBP's measures to encourage digital payments (such as waiving fee on digital transfers), government social spending to provide relief to low income households, and bar on institutional investments in NSS instruments contributed in deposit growth (**For details, see Chapter 3.1**).

Moreover, the expansion in branch network of IBIs from 3,226 branches at the end of CY19 to 3,456 branches as of Dec-20 also helped in deposit mobilization during CY20. As a result, the share of IBIs branch network in total bank branches also inched up to 22.7 percent in CY20 (21.6 percent in CY19).

Despite better deposits mobilization, higher borrowing was necessary to fund the assets growth during CY20…

The higher deposit mobilization though provided the main funding support, some increase in borrowing also occurred during CY20 to support both funding requirements and liquidity management. Since the combined increase in investment (net) and financing (net) in CY20 was higher at PKR 922.8 billion[118] than the corresponding increase of PKR 736.9 billion in deposits, borrowing from other financial institutions increased by PKR 176.8 billion (36.3 billion increase in CY19) to fund asset growth. Resultantly, the proportion of assets financed from borrowing rose to 8.2 percent in Dec-20 from 5.3 percent in Dec-19. However, this share was still lower than conventional banks whose 13.7 percent of the asset base was financed through borrowing in Dec-20 (14.7 percent in Dec-19).

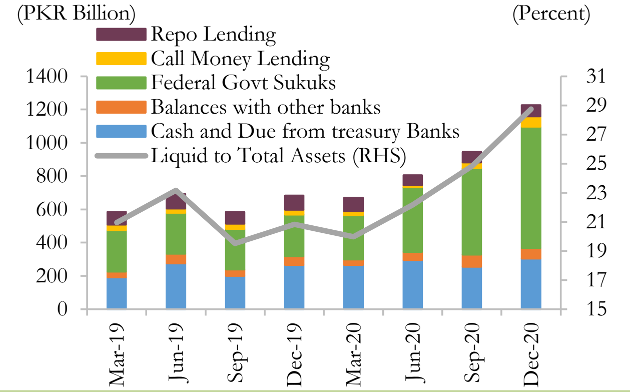
IBIs' share of liquid assets improved significantly during CY20, however, it was still lower than historical average

Though CY20 was a very challenging year, it provided opportunities to IBIs to deploy funds in Shariah-compliant investment instruments (government (Ijarah Sukuk) and energy Sukuk) in CY20. The liquid assets to total assets ratio improved to 28.7 percent in CY20 from 20.8 percent in CY19. However, the IBIs continue to face the limited availability of high-quality liquid assets (e.g. risk-free instruments) to manage the liquidity. That is why; the liquid asset ratio of IBIs was still below the recent historical average of 31.1 percent (from CY08 to CY20) and 60.1 percent ratio of conventional banks in CY20. Nonetheless, the IBIs witnessed a marked improvement in the stock of the liquid assets in CY20 and the share of these assets in balance sheet footing marked a significant improvement, reflecting that the IBIs are now relatively better positioned to cater the funding and liquidity needs of their operations **(Chart 3.2.8)**.[119]

118 Investment (net) and financing (net) rose by PKR 193.6 billion in CY19 when compared to CY18.

119 The increased share of liquid assets in short term Shariah-compliant instruments also reduced the share of 'cash' and 'balances with other banks' in total liquid assets to 30.0 percent in CY20 from, as 46.5 percent in CY19.

Chart 3.2.8: Composition of Liquid Assets of IBIs



Source: SBP

Importantly, IBIs' stock of liquid assets remained well above the Statutory Liquidity Requirement (**SLR**) of 14 percent.[120]

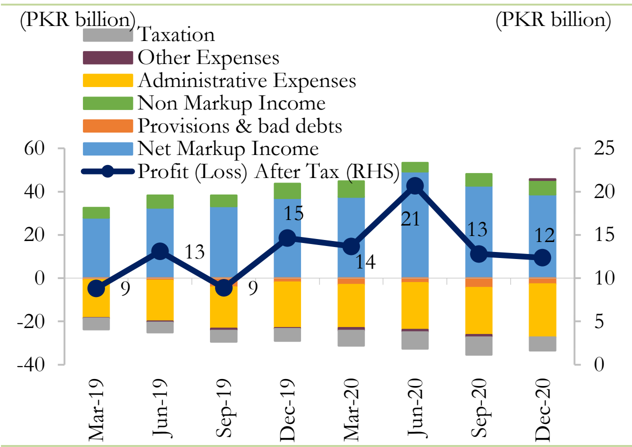
Profitability increased albeit at lower pace due to decline in profit rate…

IBIs' bottom line increased by 31.1 percent during the year under review, as they posted profit after tax of PKR 59.5 billion in CY20, compared to PKR 45.4 billion in CY19. Related profitability indicators of after-tax ROA and ROE improved to 1.62 percent and 24.51 percent, respectively, in CY20 from 1.54 percent and 23.68 percent, respectively, in CY19. Net Markup margin (**NMM**) also marginally improved to 5.39 percent in Dec-20 from 5.21 percent at the end CY19.

The major push to profitability came from Net Markup/Profit Income, which grew by 28.5 percent during CY20 and contributed 87.7 percent of the gross income. Non-markup income on the other hand grew marginally[121], as the fee, commission & brokerage income posted slower growth and income from dealing in FX fell during the year. Accordingly, the share of non-markup income in gross income contracted to 12.3 percent.

Net profit income of PKR 168.3 billion for CY20 was higher than last year, however, the growth therein decelerated to 28.5 percent in CY20 compared to 57.4 percent growth in last year. The major drag came from the sharp fall in profit rate following the reduction in benchmark rates (such as KIBOR following the reduction in SBP policy rate), which decelerated the profits on earning assets, especially in the last two quarters of CY20 (**Chart 3.2.9**).[122] Though the volume of deposit – the main funding source– grew by 27.8 percent in CY20, the sharp fall in profit rate and shift in the deposit mix towards non-remunerative deposits led to lower funding costs, supporting the net profit income.

Chart 3.2.9: Composition of Quarterly Profit After Tax



Source: SBP

Rate effect suppressed Markup income as well expense…

The contribution from change in volume was positive on profits/markup on earning assets as well as expenses/costs of funds during CY20. However, the change in profit rates have contracted both profit/markup income on assets and funding costs, and offset most of the positive impact of change in volume on earning assets and

120 The IBIs were required to maintain the liquid assets (excluding statutory Cash Reserve maintained under section 36(1) of the SBP Act, 1956) at 14 percent of their total demand and time deposits with tenor of less than one year in Pakistan. The same SLR requirement was 19 percent for the conventional banks.

121 During CY20, non-markup income increased by only PKR 1.8 billion to PKR 23.7 billion – whereas non-markup income was 21.9 billion in CY19, reflecting an increase of PKR 5.7 billion over CY18.

122 Markup expense rose 120.5 percent YoY to PKR 149.0 billion in CY19.

fund base; on overall basis the net profit/markup income increased by 28.5 percent during the year CY20 **(Chart 3.2.10 & Chart 3.2.11)**.

Chart 3.2.10a: Change in Markup Earned on Financing due to ....

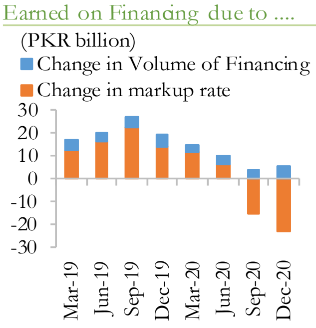
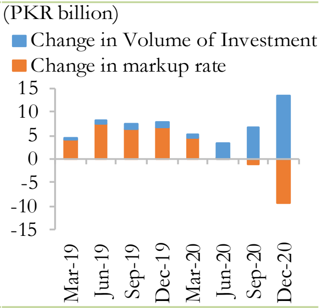


Chart 3.2.10b: Change in Markup Earned on Investment due to ....



*This chart splits the YoY change (PKR terms) in Markup earning in rate volume impact
Source: SBP

Chart 3.2.11a: Change in Markup Expense on Deposits due to ....

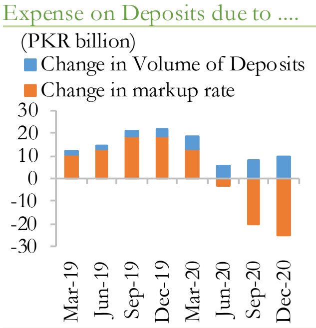
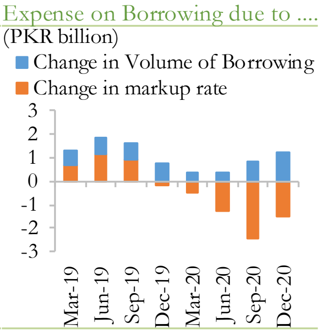


Chart 3.2.11b: Change in Markup Expense on Borrowing due to ....



*This chart splits the YoY change (PKR terms) in Markup expenses in rate volume impact
Source: SBP

Improvement in profitability and contained risk exposures improved the solvency of IBIs

The CAR improved further to 16.64 percent in CY20 from 15.36 percent in CY19 **(Chart 3.2.12)**. The improvement resulted from growth in both components of eligible capital i.e. Tier I and Tier II capital. However, in line with its high share in capital, the Tier I contributed major part of the increase (around 68 percent) in eligible capital, as the higher profits, which were ploughed back supported the solvency position during CY20. Besides 23.0 percent growth in eligible capital, a relatively slower expansion in risk weighted assets (by 13.6 percent) led to improvement in CAR.

Among the risk weighted categories, the increase was skewed towards **CRWA**, which was in line with growth in financing during CY20.

Disaggregated analysis shows that in addition to fast rise in CRWA during Q4CY20, ORWA also recorded noticeable increase, resulting in a notable increase in total RWA (**Chart 3.2.13**). The ORWA increased due to higher gross income, which forms the base for calculating ORWA under basic indicator approach of the Basel capital accord.[123] Resultantly, the CAR level fell to 16.6 percent in Dec-20 from the 19.5 percent in Sep-20, however, it was still above the local regulatory requirement of 11.5 percent as well as international standard of 10.5 percent.

Chart 3.2.12a: IBIs' CAR improved

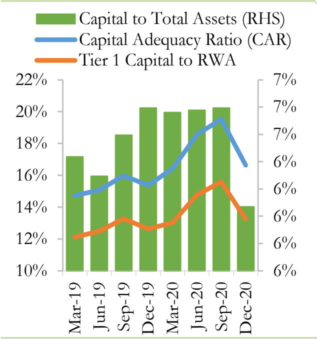
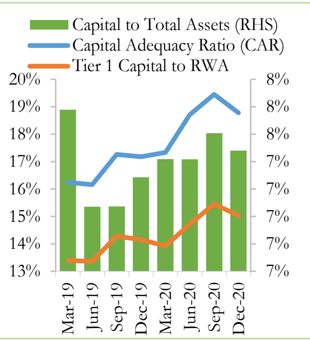


Chart 3.2.12b: CAR of Conventional

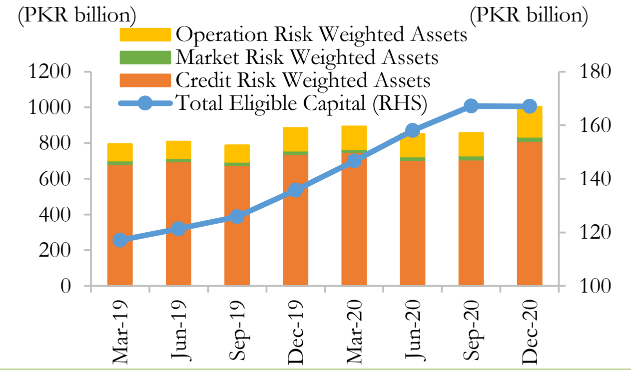


Source: SBP

It is important to note that the central bank's measures during the pandemic also played a key role in enhancing CAR level during CY20. SBP instructed banks to suspend dividend declaration for a period of two quarters to conserve capital and enhance the lending and loss absorption capacity.[124] The policy measures facilitated banks in restructuring the distressed financing and deferring principal payments on the request of borrowers also helped in containing NPLs as well as the need for provisioning that could have significant impact on the earnings and capital positions of banks.

[123] The gross income is an important input in calculating capital charge under the various approaches used in Basel-III instructions.
[124] The banks/DFIs that had approved dividend declaration for Quarter ended March 2020 by 22nd April 2020 were advised to suspend dividend distribution for June and September quarters of 2020. All other banks were advised to suspend dividend distribution for March and June 2020 quarters. Source: SBP press release available at: https://www.sbp.org.pk/press/2020/Pr1-22-Apr-20.pdf

Chart 3.2.13: Trend in Eligible Capital and Risk Weighted Assets of IBs (Full Fledged)



Source: SBP

Shariah compliance framework was further strengthened

In addition to usual risks for the banking industry, Shariah non-compliance risk (**SNCR**) is one of the important risks in business models of IBIs. In order to further strengthen Shariah compliance framework and harmonize the Shariah practices in Islamic banking industry, Accounting and Auditing Organization for Islamic Financial Institutions (**AAOIFI**) Shariah Standards are being adopted in gradual manner, after a detailed review, keeping in view the local environment and needs of Islamic Banking Industry in Pakistan.

During the period under review, the AAOIFI Shariah Standards No. 19 (Loan (Qard)), No. 23 (Agency and the Act of an Uncommissioned Agent (Fodooli)), and No. 28 (Banking Services in Islamic Banks) have been adopted from the start of CY20[125] while Standard No. 49 - Unilateral and Bilateral Promise (SS – 49)[126] was adopted from September 2020 onwards. The adoption of standards help in harmonizing Shariah practices and products in line with international Shariah standards and it may be characterized as a control to mitigate Shariah non-compliance risk in IBIs.

[125] IBD Circular No. 01 of 2020 dated January 3, 2020

[126] IBD Circular No. 03 of 2020 dated September 02, 2020

Chapter 4: Resilience of the Banking Sector under Adverse Conditions

The assessment of banking sector's resilience is based on an assumed stress scenario, which is a hypothetical, coherent risk setting designed specifically to assess the ability of the sector to withstand exceptionally large but plausible potential deteriorations in macroeconomic conditions. A counter-factual backward looking exercise without regulatory relief measures, which were introduced after the onset of COVID-19, reveals that the credit risk and the resilience of the banking sector would have been adversely affected in the absence of these measures. Looking forward, under the baseline scenario (benefiting from the earlier relief measures), the sector's current level of solvency remains stable and well above the domestic regulatory benchmark. Under a more severe hypothetical scenario as well, the banking sector is able to withstand a downturn induced by adverse macroeconomic conditions associated with a more virulent and longer lasting pandemic along with the effects of climate change. In terms of size, the large banks with a potential to cause systemic disruptions carry higher capital buffers and are expected to sustain the impact of the shock over a three-year horizon. Similarly, the medium sized banks are also expected to remain resilient to the shocks. However, the resilience of small sized banks starts waning and their CAR falls below the domestic regulatory benchmark by the third year of projections. Under the baseline, credit is projected to grow at a steady rate of 9.79 percent over the projection period. However, under the stress scenario, credit growth decelerates and turns negative towards the end of horizon. Therefore, the banking sector, with adequate capital buffers amid the on-going regulatory measures to contain the economic fallout from COVID-19, is expected to continue catering to the credit needs of the economy in the baseline. That said, the exact severity, duration and path of the COVID-19 pandemic globally and domestically remain highly uncertain. As a result, the stress-test results are also subject to a significant uncertainty. Nonetheless, the SBP continues to closely watch the unfolding situation and remains ready to take whatever actions necessary to safeguard financial stability. The banks are also expected to closely monitor the situation, especially the repayment capacity of borrowers, and may engage with the relevant stakeholders for any adjustments to maintain institutional solvency and facilitate smooth functioning of the sector.

4.1 Background

The feedback effects between the real and financial sectors have been most prominently highlighted by the GFC of 2007-08 where vulnerabilities in one sector spilled over to the other. Ever since, supervisors have enhanced the level of oversight of the financial sector and taken measures to strengthen the resilience of the sector to withstand shocks transmitting from the rest of the economy. At the same time, stress-testing frameworks are also being extensively used by supervisory authorities as well as multilateral agencies to assess the resilience of the banking sector to certain hypothetical adverse yet plausible event(s). The results of these stress tests depict the *projected* behavior of macro-financial variables and health of the banking sector under the different *assumed* scenarios.

The SBP has been conducting this exercise internally on a quarterly basis since 2005. For external stakeholders, detailed stress-testing results and assessments are being published annually in the FSRs since 2007-08 and quarterly results are shared via Quarterly Compendium: Statistics of Banking System. The stress-testing framework at SBP is being continuously revamped and strengthened. The SBP has also issued comprehensive guideline to banks, DFIs and MFBs to assess their resilience on regular basis.[127]

4.2 Scenario Design Overview

The current year's stress testing exercise is designed around two scenarios i.e. *baseline* and *stress*

[127] Recent review and enhancement in the stress testing guidelines has been made in September 2020. The latest framework is available at https://www.sbp.org.pk/fsd/2020/C1.htm

scenarios. Both the scenarios differ in terms of risk assumptions and severity.

The *baseline scenario* traces the path of macro-financial variables under the current dynamics of the domestic macro economy while taking into account the potential effects of the third wave of COVID-19 pandemic and resumption of IMF-EFF program.[128] On the other hand, the *stress scenario* assumes deep recession on the back of a protracted and wider spread of the pandemic and extreme climate change related events.[129]

Against the backdrop of economic challenges, the impact of both scenarios for the domestic macro-financial stability is assessed over the projected horizon of next three years: Q1CY21 to Q4CY23.[130] Projections under both the scenarios incorporate the impact of SBP measures taken to promote the private sector credit and preserve banks' capital position.[131] An exercise based on counterfactual scenarios; assuming absence of SBP relief measures, has also been carried out to analyze the approximate impact of these measures on the banking sector (see **Box 4.1)**.

The implications of changes in macroeconomic indicators such as output, inflation, interest rate, current account balance and exchange rate on the health of the banking sector have been captured via non-performing loans, profitability and solvency. Specifically, the economic downturn can negatively influence the income levels of firms and households, affecting their debt servicing capacity and amplifying the credit risk for banks. This in turn would put adverse pressures on the profitability of banks and negatively affect their solvency.

The feedback effects of weakened solvency of banks could spill over to the real economy, as the banks would be reluctant to provide credit for even potentially profitable investment opportunities, thus amplifying the economic downturn.

In both the scenarios, a similar methodology has been employed to evaluate the resilience of the banking sector, which capture these inter-linkages among the various sectors of the macro economy. Given the interaction between real and financial sectors, a suite of vector autoregressive (**VAR**) and Bayesian VAR models has been developed.[132,133]

In terms of risk coverage, the resilience of the banking sector has been assessed against credit, market (interest rate and exchange rate) and operational risks. In addition to the aggregate assessment, cross-sectional heterogeneity has also been captured for the different segments of the banking industry in terms of size, i.e., small, medium and large banks.

4.3 Baseline Scenario

The baseline scenario, *Scenario 0* (***S0***), is built around the two broad themes namely the ongoing third and potential future waves of COVID-19 and implications of resumption of IMF stabilization program for the domestic economy.

128 For detailed discussion of key issues relevant to global and domestic economic environment, please see Chapter 01.

129 Usually three types of shocks are considered in stress testing based on the length of the shock events i.e. V-shaped, L-shaped and U-shaped. The shapes are envisaged in terms of recovery. V-shaped assumes quick recovery; L-shape assumes protracted downturn while U-shaped assumes recovery towards the end of projection horizon. Under this terminology, stressed scenario are assumed to be L-shaped. However, owing to high level of severity in the stressed scenario, recovery takes a longer time compared with the baseline scenario.

130 Owing to unprecedented level of uncertainty, projections' horizon has been reduced from five to three years.

131 Please see Chapter 01 for brief details on government and SBP relief measures.

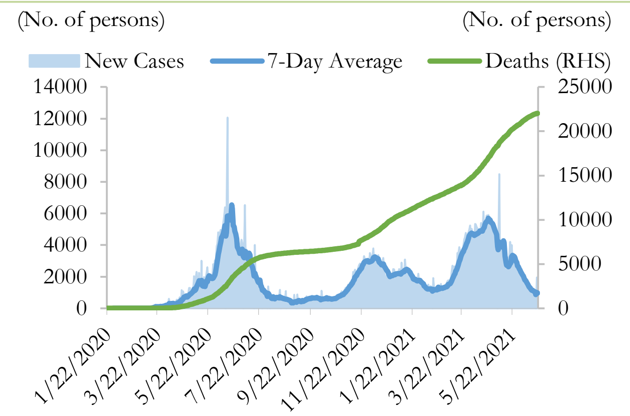
132 For details, please see *'Box 4.1 Technical Details'* of Chapter 4: Resilience of the Banking Sector, Financial Stability Review 2016, SBP. In all we use 12 variants of VAR models, and an equal number of Bayesian VAR models. The models contain different combinations of macro-financial variables. Moreover, for calculation of relevant financial soundness indicators, we have assumed a dynamic balance sheet.

133 One fifth of the authorities use VARs for macro stress testing. Bank for International Settlements (**BIS**) 2017. *Supervisory and Bank Stress Testing: A Range of Practices*, (December).

COVID-19 pandemic continues to be the key factor in determination of near-term economic outcomes…

Evidenced by a persistent rise in COVID-19 testing positivity rate, fatalities and pressure on health facilities, the country is facing a third wave of the pandemic. At the time of writing this report, the third wave have surpassed the second wave in terms of severity and, is proving to be at least as lethal as the first wave experienced last year (**Chart 4.1**). As discussed in Chapter 01, spread and duration of the pandemic and corresponding containment and relief measures are the crucial factors for determination of near-term economic outcomes.

Chart 4.1: Domestic Spread of COVID-19

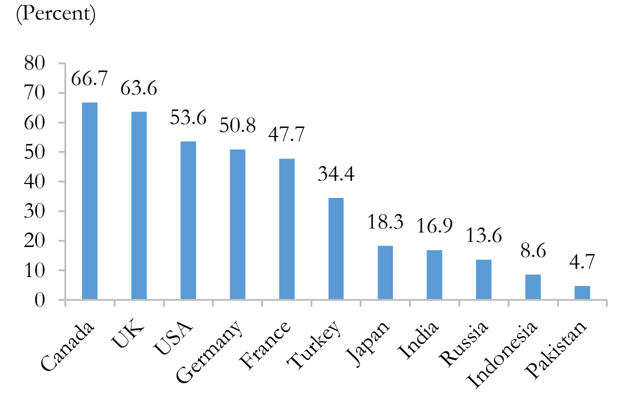


Source: Data Hub

Baseline assumes relatively contained and short-lived third wave of COVID-19…

Baseline Scenario has been prepared under two key assumptions regarding the third wave. First, assuming that similar to first and second waves, the third wave of COVID-19 will be relatively contained and short-lived -- likely to be over by the end of H1CY21. Domestic COVID-19 vaccination program; although moving on a relatively slow pace (**Chart 4.2**), but is gaining traction and is likely to dampen the severity of third wave as well as future potential waves (**Chart 4.1**).

Chart 4.2: Share of Population Vaccinated as of June 21, 2021



Source: ourworldindata.org

…requiring less stringent containment measures…

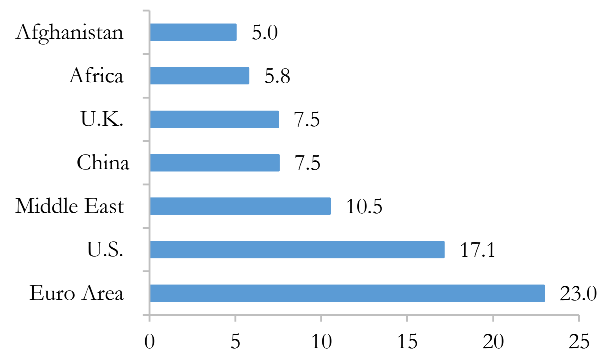
Assumptions regarding the pandemic containment measures are critical in terms of determination of economic impact. Given that a relatively contained outbreak has been assumed, Baseline Scenario rules out strict and countrywide lockdown. However, the pandemic related SOPs including smart lockdowns, targeted travel restrictions, closure of educational institutions, ban on dining at restaurants and mass gatherings may be needed to check the pandemic outbreak. While partial relaxation in these restrictions is assumed in Q2CY21, complete elimination of these restrictions may not materialize until vaccination of a sufficient fraction of population is achieved.

… affecting services sector but agriculture and export-driven manufacturing may support economic recovery…

On supply side, the pandemic containment measures are likely to negatively affect services sector growth---as observed during FY20. However, agriculture and manufacturing are likely to support recovery. In agriculture sector, the prospects of major crops, particularly wheat, are encouraging and likely to meet the respective targets[134] amid improved government support and favorable water availability[135]. Manufacturing sector is assumed to continue recovery on account of low interest rate environment, capacity enhancement, recovery in exports (Chapter 01) and rise in demand due to uptick in construction activities.

Chart 4.3: Key Export Destinations of Pakistan

(5 year Average of Percentage Share in Total Exports)



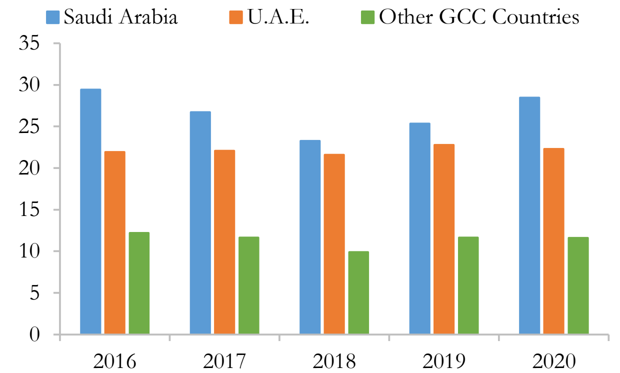
Source: SBP

Accommodating monetary policy is expected to support domestic demand while global recovery may boost exports and remittances…

On demand side, low interest rate environment is likely to encourage inter-temporal substitution and support consumption and investment demand. Encouragingly, the key export destinations also happen to be the key remittances corridors for the country (compare **Chart 4.3 & 4.4**). A stronger vaccine-driven recovery in these economies is likely to support the domestic economic recovery and consumption while giving impetus to the remittances – already at record high levels. Oil prices have also recovered to the pre-COVID-19 levels and are expected to remain stable.[136] The oil prices' rebound is expected to support remittances from Middle East countries; partially offsetting the negative impact of COVID-19 on domestic consumption demand (**Chart 4.5**).

Chart 4.4: Remittances from Middle East Countries

(Percent Share in Total Remittances)



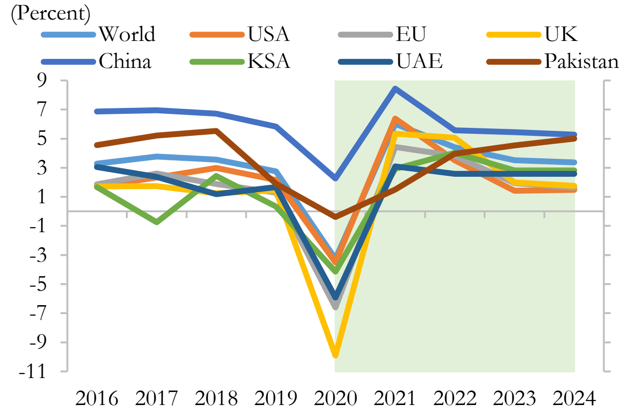
Source: SBP

Resumption of IMF stabilization program is likely to boost confidence

The IMF EFF, which was suspended last year due to COVID-19 pandemic, has resumed; it is expected to further the economic stabilization and offer a sense of stability. However, the resumption of delayed revenue enhancement measures; especially in energy sector, may lead to temporary inflationary pressures.

Chart 4.5: GDP Growth Rates in Key Economies

(Percent)



Source: IMF WEO Database April 2021

134 Press release, meeting of Federal Committee on Agriculture (FCA) held on 8th April, 2021 at NARC.
Monthly Economic Update & Outlook, March 2021, Government of Pakistan, Finance Division, Economic Advisor's Wing.

135 The State of Pakistan's Economy - Second Quarterly Report 2020- 2021

136 Based on oil futures market, average oil prices are expected to remain in the range of USD 55-59/barrel till CY22. IMF WEO April 2021.

GDP growth is likely to show a gradual recovery while inflation is expected to exhibit a moderating trend

Amid this backdrop, *S0* assumes that the GDP growth will tread an upward trajectory, registering 3.96 percent, 4.50 percent and 4.60 percent in FY21, FY22 and FY23, respectively (**Chart 4.7**)[137]. On account of a gradual recovery in the output growth, an absence of major domestic supply shocks, stable oil prices and cautious fiscal policy stance under stabilization program, improvement in domestic aggregate supply conditions is assumed to dominate increase in aggregate demand resulting from recovery of GDP growth. As a result, inflation is likely to show a gradual deceleration. Average annual inflation rates for FY21 and FY22 are assumed to be 9.04 percent and 8.80 percent, respectively (**Chart 4.8**). Going further, inflation is likely to converge to its medium-term target of 6 percent during FY23. In line with the foregoing narrative, i.e. a recovery in domestic demand and a moderation in inflation by the end of projection period, an appropriate monetary policy stance is assumed.

4.4 Stress Scenario

The domestic economy remains prone to a number of domestic and international risks. On domestic front, the leading risks include a prolonged wave of COVID-19, adverse climate-related events, risks to IMF program, FATF downgrading and political uncertainty. On global front, the risks could emanate from oil price volatility, global trade tensions, geopolitical tensions, slowdown in trading partner economies and global divergent financial conditions. The hypothetical stress scenario, *Scenario 1 (S1),* has, however, been weaved mainly around two key risk elements: (i) a more contagious spread and elongated duration of COVID-19 across the globe and in Pakistan; and (ii) adverse impacts of climate change.

Stress scenario assumes prolonged and widespread outbreak of COVID-19…

At the time of writing this report, the third wave of COVID-19 in Pakistan has surpassed the peak of second wave, in terms of seven-day average of new confirmed cases (**Chart 4.1**). The recent statistics show that the wave is yet to touch its peak (at the time of writing this report) and the number of new confirmed cases are rising.

As shown in **Chart 4.2**, only 4.71 percent of total population has been vaccinated for COVID-19 as of June 21, 2021. Indian experience with second wave of COVID-19 suggests that the countries lagging behind in inoculation are at a high risk of the pandemic. Domestically, the risk of a sharp outbreak may further exacerbate owing to the population density, lack of awareness about sanitization, inter-regional mobility of work force, and the limitations of the health infrastructure to handle a mass-level outbreak. Besides, risk of its reemergence in the coming years continues to exist owing to the occurrence of new and more infectious strains of the virus.

…strict containment measures may be essential to contain the pandemic.

Owing to a prolonged and widespread pandemic outbreak amid a limited vaccine availability, stress scenario assumes that strict and countrywide lockdowns may be inevitable. The lockdown, as the experience shows, is expected to severely affect the services and manufacturing sectors while badly affecting consumer and business confidence.

[137] Incidentally, IMF (2021) forecasts Pakistan GDP growth for FY21 to 1.5 percent. *World Economic Outlook*, April. World Bank (2021) also forecasts Pakistan GDP growth of 1.3 percent for FY21 with significant amount of uncertainty. *Pakistan Development Update,* April.

Climate change related catastrophes pose a serious risk to macro financial stability

Global warming and the consequent climate change have been postulated to lead to extreme weather conditions causing droughts, floods, famine and cyclones. Historically, Pakistan has been a victim of a series of climate-related catastrophes such as, severe droughts (1998-2002), massive flooding (2010), extreme heat waves, heavy rainfalls, land sliding and glacier melting. These episodes have resulted in significant supply shocks and output losses.

Even though Pakistan does not rank as a top emitter of greenhouse gases,[138] it has remained 8th most affected country by climate changes in terms of human and output losses. According to Long-Term Climate Risk Index (**CRI**) 2021, during last two decades (2000-2019), Pakistan experienced 173 climate related extreme events and has been included in the category of countries that are recurrently affected by the catastrophes and continues to be ranked among the most affected both in the long-term index and in the index for each respective year.

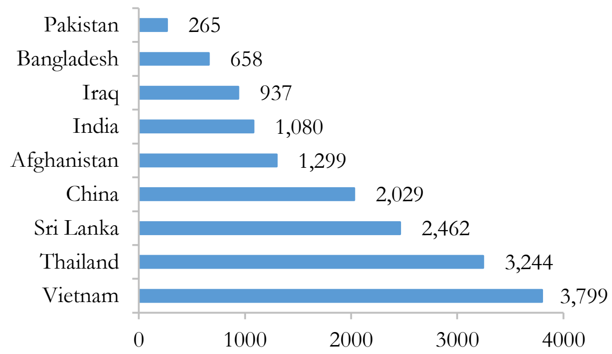
On production side, around one-fifth of the domestic production is directly contributed by agriculture sector. Further, the sector's interlinkages with industry and services sectors[139] make it an important driver of the overall economic growth. However, agriculture sector is highly prone to global warming and natural calamities such as periodic floods, droughts, extreme temperatures and untimely heavy rainfalls.[140] Apart from climate change, agriculture sector is also facing issues like declining crop yield, water shortage and rapid urbanization.

Water availability continues to be an important risk factor

Low and declining water availability continues to be a source of concern for domestic economic prospects (**Chart 4.6**). Unfortunately, the domestic water storage capacity can preserve only 10 percent of the annual river flows - equivalent of 30 days of country's water demand and the rest of the flows fall into the sea.[141].

Chart 4.6: Water Availability per Capita

(Renewable Internal Fresh water Resources -Cubic Meters)



Source: World Bank Data, 2017

The assumed water shortages could also weigh on the hydropower generation, which constituted around 30.9 percent of total electricity generation during FY20.[142] The resulting stressed energy conditions may depress the industrial production causing a drop in domestic output.

Macroeconomic indicators may deteriorate in response to negative shocks

Against this backdrop, *S1* assumes a simultaneous occurrence of prolonged and widespread outbreak

138 Climate Watch Historical GHG Emissions. 2021. Washington, DC: World Resources Institute. Available online at: https://www.climatewatchdata.org/ghg-emissions.

139 A unit increase in the production of manufacturing, transport and accommodation sector requires 0.30, 0.08 and 0.12 units of inputs from agriculture sector, respectively.
Zeshan, M., & Nasir, M. (2019). Pakistan Input-Output Table 2010-11 (No. 2019: 162). Pakistan Institute of Development Economics.

140 A World Bank assessment suggests that the crops in Pakistan are highly sensitive to changes in temperature and water availability. Available at: https://climateknowledgeportal.worldbank.org/country/pakistan/impacts-agriculture

141 For details, please refer to: http://www.wapda.gov.pk/index.php/newsmedia/news-views/417-world-water-day-on-march-22-wapda-plans-to-add-10-maf-water-storage-by-2030#:~:text=Pakistan%20can%20store%20only%2010,40%20to%2050%20years%20ago.

142 Pakistan Economic Survey 2019-20. http://www.finance.gov.pk/survey/chapter_20/14_Energy.pdf

of COVID-19 and major crop failures due to climate related extreme events at home. Domestic economic activity and employment are expected to be substantially restrained by necessitating stringent SOPs to contain the spread of the contagion.

With a drop in agriculture output, *S1* further assumes that agriculture exports, which constituted around 16.3 percent of total exports, on five years period average, would fall substantially. Non-agriculture exports, which use agriculture produce as raw materials, would also be hampered. The crop failures may also necessitate import of essential items. Amid weak prospects for exports, an increased import bill could translate into pressures on the current account balance and the exchange rate. Such a situation is likely to result in elevated price levels, mainly via pass-through to consumer goods.

Accordingly, the stress scenario assumes GDP to register a growth of 3.96 percent in FY21 with a slide to *negative* 1.50 percent during FY22.[143] The contraction is assumed to subside to *negative* 0.50 percent in FY23. (**Chart 4.7**) Moreover, under the stress scenario substantial supply chain disruptions and crop failures are likely to dominate the slack in aggregate demand; thereby leading to upward price pressures. The scenario assumes that average inflation may moderate to 9.25 percent[144] during FY21 and elevate to 13.03 percent in FY22 before slowing down to 9.50 percent by FY23 (**Chart 4.8**).

4.5 Stress Testing Results: System Level

The following paragraphs discuss the results of stress tests, which, incidentally, do not assume the winding up of pandemic related relief measures during the projection horizon. However, a special **Box 4.1** discusses the likely impacts of these SBP relief measures on asset quality and solvency of banking sector.

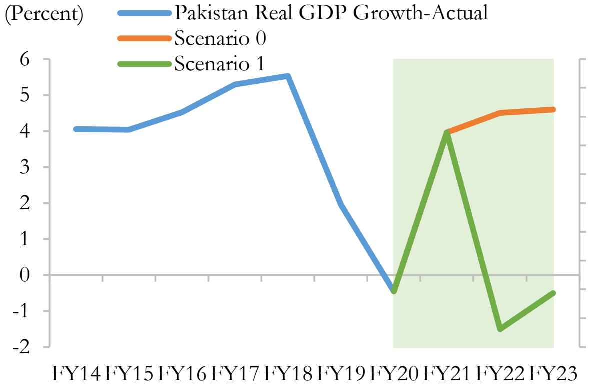
(a) Impact on Credit Riskiness

The results of the stress test exercise indicate that the GNPLR, under *S0*, is likely to remain on lower side over the three-year projection horizon, given gradual recovery in domestic demand, reconciled supply conditions, stable external sector and fiscal consolidation under IMF stabilization program (**Chart 4.9**). The lending portfolio of banking sector is projected to expand, on average, by around 9.79 percent over the projection period.

143 At its peak level in FY22, the stress scenario assumes 6.00 percent less GDP growth relative to baseline.

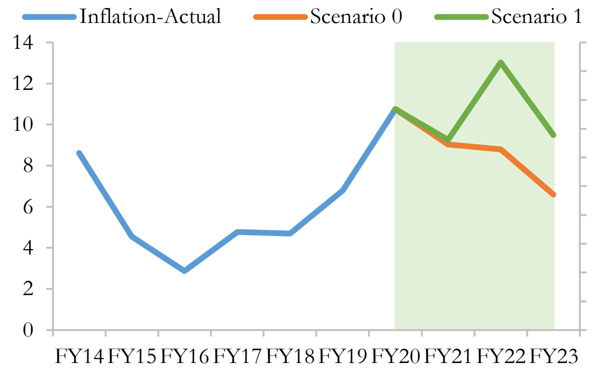
144 At peak level during FY22, the stress scenario assumes 4.23 percent higher inflation relative to baseline.

Chart 4.7: Pakistan Real GDP Growth under various Scenarios



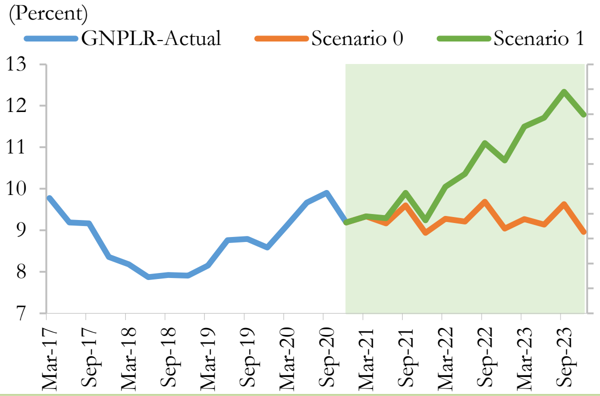
Source: SBP Calculations

Chart 4.8: Projected Inflation under various Scenarios



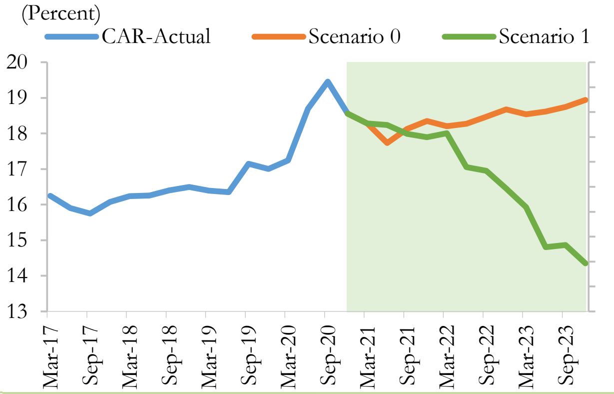
Source: SBP Calculations

Chart 4.9: Projected System-Level GNPLR under various Scenarios



Source: SBP Calculations

Chart 4.10: Projected System-Level Capital Adequacy Ratio under various Scenarios



Source: SBP Calculations

The GNPLR attains the peak of 9.69 percent and settles at 8.96 percent by the end of projection period CY23. This projection is 22 basis points (**bps**), lower than the level of 9.19 percent as of end CY20. This is mainly in line with our assessment of the domestic economy, where recovery in identified macroeconomic indicators may mute the credit risk for banking sector. The stable growth of denominator i.e. advances also explains relatively contained GNPLR.

The asset quality indicator, under hypothetical scenario, *S1*, on the other hand, follows an upward trajectory because of the assumed greater and prolonged deterioration in macroeconomic conditions, which could significantly affect the credit supply of the banking system. Unser *S1*, growth of lending portfolio is projected to slacken sharply to *negative 0.40* percent at the end of CY22 and settles at *negative 4.08* percent in CY23, while the delinquency rate peaks at 12.34 percent before settling at 11.79 percent by the end of projection horizon (**Chart 4.9**).

(b) Impact on Solvency

The impact on solvency is measured via the CAR of the banking system. As explained in the scenario design, besides credit risk, two other risks are likely to have an impact on solvency: market risk, realized via movements in interest and exchange rates, as well as operational risk. These three risks, therefore, have also been factored in while analyzing the impact of each scenario on capital as well as risk-weighted assets. Under the baseline scenario, the CAR of the banking system falls by 83 bps in Q2CY21 from the prevailing level of 18.56 percent; but recovers and settles at 18.94 percent at the end of projection horizon (**Chart 4.10**). In stress scenario, however, it declines to 14.35 percent by end-CY23, which is

459 bps lower than the comparable level of baseline CAR.

Nevertheless, under both the scenarios the banking industry maintains its CAR above the local minimum regulatory requirement of 11.5 percent and global benchmark of 10.5 percent during the entire period of projection horizon.

The resilience of the banking sector, despite substantial level of assumed turmoil in real economy, can be justified based on three facts. First, the banking sector has entered the COVID-19 crisis with sufficient capital buffers.[145] Second, this ample amount of capital buffers is further supported by a timely macro-prudential measure, viz., temporary halt on dividend distribution and the release of 100 bps capital conservation buffer etc., to ensure financial stability (see **Box 4.1**). Finally, ample liquidity via deposit flows coupled with a weaker demand for credit during contractions, and aggressive portfolio re-balancing from riskier private sector loans to risk-free treasury investments, keeps the banking sector well above the minimum regulatory CAR standards. (**See Chapter 3.1)**

4.6 Stress Testing Results – Banking Segments

In line with the system-level credit risk analysis, infection ratios of banking segments (small, medium and large sized banks)[146] have also been projected. This aspect of the banking industry is included to assess how cross-sectional heterogeneity affects the resilience of banks against various macroeconomic risks.

For GNPLR, system-level projections of non-performing loans and gross advances are distributed proportionately based on the contribution of each segment to the loan portfolio of the entire banking system as of December 2020. Similarly, capital is also distributed proportionately to compute segment level CARs.

(a) Large Banks

The large banks segment - comprising 77.97 percent of the banking system - witnesses a fall of 19 bps in GNPLR by the end of CY23 from its current level of 7.84 percent. Under stress, however, the infection ratio rises by 222 bps by the end of projection horizon. As a result, CAR rise by 39 bps and falls by 435 bps in the baseline and stress scenarios from the prevailing level of 19.19 percent over similar horizon, respectively (**Chart 4.11**). Nevertheless, the CAR remains a hefty 809 bps higher than the local benchmark in *S0* while staying 334 bps above the minimum requirement under *S1*.

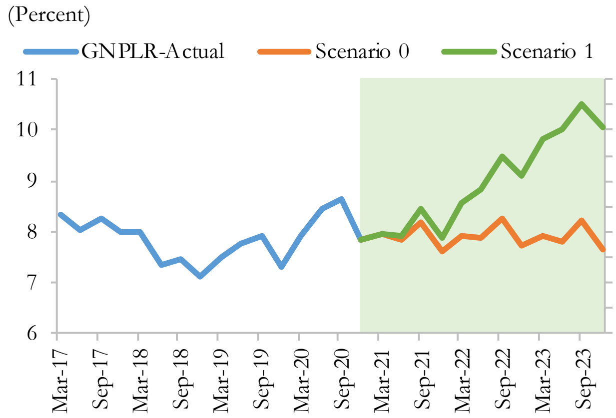
The large banks are generally well-placed to withstand stress over the simulation horizon (**Chart 4.11 (b)**). Sufficiently higher capital buffers available with larger banks are a likely factor behind this resilience. More importantly, the systemically important banks are also likely to remain well-capitalized and resilient to the shocks assumed in stress scenario.

[145] CAR at the end of CY19 (17.00 percent) was substantially higher than CAR at the end of CY07 (13.52 percent).

[146] The categorization has been done based on balance sheet footing. The banks with assets above (resp. below) 70th (resp. 30th) percentile of the entire banking sector are termed as Large (resp. Small), while those falling in between are categorized as Medium sized banks.

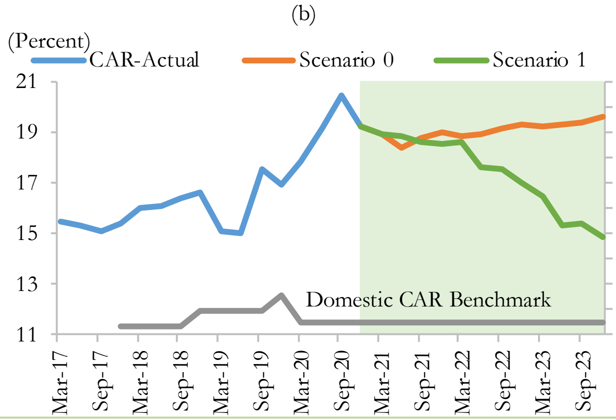
Chart 4.11: Projected GNPLR and CAR of Large Banks

(a)



Source: SBP Calculations

(b)



Source: SBP Calculations

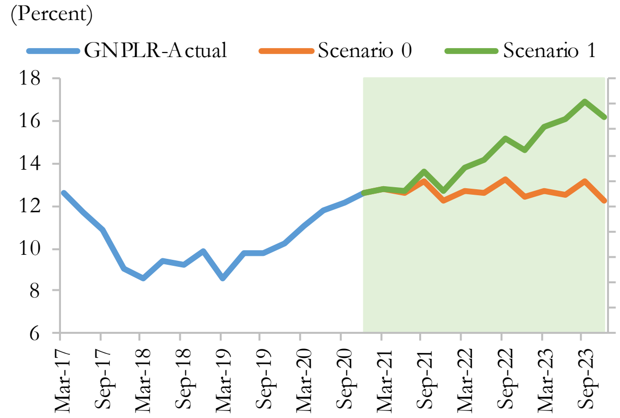
(b) Medium-sized Banks

By the end of the projection period, the GNPLR of medium-sized banks (asset share 17.85 percent) falls by 31 bps in *S0* and rises by 357 bps in *S1* from existing 12.60 percent. The CAR, correspondingly, rise by 35 bps and falls by 388 bps under the two scenarios compared with prevailing reading of 17.11 percent. Nevertheless, the medium-sized banks are also expected to remain compliant to the regulatory CAR standards, even under the stress scenario (**Chart 4.12**).

Their level of CAR remains 596 bps and 173 bps percentage points above the minimum regulatory requirement (11.5 percent) in *S0* and *S1*, respectively. That said, their relatively higher levels of delinquency ratios and lower level of pre-shock capital buffers possibly make medium banks relatively more vulnerable to shocks than large ones. Specifically, as the CAR nears the regulatory benchmark relatively faster over the projection horizon, a prolongation of stress period could weigh adversely on the resilience of this segment of banks. On a positive note, though, the medium sized banks are likely to stay resilient even under a stress that lasts for three years!

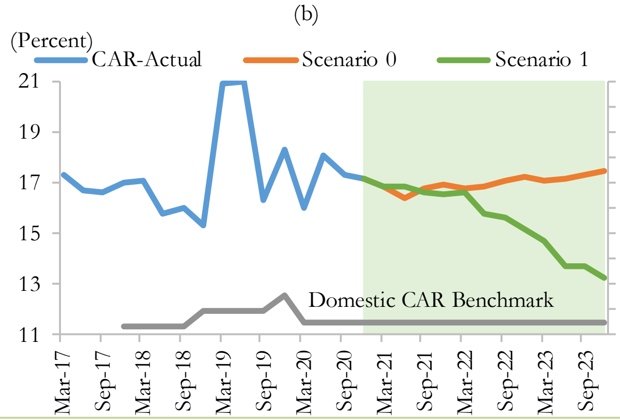
Chart 4.12: Projected GNPLR and CAR of Meduim-sized Banks

(a)



Source: SBP Calculations

(b)



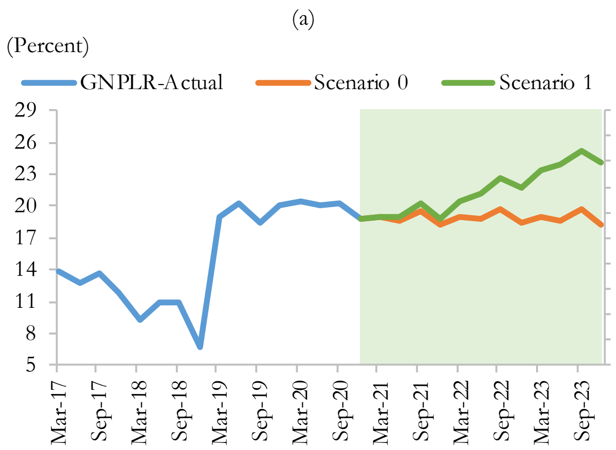
Source: SBP Calculations

(c) Small Banks

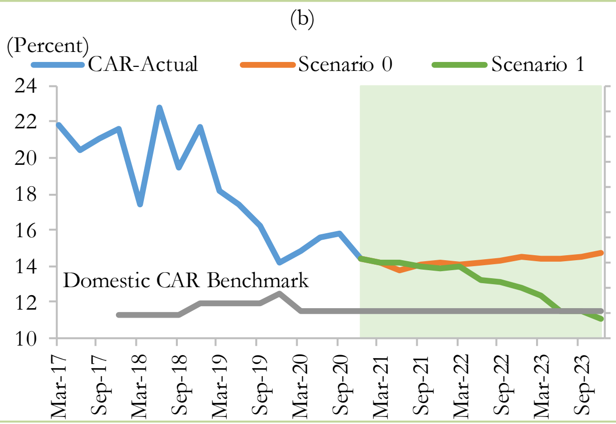
Small banks – constituting 4.18 percent of the banking system – are found to be the least resilient against both scenarios. From its existing level of 18.72 percent, the loan delinquency rate of small banks decreases by 46 bps in *S0*, whereas it rises by 530 bps under *S1*, by the end of three-year horizon (**Chart 4.13 (b)**). This is the highest level of infections in any segment of banks under stress scenario.

Given their comparatively lower lending exposure, the CAR of small banks rise by 30 bps in *S0* and falls by 326 bps under *S1* from the prevailing 14.39 percent (**Chart 4.13 (a)**).

Chart 4.13: Projected GNPLR and CAR of Small Banks



Source: SBP Calculations



Source: SBP Calculations

While maintaining resilience under the baseline, the small sized banks on aggregate basis may breach the domestic regulatory CAR standard towards the end of projection horizon under stress scenario. This is mainly due to the lowest level of pre-shock CAR among all categories. Small banks thus demonstrate the least resilience in terms of maintaining compliance with domestic minimum capital requirements.

Overall, under the baseline scenario, the solvency of the banking sector portrays an encouraging picture with the delinquency ratio mostly hovering around the current level (9.19 percent) while capital adequacy staying well above the domestic regulatory benchmark. Under the hypothetical stress scenario as well, the banking sector should be able to withstand a severe and protracted downturn induced by adverse global and domestic macroeconomic conditions, including the COVID-19 pandemic. In terms of size, the medium and large segments can withstand the stress conditions as well. Reassuringly, the large size banks, with the potential to cause systemic disruptions, carry sufficiently higher capital buffers and are thus able to sustain the impact of hypothesized shocks for three years. Also, the medium-sized banks never breach the solvency criteria during the projection horizon. The resilience of small-sized banks segment, however, starts waning towards the end of simulation period under stress – CAR breaching the minimum standard by a narrow margin. These banks however have quite contained systemic implications due to their limited market share.

That said, the exact severity, duration and path of the COVID-19 pandemic globally and domestically remains clouded in uncertainties. As a result, the stress-test results are also subject to a significant uncertainty. Consequently, the SBP continues to closely watch the evolving situation and shall remain ready to take whatever actions necessary to safeguard financial stability.

Box 4.1. SBP Relief Measures: Impact on Credit Riskiness and Solvency of the Banking Sector - A preliminary analysis

After the onset of COVID-19 in Pakistan, the SBP took several relief measures to insulate the financial sector and the economy from negative effects of the pandemic.[147] The evidence so far suggests that the interventions have not only safeguarded the profitability and solvency of the banks but have helped avoid corporate and household defaults, keeping firms and businesses afloat by providing concessionary finances to prevent unemployment, encourage capital investments etc.[148] In absence of these measures, the firms/households level defaults could have increased and, consequently, the banking sector's solvency and resilience could also have been adversely affected.

Segregating the exact impact of all the measures could be challenging; however, in this piece, an effort has been made to gauge the consequences of potential defaults for the profitability and solvency of the banking sector, particularly in absence of deferments and Restructure and Reschedule Loan (**RRLs**).[149] The analysis has been carried out using aggregate as well as firm level data on banking exposures.

A. Aggregate Credit Risk and Solvency

Under the schemes of principal repayment deferment and RRL (collectively **DRRL**), scheduled banks allowed relaxations of PKR 757.3 billion by the end of December 2020. On the other hand, the quantum of loans issued through COVID-19 related concessionary refinance schemes stood at PKR 245.6 billion at the end CY20.[150]

Considering the fact that total NPLs of banking industry stood at the level of PKR 805.8 billion at the start of COVID-19 in Pakistan (end-March 2020), the relaxations to the tune of PKR 757.3 billion in terms of DRRL have significant implications for credit risk in the medium term. First, had banking industry not been allowed the DRRLs, the asset quality would have witnessed considerable deterioration, leading to a significant rise in provisioning expenses of the banks. Second, if the third wave of COVID-19 turns out to be prolonged and widespread, requiring strict lockdowns, the potential defaults coupled with the erstwhile DRRLs might pose a formidable risk to the financial stability.

To analyze these issues, the level of GNPLR has been estimated that would have prevailed in absence of COVID-19 relief measures. More specifically, four scenarios were envisaged assuming that 25, 50, 75 and 100 percent of the amount of DRRLs could have gone into NPLs in absence of relief measures. Under these scenarios, the implied GNPLR is calculated as:

$$GNPLR = \frac{NPLs + DRRLs^{k}}{Advances - (TERF + RFCC + Rozgar)^{k}}$$

where, k represents one of the four assumed scenarios i.e. 25, 50, 75 and 100 percent of the DRRLs turning non-performing. Results show that by end-December 2020, under 100 percent and 50 percent scenarios, GNPLR would have risen to 18.07 percent and 13.57 percent, respectively. These numbers are substantially higher than the end-CY20 level of 9.19 percent. It is clear that these sharp increments would have substantially dented the profitability and capital adequacy of the banking sector in the absence of

147 For details, please see https://www.sbp.org.pk/COVID/index.html. Incidentally, the schemes for allowing deferments and rescheduling/restructuring expired on Sept 30, 2020 and March 31, 2021, respectively.
148 For details, see https://www.sbp.org.pk/covid/index.html
149 In a sense, we are estimating only a partial impact of some of the macro-prudential measures.
150 Latest information on disbursements and outstanding amounts is available at https://www.sbp.org.pk/covid/index.html

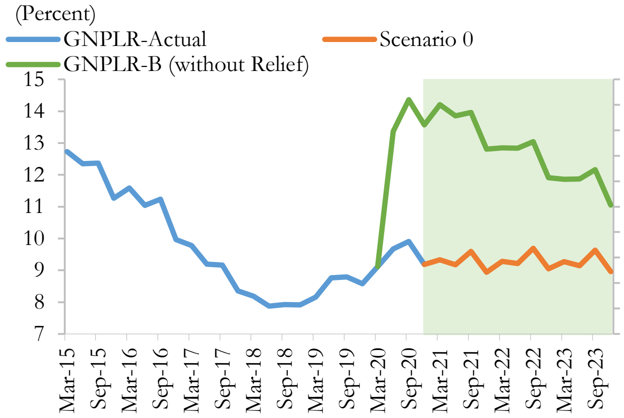
relaxation measures. The CAR estimate at these assumed levels of defaults are estimated at 14.58 percent and 16.17 percent, respectively - substantially down from the existing 18.56 percent.

Assuming a counterfactual of 50 percent defaults – a path '*without relief measures*', the near term impact under the baseline assumptions of Chapter 4, is given in **Chart B4.1.1**. For comparison, projections under baseline (*S0*) are also included, which has been estimated '*with relief measures*'.[151]

With the revised initial conditions, the projected levels of delinquency rate (resilience level) would have, thus, remained much higher (lower) over the simulation horizon than the baseline projections with relief measures. The gaps, however, narrow as the assumed economic recovery takes hold. Specifically, after the initial higher levels of infections have been expensed out, the resilience strengthens over the projection horizon as the gap between the CAR levels under two scenarios narrows to 88 bps from 239 bps (Dec-20) while that of GNPLR subsides to 209 bps from 438 bps (Dec-20) towards the end of projection period. A quicker closing of the CAR gap indicates the strength of the banking sector in terms of not only withstanding the shock but its ability to regain the resilience.

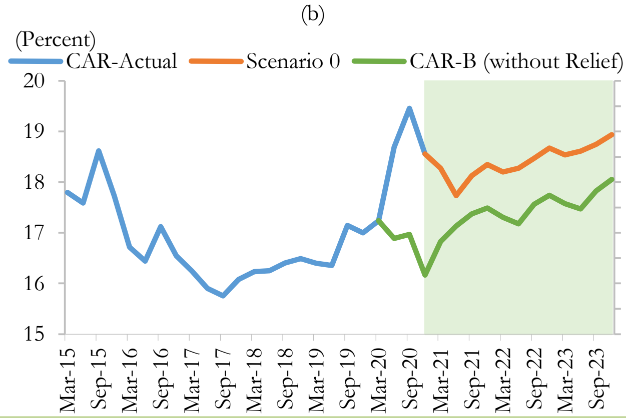
Chart B4.1.1: Projected GNPLR and CAR under Counterfactual Scenario

(a)



Source: SBP Calculations

(b)



Source: SBP Calculations

B. *Credit Risk Rating Migration – A borrower Level Analysis*

Besides the aggregate impact, a borrower level analysis has also been carried out. The analysis stresses the obligor risk rating (**ORR**) of each borrower. The ORRs reflects the ability of obligor to fulfill their credit obligations.[152]

The onset of COVID-19 and the consequent economic slowdown has affected the repayment capacity of the borrowers, it can be expected that the banks/DFIs would have re-assessed and revised the credit rating of the affected borrowers downwards. However, under the announced regulatory relief, the banks/DFIs may postpone the downgrade of the credit facilities of borrower

[151] The projections are using the same assumptions as in the baseline scenario of Chapter 4.
[152] Banks/DFIs are required to assess and assign an ORR to a borrower in corporate/commercial portfolio, which comprises the corporate and SME loans. Borrowers are rated on a scale of 1 to 12, where 1 broadly reflects AAA credit rating assigned by external credit rating agency and 10, 11, and 12 represent D or default grade (see BSD Circular No. 08 of 2007)

who has approached the bank/ DFI to either defer the principle payments or restructure/ reschedule of the facility. This counterfactual scenario, therefore, assesses the impact on the profitability and solvency of any adverse migration in the ORR in absence of relief measures. The assessment has been carried for each quarter of CY20.

Modus operandi and Assumptions

1. The model *stresses* the ORR of borrower in corporate/commercial portfolio of the banks/DFIs, mainly comprising the corporate and SMEs loans.
2. The level of stress is based on the *sectoral risk* of the borrowers i.e., *low*, *medium* and *high*. Sectoral risk ratings of different economic sectors are based on judgment developed in consultation with various banks, which particularly takes into account the idiosyncratic factors and the ability of the sector to weather the ongoing pandemic. More specifically, the ORR of each borrower is *downgraded* by *one*, *two* or *three notches*, depending upon the level of risk of the sector to which a borrower belongs. Particularly, the higher a sector is exposed to and affected by the pandemic, the higher would be the level of adverse migration of that borrower.
3. On the basis of stressed ORRs, borrowers with final post-stress ORR of 10, 11 or 12 (default ratings) have been classified in Substandard, Doubtful or Loss category, and the prevailing provisioning requirements are applied.[153]
4. Loans already classified in Substandard or Doubtful categories have, however, been treated as Loss and charged to the capital at full value without accounting for the benefit of forced sale value of the collateral.
5. The eligible capital and risk-weighted assets of the banks/ DFIs are adjusted for the impact of *additional* provisions and NPLs, and their *post-shock* CARs have been estimated.

Results

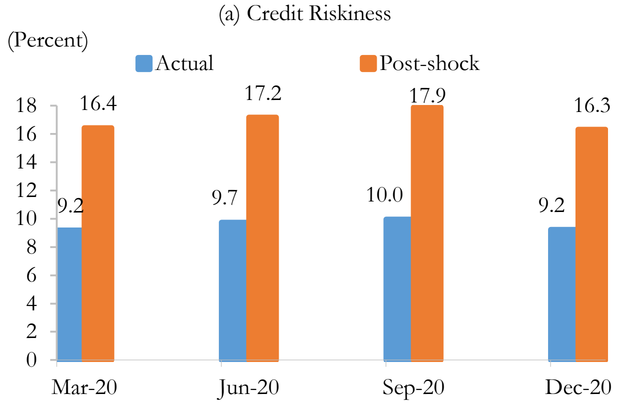
Summary results from the exercise, based on end-quarter data for each quarter of CY20 are presented in **Chart 4.15**.

The results are in line with the findings under aggregate level analysis. The infection ratio of the banking sector may have significantly increased with substantial adverse implications for the solvency. However, given significant capital buffers, the system on aggregate basis could still withstand this shock as, despite non-trivial deterioration, the CAR would have remained above the local and global minimum of 11.5 percent and 10.5 percent, respectively.

[153] Provisioning requirements for loans classified as Sub-standard, Doubtful and Loss are 25 percent, 50 percent and 100 percent, respectively.

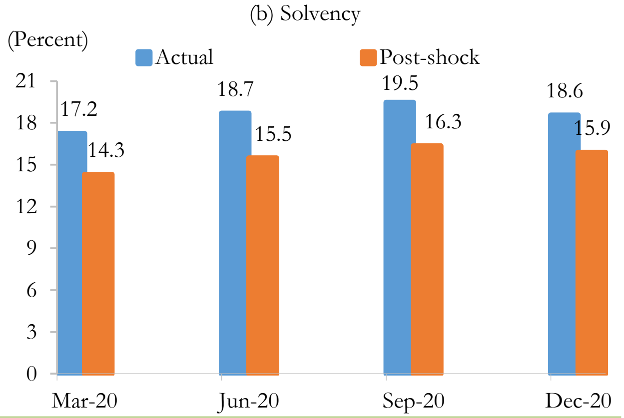
Chart B4.1.2: Impact of SBP Support Measures - Borrower Level analysis

(a) Credit Riskiness



Source: SBP Calculations

(b) Solvency



Source: SBP Calculations

The regulatory relief has thus helped the financial sector weather the pandemic related adversities by stemming the potential rise in delinquencies and the consequent infections, keeping credit risk in check, shielding sector's profitability, supporting the solvency and keeping resilience intact. Because, the loan losses and deterioration in solvency would have induced the banks to curtail the flow of credit, which in turn could have created a mutually-reinforcing downward spiral between economic downturn and delinquencies in loan portfolios. Given the uncertainties surrounding the re-emergence of pandemic and new variants of the virus, the banks should also continuously assess the situation, especially the repayment capacity of the borrowers, and may engage with the relevant stakeholders for any adjustments to facilitate smooth functioning of the sector.

Section B: Performance and Risk Analysis of Non-Banking Financial Sector

Chapter 5.1: Development Finance Institutions (DFIs)

DFIs were able to increase financing, partially supported by the SBP sponsored schemes. In a low interest rate environment, search for yield motivation seems to have dominated investments decision as DFIs observed an uptick in advances and a shift to long term government securities. Asset mix, however, remained skewed towards treasury investments. The deposits base showed an uptick during the year; however, their reliance on short-term borrowing to fund long-term assets continued. The sector posted substantial growth in profitability at the back of improved net interest income and non-interest income largely due to gain on sale of securities and dividend income. Earnings further augmented the capital base that helped maintaining the CAR well above the regulatory benchmark. With strong capital cushions, the DFIs need to focus on expanding their long-term advances portfolio. In this regard, the start of mortgage refinance activity by a DFI may provide further impetus to government's efforts for low-cost housing initiative.

Assets growth moderates due to stemming in the flow of borrowings, as the institutions strive to diversify their funding and investment avenues…

The balance sheet footing of DFIs has increased by 16.50 percent during CY20 - lower than 58.12 percent growth witnessed during CY19, which was led by investments and financed through a sharp increase in borrowings. This year's growth, however, has been funded by a mix of deposits, equity and borrowings, which is encouraging as the DFIs were mainly reliant on the borrowings from financial institutions. Similarly, increase in assets has resulted from a mix of growth in advances and investments, though the later saw a sharp deceleration during CY20 **(Table 5.1.1)**.

Table 5.1.1: Key Variables & Financial Soundness Indicators

	CY16	CY17	CY18	CY19	CY20
			PKR billion		
Investments (net)	109	122	122	240	287
Advances (net)	69	77	82	92	111
Total Assets	209	228	238	377	439
Borrowings	98	101	111	229	261
Deposits	11	17	12	12	27
Equity	82	99	106	117	132
NPLs	14	15	15	15	16
			Percent		
CAR	40.78	47.04	46.95	44.95	43.14
NPLs to Advances	17.48	17.15	15.83	14.53	12.77
Net NPLs to Net Advances	4.51	5.52	5.29	4.17	3.15
ROA (After Tax)	3.56	2.36	2.25	2.68	3.27
ROE (After Tax)	8.66	5.77	4.89	7.16	10.72
Cost to Income Ratio	38.78	37.28	40.08	32.38	25.19
Liquid Assets to Short-term Liabilities	90.23	90.90	86.95	97.60	97.51
Advances to Deposits	627.65	447.93	707.08	763.81	405.09

Source: SBP

The assets mix is traditionally skewed towards investments as the institutions focus more on risk-free avenues over the core business of loans and advances. During the last year, investment posted a strong growth which significantly decelerated during the year under review. However, the investments still constitute 65.34 percent share in the assets in CY20 (63.71 percent in CY19). The share of advances has, however, inched up a 93 bps to 25.31 percent during the year. The maturity profile of the assets shows that there has been a higher increase in the assets having relatively long-term maturity, implying that in a declining interest rate environment, the search for yield and prospects of revaluation gains have encouraged DFIs to increase exposure to long-term investments and advances. Moreover, SBP's refinance schemes such as Long Term Financing Facility (**LTFF**), TERF, and Renewable Energy (**RE**) refinance facility facilitated the DFIs to increase long-term financing.

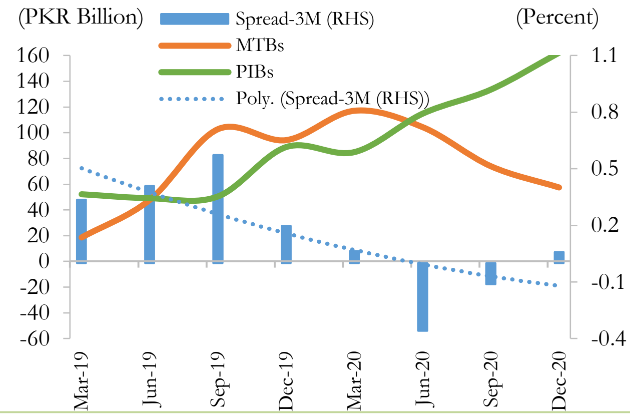
… Short-term investments decelerated significantly as preference shifted to long-term instruments in the wake of easing monetary policy environment

The stock of investments in treasuries increased during the year, however, the pace of the growth slowed down. On the other hand, DFIs continued to heavily rely on short-term borrowing from interbank market to finance their assets, especially the investment in government securities, as around 59 percent of assets are being funded through borrowing.

Further, the tenor-wise composition of investments changed from short- to long-term maturities, as the share of PIBs in total government securities increased from 48.55 percent by end-CY19 to 73.84 percent by end-CY20. More specifically, the stock of investments in PIBs increased significantly to PKR162 billion in CY20 compared with PKR 89 billion in CY19, a growth of 82.27 percent. Besides, the institutions have also tried to hedge their repricing risk through investments in floating rate PIBs, which constituted a little over half of total investments in PIBs as at end-CY20.

As for investments in MTBs, an inflow of PKR 23 billion was recorded during Q1CY20 – bringing stock to PKR 117 billion, highest since December 2008. A sharp decline in the benchmark interest rates during the ensuing quarter, however, brought about a drastic decline in MTB holding to PKR 57 billion by the end December 2020. The shrinking margins[154] in a pandemic-induced low interest rate environment and shift in government's strategy to elongate the maturity of its borrowing prompted a change in investment strategy by DFIs, as they started to invest more in long-term PIBs (**Chart. 5.1.1**).

Chart 5.1.1: Post pandemic investment in MTBs remained less attractive due to low margins

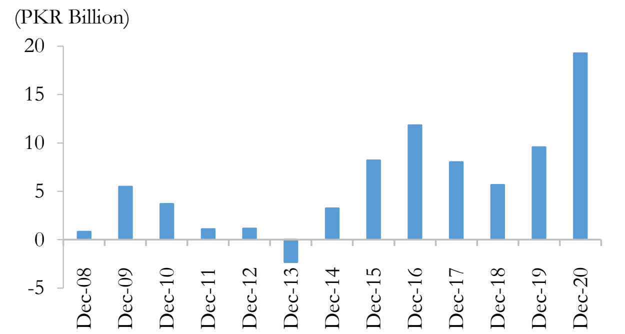


Source: SBP

While, advances growth accelerated …

Advances growth, on the other hand, was recorded at 20.96 percent during CY20 compared with 11.63 percent in CY19. Despite the ongoing health crisis, there was a broad based addition to the advances of PKR 19 billion, the highest disbursement in a single year in over a decade **(Chart 5.1.2)**. Incidentally, SBP-sponsored long-term refinance schemes and strong surge in the lending by a relatively new mortgage refinance company facilitated the growth and advances. House financing (PKR 7.1 billion), LTFF (PKR 3.0 billion), RE (PKR 1.5 billion) and TERF (PKR 0.9 billion), remained major drivers.

Chart 5.1.2: The highest disbursement of advances in line with their core business



Source: SBP

..However, the short term financing still dominates...

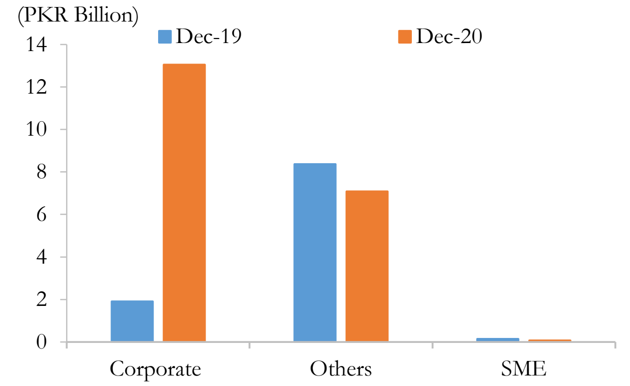
Although a significant amount of long-term advances has been disbursed during CY20, the short-term loans still dominate the outstanding advances portfolio. For example, more than 64 percent advances are maturing within three years, whereas, only 17.75 percent advances have maturities of more than five years. If the lending portfolio of a housing finance institution is excluded, the share of long-term advances with maturity of more than five years reduces to 11.10 percent.

[154] Margin is the difference between three-month repo rate and the yield on three-month MTBs in the secondary market

Corporate segment advances show significant growth…

Corporate segment which consumes lion of share of financial sector financing (i.e. more than 70 percent share in advances), availed a substantial amount of additional lending (i.e. PKR 13 billion) during CY20 **(Chart 5.1.3)**. More than half of these fresh advances (56.59 percent) were for fixed investments; around one-third (i.e. 34.72 percent) was working capital and the rest was trade finance.

Chart 5.1.3: A significant flow of advances towards corporate segment

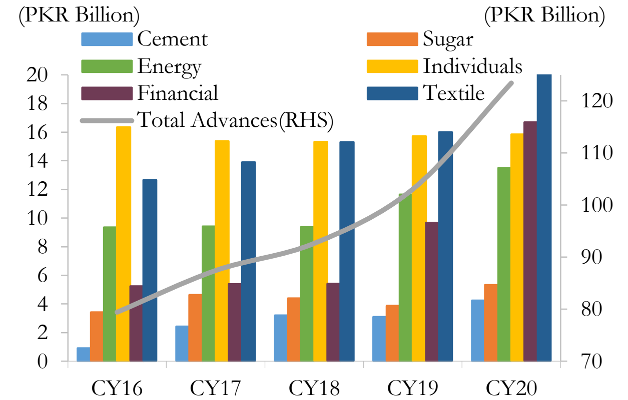


Source: SBP

… and remained broad based…

The sector wise analysis reveals abroad based growth in advances during CY20. More specifically, the 'Financial' sector availed PKR 7 billion, followed by Textile (PKR 4 billion), Energy (PKR 2 billion), Sugar (PKR 1 billion) and Cement (PKR 1 billion) **(Chart 5.1.4)**. The advances to financial institutions surged by 72.40 percent during CY20 and constituted 13.52 percent of the total advances. This addition mainly came from strong growth in financing to financial institutions by a mortgage refinance company. This segment achieved a significant advances growth owing to a couple of reasons: broadening of customer base and introduction of a unique product in the market by this mortgage refinance DFI.[155] The mortgage refinance activity was also facilitated and promoted by government's efforts for low cost housing under 'Naya Pakistan Housing Program'. Moreover, despite COVID related health crisis, loans to the textile sector experienced a significant growth of 27.46 percent in CY20 compared to a meager 4.62 percent during CY19. The current addition in advances was mainly observed in the first and last quarter of CY20. The enhancement in both quarters was mainly due to outlays under LTFF, as SBP extended the scope of LTFF to boost exports and accommodate the financing requirement of export-oriented sectors and manufacturing concerns.[156] The addition in textile sector advances was primarily attributed to a few large textile companies, which invested to enhance their capacity so as to meet increase in export orders.

Chart 5.1.4: A broad based growth in advances across the sectors was observed



Source: SBP

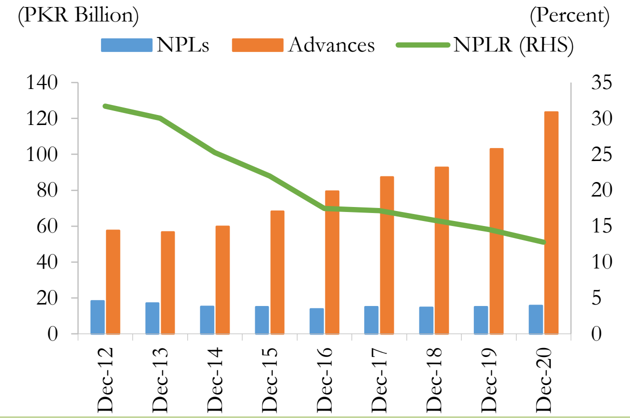
Assets quality continues to improve…

Infection ratio of the DFIs has continued to decline and lowered to 12.77 percent in CY20 from 14.53 percent in CY19 – mainly driven by a higher growth of advances compared with non-performing loans **(Chart 5.1.5)**. Moreover, by allowing deferrals of PKR 12 billion and

155The DFI with the mortgage refinance mandate is in an expansionary phase and has broadened customer base to conventional and Islamic banks, regional banks, microfinance bank, microfinance institution, Modaraba and NBFCs. Moreover, the DFI has developed a working model with banks where it will fund one of their fixed mortgage products.

156Maximum limit of PKR 2.5 billion has been enhanced to PKR 5 billion per project under LTFF (http://www.sbp.org.pk/press/2020/Pr2-28-Jan-20.pdf) restructuring/rescheduling loans of PKR 5 billion under SBP relief measures to combat the pandemic, the DFI sector was shielded from potential rise in infections and the related provisioning expenses.

Chart 5.1.5: Asset quality continues to improve



Source: SBP

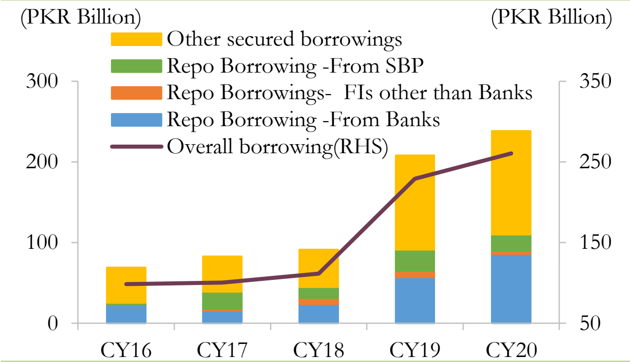
Encouragingly, deposit inflows increased….

The remunerative deposits in the form of Certificate of Investments (**COIs**)[157]appreciably increased (by PKR 15 billion) during CY20, and their share in overall asset base rose to 6.25 percent of total assets compared with 3.19 percent in CY19. The increase in deposits was mainly due to: i) Covid-19 related uncertainties that restricted corporations from investing in their businesses as well as the bar on corporate investments in CDNS prompted placements with DFIs[158], ii) efforts by DFIs to expand funding base and divert to the sources other than repo borrowing.

Borrowing still remained major source of funding…

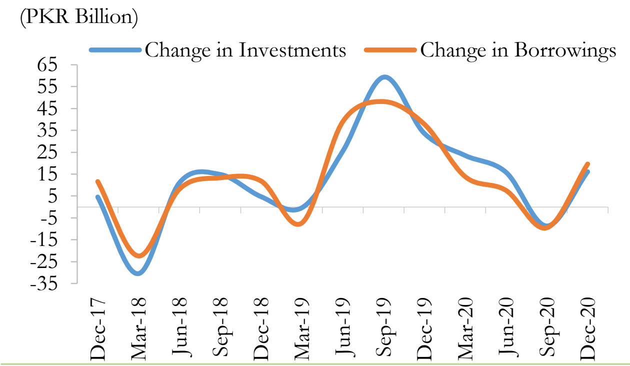
Due to the limited outreach of the capital market to raise capital and dearth of direct funding sources, DFIs mainly depend upon short-term secured borrowing, especially against treasury securities, from interbank market to finance their assets. Last year these borrowings surged to more than double (i.e. 105.47 percent increase); however, the pace of borrowing decelerated to 13.77 percent in year under review **(Chart 5.1.6).** The sharp deceleration in borrowing was naturally followed by a corresponding retardation in growth of investments **(Chart 5.1.7).** The squeezing margins in the wake of sharp reduction in policy rate COVID-19 may have dampened the prospects and incentive to invest in short-term securities through interbank repo borrowings.

Chart 5.1.6: Borrowing decelerated during CY20



Source: SBP

Chart 5.1.7: Sharp deceleration in borrowing led to decline in investments



Source: SBP

Strategy to rely more on short-term funding, however, created maturity mismatches...

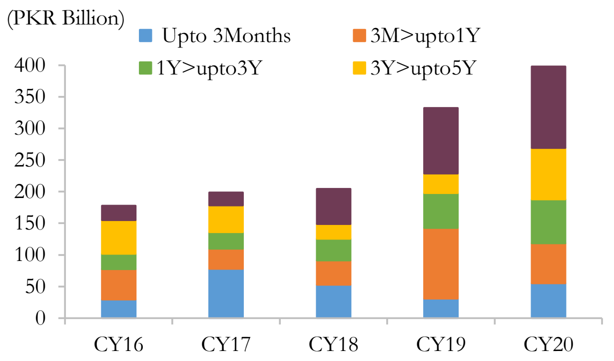
More than 80 percent of inflows (borrowing and deposits) had a maturity of up to one year, whereas only 29.69 percent outflows (advances and investments) matured within a year, creating a huge maturity mismatch in up to one-year bucket. Moreover, 52.82 percent of asset maturing beyond three years is financed by only 10.26 percent of funds with similar maturity. The DFIs are thus

[157] SBP allowed all DFIs (except HBFCL) for Issuance of Certificate of Investments. (BPRD circular No.2 of 2015).

[158]The government barred institutional investments in CDNS w.e.f. July 01, 2020

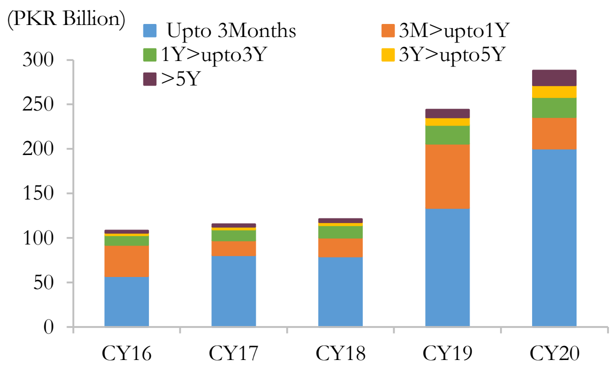
remain exposed to the rollover and refinance risks. The sector therefore needs to make efforts to raise funding from stable sources **(Chart 5.1.8 A & B).**

Chart 5..1.8-A : Maturity-wise breakup of earning assets



Source: SBP

Chart 5.1.8-B: Maturity-wise breakup of funding sources

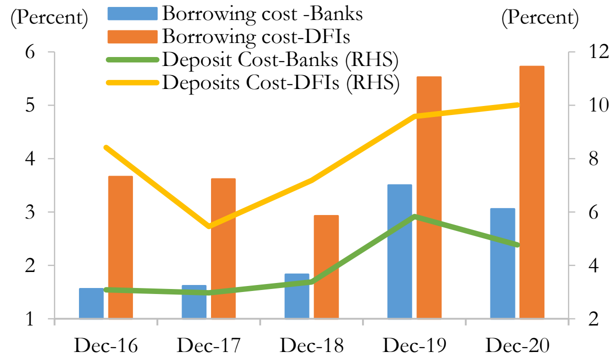


Source: SBP

Reliance on costly and wholesale interbank funding restricts assets expansions…

Moreover, heavy reliance on borrowing from financial institutions and institutional remunerative deposits have raised the cost as well as the uncertainty about the availability of funds, which further restricted the DFIs' ability to expand their assets base and optimize the returns. On average,[159] the rates on borrowing and deposits for DFIs remained, respectively, 193 bps and 426 bps higher than the banking industry.[160] **(Chart 5.1.9)**

Chart 5.1.9: High cost of borrowings restrict DFIs from assets expansion



Source: SBP

Due to lack of stable sources of funds, equity remains a major source of funding…

Since December 2008, DFIs seem to have remained reluctant to raise long-term funding through capital market, as both capital market as well as investment opportunities to invest in long-term projects remained limited. Moreover, due to their access to stable funding sources and better resources, the banks enjoy significant competitive advantage over DFIs. Therefore, strong capital base of the DFIs cannot be leveraged, as they focus on money and capital market activities through short-term borrowings, which are invested in relatively long-term investments so as to increase their margins. Accordingly, higher amount of capital is also required to cover any liquidity risks. The equity, therefore, remains the major source for funding. During the year under review, the equity of the DFIs increased by 12.52 percent (YoY growth) to PKR 132 billion. This growth in equity was largely (73.29 percent) explained by retained earnings.

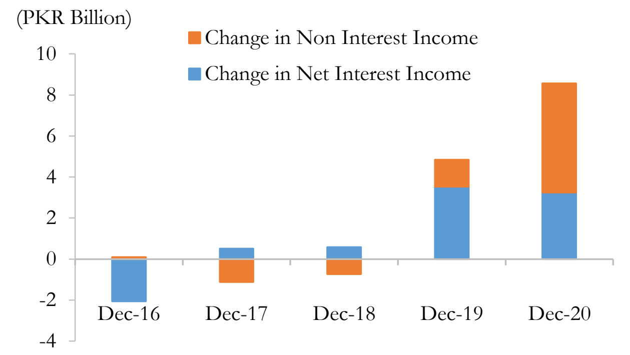
Profitability of the DFIs accelerated significantly…

Despite the challenging environment, the profitability (after tax) of the DFIs increased significantly to PKR 13.4 billion in CY20, a YoY rise of PKR 6 billion or 70.64 percent. This was

159 Last three years average
160 Cost of funding for borrowing and deposits are calculated as follows: Interest expense on borrowing is divided by average borrowings in last two years, and Interest expense on deposits divided by average deposits in last two years.

the highest profit ever recorded during any calendar year in over a decade **(Chart 5.1.10).**

Chart 5.1.10: Earnings accelerated during CY20



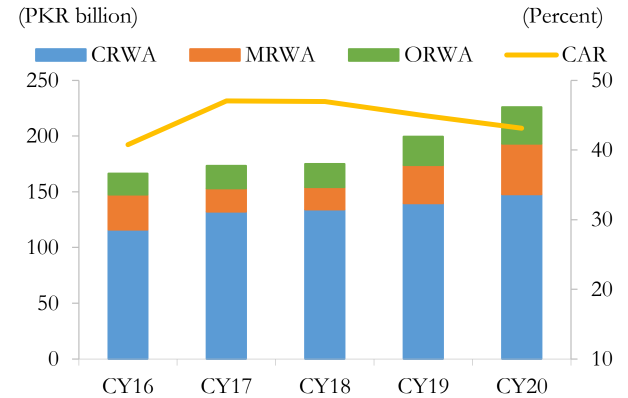
Source: SBP

The strong growth in profitability was supported by increase in net interest income as the timely investment decisions helped to boost the interest income. Moreover, DFIs posted healthy gains on sale of fixed income securities in the wake of sharp decline in interest rates, while the dividend and other income also witnessed appreciable growth during the year under review. Incidentally, SBP's Covid-19 relief measures to ensure the flow of credit and preserve the capital base of regulated institutions may have contributed in the profits by obviating provisioning expenses for deferred and rescheduled/restructured loans. In line with the growth in bottom line, the key earning indicators of ROE also improved to 10.72 percent (from 7.16 percent in CY19).

CAR marginally declined, but remained significantly higher than regulatory benchmark …

Due to strong capital base and limited financing operations, the capital adequacy ratio (**CAR**) of the DFIs generally remains high. The CAR of the sector marginally declined to 43.14 percent in CY20 from 44.95 percent in CY19. However, CAR remained significantly higher than the regulatory benchmark of 11.50 percent **(Chart 5.1.11).** The decrease was due to an increase of 13.22 percent in total RWA during CY20. More specifically, expansion in advances contributed to an increase in credit RWAs by 5.70 percent. The market RWAs also increased significantly by 33.30 percent owing to an increase in investments and shift in their mix from short-term investments (MTBs) to long term investment (PIBs) which, especially the fixed rate bonds, involves relatively higher capital charge.[161]Finally, Operational RWAs increased by 27.51 percent due to continuous increase in gross income of the DFIs.

Chart 5.1.11: Solvency profile of DFIs moderated



Source: SBP

With strong capital cushions, the DFIs are in a position to withstand unusual shocks and have the capacity to expand their earnings assets e.g. financing to real sector.

….DFIs need to focus on their core objectives…

In CY20, DFIs have displayed some efforts to revive their core business, as long term funding accelerated, partially on the back of SBP-sponsored schemes as well as mortgage financing, including low cost housing finance. However, DFIs still remain shy of meeting their stated objectives. The sector is facing a number of limiting factors e.g. lack of depth and outreach of

[161] As per Basel standards, interest rate risk has two components i.e. (i) issuer specific risk and (ii) general market related risk. The higher duration of instruments, attract higher capital charge for general market related interest rate risk.

the capital market to raise long-term funding at economical rate, limited demand for long-term finance and tough competition from banks which enjoy both access to stable and economical funding and resources. While there is a need to improve the infrastructure and market development, the DFIs can also enhance their dynamism and improve the capacity in the core business.

Chapter 5.2: Non-Bank Financial Institutions

Despite the emergence of the COVID-19 pandemic and the ensuing lockdowns, Non-Bank Financial Institutions (NBFIs) managed to increase their asset base on the back of increase in the Asset Management (AM) segment, which has the largest share in NBFI sector. However, lending NBFIs faced pressures due to asset quality challenges on account of slowdown in economic activity and resultant impairment in repayment capacity of the borrowers. The delinquencies and non-performing assets occurred despite the SECP relaxations and exemptions to defer or restructure advances and leases of borrowers. Going forward, the earnings and solvency indicators of the sector will largely depend upon the dynamics of the pandemic, continuity of COVID-related support measures, and general macro financial-conditions of the economy.

NBFI sector posted asset management-led growth during the pandemic; however, the performance of lending NBFIs dampened …

Despite the slowdown in economic activity due to the Pandemic and ensuing lockdowns – which resulted in the largest albeit short lived dip in the equity market in the last six years, the Non-Bank Financial Institution (**NBFI**) sector[162] managed to enhance its asset base with Mutual Funds and Portfolios registering significant increases. **(Table 5.2.1)**

Table 5.2.1: Asset Profile of NBFIs

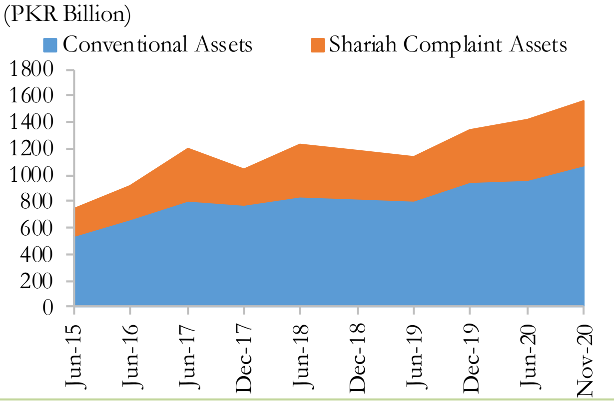
	Jun-18	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
	PKR billion					
AMCs/IAs (own assets)	**39**	**36**	**37**	**40**	**40**	**44**
Mutual Funds	679	642	578	724	802	985
Pension Funds	27	27	26	30	31	36
Portfolios	153	188	198	226	229	314
Total AUMs	**859**	**857**	**802**	**980**	**1,062**	**1,335**
RMCs	5	6	6	6	6	6
REITS	42	46	46	50	49	54
PE & VC Firms	0	0	0	0	0	0
PE Funds	5	6	7	7	7	8
Modarabas	53	54	53	54	51	51
Leasing Companies	10	10	10	11	11	6
IFCs	58	58	63	66	65	66
NBMFCs	97	110	117	126	122	129
Total Assets	1,169	1,184	1,140	1,339	1,412	1,700

Source: SECP

The Asset Management (**AM**)[163] segment continues to dominate the NBFI sector – as the market share of Assets Under Management (**AUMs**) further increased from 73.20 percent in CY19 to 78.53 percent in CY20.

However, NBFIs involved in the financing business[164] registered an overall decrease in assets as the Leasing sector experienced consolidation as a public leasing company – the largest leasing company in terms of asset size - merged with and into the associated public sector bank.[165]

Chart 5.2.1: Breakup of conventional & Sharia compliant assets



Source: SECP

During the year, the share of Shariah-compliant assets in total assets has increased from 28.85 percent for the year ended December 31, 2019 to

162 NBFIs for our analysis purpose include NBFCs, Real Estate Investment Trusts (**REITs**), and Modaraba Companies. As per section 282A of Companies Ordinance, 1984, Non-banking finance companies (**NBFCs**) include companies licensed by the Commission to carry out any or more of the following forms of business, namely: Investment finance services, Leasing, Housing Finance Services, Venture Capital Investment, Discounting Services, Investment Advisory Services, Asset Management Services, and any other form of business which the Federal Government may, by notification in the official Gazette specify from time to time. Non-bank Microfinance Companies (**NBMFCs**) are also included in NBFCs.

163 The Asset Management (**AM**) segment includes Asset Management Companies (**AMCs**), Investment Advisors (**IAs**), REITs, Mutual Funds, Pension Funds, and Discretionary/ Non-discretionary Portfolios.

164 NBFIs involved in the financing business (also referred to as the non-AM segment) include Leasing Companies, Modarabas, Investment Finance Companies (**IFCs**), and NBMFCs.

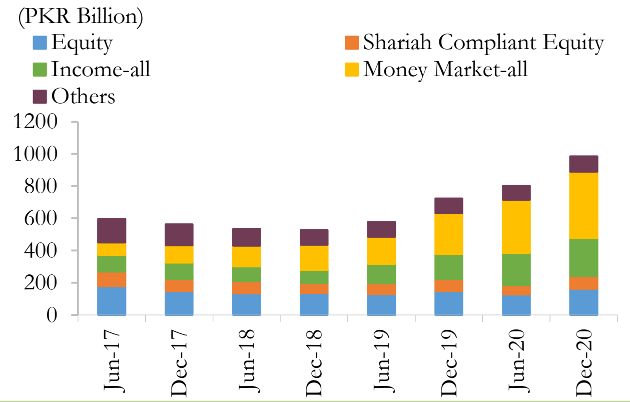
165 See Merger of Sindh Leasing Company Limited; http://www.sindhleasingltd.com/wp-content/uploads/2021/01/sl_emerger.png

31.32 percent in November 30, 2020 mainly on the back of growth in Shariah-compliant Mutual Funds, particularly, Money Market funds. Shariah-compliant assets have grown on the back of continuing supportive government policies and resilient demand. In addition, Shariah-compliant Money Market funds are allowed to take clean corporate exposures (provided they meet credit quality requirements), which resulted in their significant growth. **(Chart 5.2.1)**

Due to volatility in the equity markets in CY20, Net Sales of Money Market and Income Funds have increased in the Mutual Funds sector…

The Mutual Funds sector is mainly dominated by the Money Market Funds (41.86 percent market share), followed by Equity Funds (24.51 percent market share) and Income Funds (24.09 percent market share), indicating a general risk-averse nature of investors. The Pandemic-related uncertainties and volatilities have further affected the risk-appetite of investors as indicated by the drop in market share of Equity Funds from 30.95 percent in CY19 to 24.51 percent in CY20. **(Chart 5.2.2)**

Chart 5.2.2: Composition of Mutual Funds



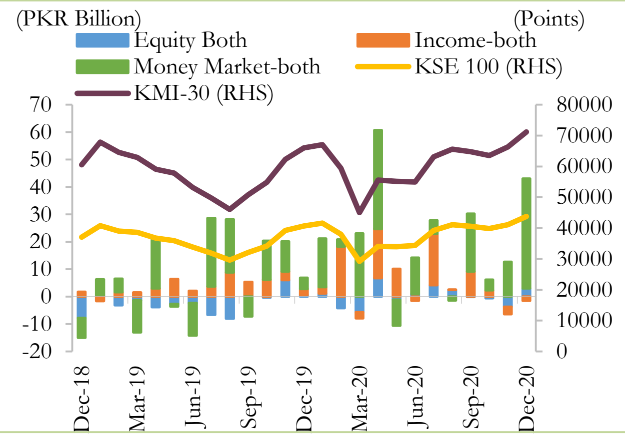
Source: SECP

There has been a large spike in the assets of mutual funds (36.04 percent increase) as risk-averse investors search for higher returns in the backdrop of heightened uncertainties and easing monetary policy, which resulted in corporates parking their excess liquidity in Money Market funds.

The risk appetite of general investors was largely influenced by the cumulative cut of 625 basis points in the policy rate and the volatility in the equity markets during CY20 – with the KSE-100 index dipping to almost 27,000 points in March 2020 and then recovering to 43,755 points by December 2020. This is demonstrated by the increase in Net Sales for Money Market and Income Funds (as fund performance is gauged vis-à-vis market rates). (**Chart 5.2.3**)

Investment in mutual and pension funds was also supported by the government's decision[166] to bar institutional investors from investing in Central Directorate of National Savings (**CDNS**) instruments. As a result of this decision, the AM segment became an attractive alternative for the institutional investors.

Chart 5.2.3: Net Sales of top three mutual funds



Source: MUFAP & PSX

Due to the dip in equity markets, Equity Funds witnessed Net Redemptions while Money Market Funds witnessed Net Sales in the February-March 2020 period. Since then, the markets rallied, which spurred recovery in Equity Funds resulting in overall Net Sales in CY20. The recovery was aided by the relief measures introduced by the

[166] The government barred institutional investments in CDNS w.e.f. July 01, 2020.

government and regulatory authorities[167] and strong fundamentals of the underlying stocks.

Consequently, growth in Money Market and Income Funds mainly drove the increase in Mutual Funds assets (constituting 72.32 percent and 34.34 percent of overall growth, respectively) in CY20. **(Chart 5.2.2)**

The small asset base of the 23 AMCs and IAs – which is only 3.27 percent of total AUMs – could involve the moral hazard of excessive risk taking, particularly, since AMCs' investments in funds under management constitute only 2.13 percent of total AUMs. However, this moral hazard is well contained through a strong regulatory and governance regime, and checks and balances (including the arrangements between trustees, custodians, and audit process, disclosures requirements, etc.) to ensure that the investments and risks are strictly in line with the stated risk profile and constituting document of the respective funds.

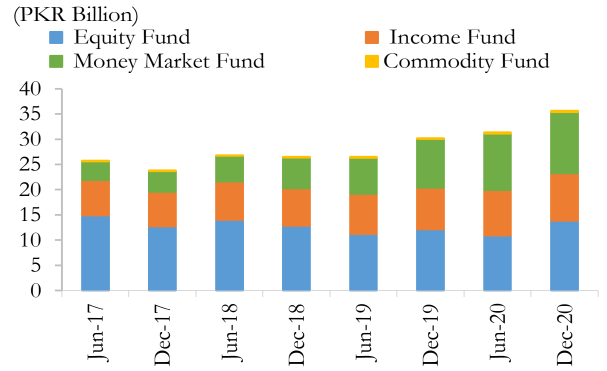
The credit risk for the sector is low with Classified Assets of PKR 3.8 billion (0.38 percent of gross AUMs) while AMCs held provisioning of PKR 3.6 billion (provisioning coverage of 96.56 percent) as of December 31, 2020. The small amount of Classified Assets are partly due to the large market share of the relatively safe Money Market and Income Funds.

Money Market Funds have driven the growth in Pension Funds…

Pension Funds increased their asset base by 17.85 percent to PKR 36 billion in CY20 despite the onset of the Pandemic, which led to a cut in policy rates. Money Market funds increased their balance sheet footing from PKR 10 billion to PKR 12 billion contributing 45.21 percent to overall growth for the sector.

The sector is highly concentrated with one fund manager managing 34.41 percent of total assets through a single fund (consisting of four sub-funds) for the sector.

Chart 5.2.4: Composition of pension funds

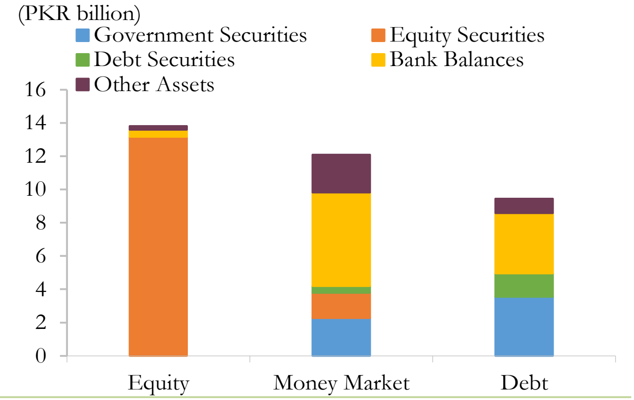


Source: SECP

Although growth in Pension funds has been mainly driven by Money Market funds, Equity funds still constitute the largest share (38.75 percent of Total Assets) in the pension funds segments with growth of 13.90 percent over the year. Despite volatility in the first half of CY20 – which led to a year-on-year decrease of 2.53 percent in Equity funds - the stock market recovered in the second half of the year that led to strong growth in the value of Equity funds, which contributed 31.21 percent of the overall YoY growth in the pension fund portfolio. **(Chart 5.2.4)**

[167] Some of the relief measures introduced by the SECP in light of the Pandemic for mutual funds include: extension in the maximum period of borrowing by mutual funds for redemption purposes; increase in time for regularization of breach of investment limits due to redemptions from four months to six months for mutual funds/collective investment scheme (**CIS**); extension in time period for classification of non-performing securities by mutual fund/CIS from 15 days to 180 days; among others.

Chart 5.2.5: Asset Allocation of Pension Funds in CY20



Source: SECP

However, the capital market of the country is quite shallow and significantly lacks width and depth. Large institutional investors such as Life Insurers and Pension Funds do not invest in long-term projects, partly because of a dearth of such long-term investment avenues and partly because of their risk-averseness. A look at the asset allocation of Pension Funds (barring Equity Funds) suggests that most have a short-term investment horizon although their liquidity needs are generally low. **(Chart 5.2.5)**

Development of long-term financial products by the private sector and enabling policy and macro environment may lead such institutional investors to elongate their investment horizons, which may help maximize returns and, in turn, partly bridge the financing gap that the country faces.

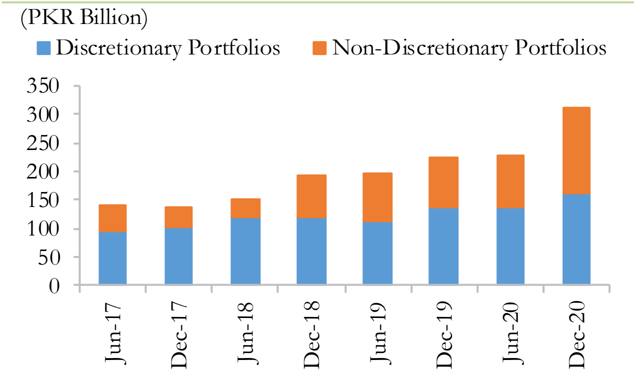
Decrease in economic activity did not affect growth in Portfolios Under Management [168]*…*

Despite the uncertainty surrounding the Pandemic, there has been a significant increase in the growth of Portfolios (39.15 percent increase in CY20) suggesting that high-income individuals and entities were largely unaffected by the decline in economic activity.

However, the uncertainty of the Pandemic led to a decrease in the share of Discretionary Portfolios from 60.92 percent in CY19 to 52.07 percent in CY20 indicating that clients increasingly took investment decisions in their own hands. **(Chart 5.2.6)**

The macroeconomic uncertainty might have led to panic sell-outs and shorter investment-holding periods as these large investors tend to capitalize on the market volatility rather than holding investments in line with market fundamentals.

Chart 5.2.6: Portfolios classified by investment decision making



Source: SECP

Despite a decrease in rental income, the REIT scheme has managed to retain high occupancy levels and long lease terms…

Despite the presence of seven REIT management companies, only one has launched a REIT scheme yet.

Table 5.2.2: Two Major heads of REIT Earnings

	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
	PKR Billion				
Total Assets (Stocks)	45.90	47.02	49.53	52.03	54.40
Change in Total Assets	2.91	1.12	2.51	2.50	2.37
Rental Income (HY)	1.61	1.73	1.70	1.12	1.42
Change in fair value of property (HY Flows)	2.87	0.96	2.42	3.04	2.13

Source: Financial Statements of REIT

168 Portfolios (Under Management) are investments of eligible investors (person offering a minimum of PKR 3 million investment) managed by Investment Advisors. Under "Discretionary Portfolios", investment decisions are made and executed by the Investment Advisor on behalf of clients. While under a "Non-Discretionary Portfolio", investment decisions are executed as per the written instructions of the clients.

During the year, the REIT scheme managed to increase its asset base on the back of increased property valuation. **(Table 5.2.2)**

Even in the face of the pandemic-induced lockdowns, which hampered business activity and interrupted retail sales, the REIT management company strived to retain tenants by providing rental waivers, and enhancing customer engagement while implementing prescribed safety protocols to encourage footfall and retail sales. While the renegotiation of tenancy contracts (in light of the pandemic) reduced rental income in the short term, it helped maintain occupancy level above ninety percent. Besides these dynamics of occupancy rate, the other key performance indicator i.e. weighted average lease expiry (**WALE**) was 3.3 years[169].

Leasing Companies continue to lose market share…

The leasing sector, which holds a minimal market share contracted sharply as the largest leasing company exited the sector with its merger into the associated public sector bank. This has resulted in a 44.12 percent and 40.81 percent decline in the asset base and advances & leases of the leasing sector, respectively**. (Table 5.2.3)**

Asset quality issues coupled with funding constraints still hamper the growth of the leasing sector. With the exit of the largest leasing company, the Classified Assets to Total Assets ratio has increased from 18.31 percent in CY19 to 36.70 percent in CY20.

Table 5.2.3: Key statistics of Leasing sector

	Jun-18	Dec-18	Jun-19	Dec-19	Jun-20	Dec-20
	PKR Billion					
Total Assets	10.4	10.5	10.2	10.7	10.6	6.0
Advances & Leases	7.6	7.9	8.2	7.7	7.2	4.6
Asset Classified	1.9	1.9	1.7	2.0	2.4	2.2
Provisions	1.5	1.4	1.4	1.5	1.5	1.5

Source: SECP

If statistics are compared only for the existing leasing companies, the results are still insipid with 8.29 percent decline in advances and leases and a 12.00 percent increase in Classified Assets during CY20, indicating that leasing companies are still losing market share.

Competition from commercial banks, which enjoy access to relatively low-cost and stable funds, and Modarabas has slowly chipped away at the business from leasing firms over the years. A few firms continue to struggle due to liquidity crunch and shortage of capital.

Declining discount rates can be a boon for leasing companies as it can reduce cost of funding; however, competition from other sectors will remain fierce.

Going forward, once COVID-related relaxations and exemptions – including deferral in repayment of principal, rescheduling/ restructuring the financing facility, relaxation in classification of the deferment/ rescheduled request, among others - lapse, leasing companies may experience an uptick in non-performing loans putting further strain on their profitability and equity.

To mitigate risks, IFCs curtail disbursements…

The pandemic has resulted in a decline in Advances and Leases for the IFC sector as some IFCs have curtailed disbursements during the year.

169 Higher occupancy rates and longer average lease terms are two primary determinants of a quality REIT. WALE is a measure of a property portfolio's risk of going vacant. A longer WALE points to a stable tenant base and high satisfaction among tenants. A shorter WALE will lead to a quicker turnaround among tenants, with extra potential costs involved in managing and minimizing those turnarounds.

The IFC sector overlaps with the NBFI sector as a NBFC licensed to undertake the business of Investment Finance Services might also undertake the business of leasing, housing financing, discounting, and micro-financing under the same license.[170] In view of the above, the two largest IFCs are involved in leasing and microfinance activities. The sector is also heavily concentrated with these two IFCs constituting 77.11 percent of the total market share in terms of assets and making up 96.19 percent of total Advances & Leases for the sector for the period ended December 31, 2020.

Non-availability of low-cost funds remains a challenge for the Modaraba sector…

Despite the entrance of three new Modaraba companies in CY20 (taking the total up to 27[171]), the concentration in the sector remains high. The big three Modarabas hold 56.84 percent of total assets of the sector as of December 31, 2020.

Although the various Modaraba companies are clubbed under the same sector, the Modaraba companies differ from each other as various Shariah-compliant business ventures can be operated on the premise of Modaraba, including equipment-rental services, trading, manufacturing, and Islamic financing services.

Some of the companies are still undercapitalized, with one of the largest (constituting 21.06 percent of total assets) registering significant negative equity. However, since this is a manufacturing Modaraba that is not involved in the financing business, it does not pose systemic risk to the rest of the sector. The company aims to convert debt obtained from its parent company into equity and spinoff one of its loss-making segments into a separate entity.

The sector's growth is still hampered by the non-availability of relatively low-cost funds with the sector registering a 4.29 percent decline in assets for CY20. Out of the 27 Modaraba companies, only five raised deposits (with one raising negligible amounts); consequently, the deposit to equity ratio for the sector is 0.61, indicating that significant room exists for Modarabas (which are engaged in financing business) to expand their business through deposits and optimize the risk-return matrix and meet the financing demand of the real economy.

Asset Quality of NBMFCs has deteriorated rapidly…

Generally, the purpose of most NBMFCs is not profit-maximization but to alleviate poverty and enhance financial inclusion by providing microfinancing, among other services; however, these NBMFCs still need to have a sustainable business model.

The NBMFCs sector is highly concentrated with the top three NBMFCs constituting 64.06 percent and 68.77 percent of total assets and total microcredit loans, respectively, in CY20.

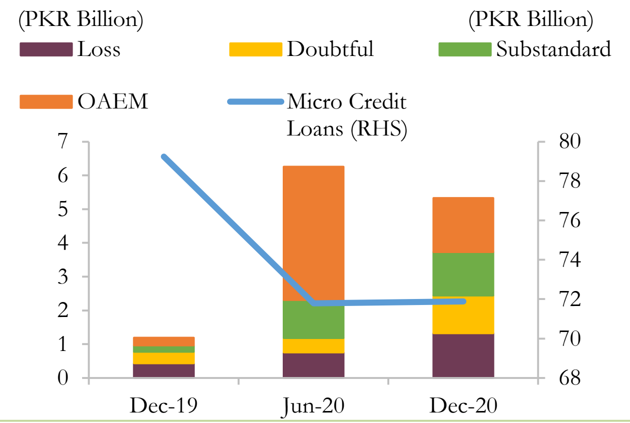
Due to the implementation of lockdowns and the ensuing slowdown in economic activity, the NBMFC sector has registered a decline of 9.27 percent in Microcredit Loans for the year ended December 31, 2020. A combination of demand- and supply-side factors led to the decline. To keep their risk profiles manageable, some NBMFCs began to restrict loans to borrowers who availed financing from multiple sources. In addition, field teams involved in client outreach adopted a conservative approach while disbursing loans. With regards to demand-side factors, due to the slowdown in economic activity, some existing clientele did not avail new loans from NBMFCs.

170 Incorporation of NBFC and grant of license; https://www.secp.gov.pk/licensing/nbfcs/investment-finance-services/

171 While there are 28 Modarabas, this analysis is based on the available data of 27 Modarabas, covering 99.61 percent of the sector (in terms of assets).

The real cause for concern is the substantial increase in Classified Assets, which, despite SECP's special pandemic-related relaxations, have increased by 347.90 percent to PKR 5 billion for the year ended December 31, 2020. While the associated provisioning has increased, it has not increased on a proportionate basis resulting in a decline in Provisioning Coverage from 54.54 percent in CY19 to 41.50 percent in CY20. Accordingly, the Classified Assets to Microcredit Loans ratio has increased from 1.50 percent in CY19 to 7.41 percent in CY20.

Chart 5.2.7: NBMFCs' Composition of Classified Assets



Source: SECP

In addition, the composition of Classified Assets has worsened over the year. Initially, there was a large increase in the classification of assets as "Other Assets Especially Mentioned (**OAEM**)" in the half-year ended June 30, 2020. Subsequently, the majority of OAEM classified assets transitioned to lower categories such as "Loss" by the year ended December 31, 2020; this resulted in a 206.50 percent increase in Loss classified assets in CY20. This caused a deterioration in asset quality and increase in provisioning expense, which, in turn, affected the NBMFCs' earnings and solvency. (**Chart 5.2.7**)

One reason for this deterioration in asset quality may be the fact that most microfinance borrowers might be unaware of the SECP's loan deferment and restructuring package, resulting in increasing delinquencies as the income and cash flow of capacities of the microfinance borrowers were also affected by the pandemic

This deterioration in the asset quality of NBMFCs may have implications for microfinance intermediaries – including investment finance companies and wholesale lenders to NBMFCs. These intermediaries mobilize funding from donors and commercial lenders i.e. development agencies, financiers, commercial banks and capital markets, and are key providers of funding for a number of NBMFCs. As of June 30, 2020, a leading IFC had provided financing of PKR 21 billion to NBMFCs. This forms 37.73 percent of total borrowings for 17 NBMFCs, which may not seem significant. However, if the borrowings of the top two NBMFCs (whose funding sources are well diversified) are excluded, the borrowing provided by the IFC to the remaining 15 NBMFCs constitutes 68.83 percent of their total borrowings, which is quite significant for these small-sized firms. This may raise concerns for the health of the IFC and highlights a feedback channel between the investment finance and NBMFC sectors.

Detailed analysis shows that in order to fund its financing operations, the IFC had obtained borrowings worth PKR 7 billion (24.40 percent of its total assets) from the banking sector as of June 30, 2020. This delineates how the IFC channelizes liquidity between the banking sector and the NBMFC sector. The asset quality issues that the NBMFC sector is currently facing can portend the build-up of system-wide risk for the microfinance intermediaries and the banking sector. However, the quantum of the banks' exposure to the sector remain minute, especially in comparison with the asset base and capital levels of the banking sector. Moreover, a decrease in micro-credit loans by NBMFC during CY20 also shows that these firms are trying to implement prudent risk management practices in their lending activities.

Nevertheless, upon withdrawal of SECP's relaxations to NBFCs engaged in lending business (including NBMFCs), the asset quality and earnings indicators could face further pressures.

Interconnectedness between the AM segment and the banking sector remains high …

The Asset Management (AM) segment remained interconnected with the banking sector especially in terms of banks' investments in mutual funds' unit, which was 38.23 percent of total AUM. In addition, mutual funds' exposure in different instruments of banking sector constituted 94.31 percent of the segment's total exposure in financial institutions in the form of investments in deposits, Certificate of Deposits (**COD**), Term Deposit (**TDR**), Certificate of Investment (**COI**), and money at call/placements with banks. Indicators for banks' share remained somewhat stable over the previous year. **(Table 5.2.4)**

Further, bank-owned AMCs/ IAs had 76.90 percent share in total AUM, highlighting another aspect of interconnectedness that banking sector provides significant ownership and sponsorship support to AM segment.

From the AM segment's perspective, the transfer of vulnerabilities from the banking sector, in terms of Mutual Fund exposure, is a concern as the AM segment has placed a significant portion of its assets in banks. However, given the resilience of the banking sector, with CAR at more than 18 percent and ample liquidity buffers, the residual risk is minimal for AM segment. Further, the CAR non-compliant banks do not have associates in AMCs.

In addition, the investments in Mutual Funds by their associated Banks, DFIs and AMCs constituted 3.48 percent of the value of total investments as of December 31, 2020. Similarly, Other Banks/DFIs' investment in Mutual Funds as percentage of total investment in Mutual Funds was only 1.12 percent.

From the banking sector perspective, vulnerability from the AM segment can emanate from sudden withdrawal of funds placed with banks. However, given the overall low risk profile of the AM's asset composition and strong liquidity cushion of banks, this risk remains low.

The AM segment increased its exposure in the NBFC sector through different modes of investments including Term Deposit, COI, COD, Certificate of Musharaka (**COM**), Debt Security, and Equity Security. It has increased from PKR 1 billion in CY19 to PKR 4 billion in CY20, which, nevertheless is still negligible - constituting 0.31 percent of overall asset base of AM segment.

In addition, the microfinance intermediaries, which partly borrow from banks and provide financing to NBMFCs, are a source of interconnectedness between the NBMFCs and the banking sector. Though, the asset quality issues plaguing the NBMFCs may reflect the buildup of cross-sectoral vulnerabilities for the banking sector; however, again, given the footing of the banking sector and strong capital base, any transfer of risks from the NBMFC sector will be negligible and remote.

The rest of the lending NBFCs are not significantly interconnected with the banking sector. Over the years, the reliance of this NBFC sector on banks has declined due to high cost and uncertainty in the availability of bank financing.

Going forward, the performance of overall NBFI sector will largely depend upon the success in controlling the pandemic, continuity of regulatory support measures, and general economic conditions and liquidity in the financial markets.

Table 5.2.4: Asset Management segment's flow of funds & exposure to the banking sector

	Total Value (i)	Banks share (ii)	Banks share in Total* (iii= ii/i)	Total Value (iv)	Banks share (v)	Banks share in Total* (vi= v/iv)	Total Value (vii)	Banks share (viii)	Banks share in Total* (ix= viii/vii)
	Dec-18			Dec-19			Dec-20		
	PKR billion		Percent	PKR billion		Percent	PKR billion		Percent
1. Equity of AMCs/ IAs	23.7	12.9	54.42	28.5	14.4	50.46	31.9	17.0	53.36
2. Assets Under Management of AMCs/ IAs	856.6	645.9	75.41	979.9	761.6	77.73	1,334.7	1,026.4	76.90
3. Mutual Funds size	641.7	16.6	2.59	724.1	12.9	1.79	985.2	15.5	1.58
4. Mutual Fund exposure in Financial Institutions	277.8	257.1	92.54	357.6	342.5	95.79	541.0	510.2	94.31
5. Mutual Funds exposure in top 20 equity securities	84.7	6.2	7.27	81.3	6.4	7.91	76.5	9.2	12.07
6. Mutual Funds exposure in top 10 debt securities	16.7	8.0	47.55	17.3	5.6	32.24	20.3	6.0	29.62
7. Top 20 holders of mutual fund units	68.8	11.2	16.25	97.4	6.0	6.16	359.0	205.4	57.22

Source: SECP

*Banks share for the respective head means:

1.Equity of Bank-owned AMCs /IAs

2.Mutual/Pension Funds and Portfolios being managed by bank-owned AMCs /IAs

3.Banks' investments in mutual fund units

4.Mutual Funds' investments in deposits, COD/TDR/COI and money at call/placements with banks

5.Mutual Fund investments in ordinary shares of banks

6.Mutual Funds investments in TFCs/Commercial Paper/Sukuk etc. issued by banks

7.Banks(investment value) in the top 20 holders of mutual fund units

Chapter 5.3: Insurance and Takaful Companies

The pandemic has led to muted premiums for both the life and non-life sectors of the insurance industry. However, while Net Claims for the life sector have increased due to a spike in Surrender Claims, Net Claims for the non-life sector have witnessed a decline mainly due to a drop in Motor Claims as a result of the imposition of lockdowns, which led to mobility restrictions. The low interest rate environment has prompted life and non-life insurers alike to recalibrate their portfolios away from term deposits. Given the uncertainty surrounding the domestic vaccination campaigns and the emergence of new strains of the virus, growth in the insurance sector will remain dependent upon the effective handling of the pandemic.

Overall Industry Snapshot

Even in the face of significant health challenges of COVID-19, which severely affected the economic and financial conditions in the economies, the insurance industry of Pakistan increased its asset base by 13.03 percent during CY20 (14.99 percent growth in CY19) to PKR 1,871 billion[172]. The growth was significant both in the non-life and in life sectors. Asset base of non-life sector grew by PKR 23 billion to PKR 232 billion while balance sheet footing of life sector, which dominates the overall market, grew by PKR 187 billion to reach PKR 1,563 billion in CY20. It is important to note that both life and non-life insurance sectors are quite concentrated in terms of asset base and premium revenue, though there are sufficient number of players.

Foreign ownership in the industry is insignificant…

Domestic stakeholders mainly own the companies operating in the insurance sector of Pakistan, while public sector also plays a leading role as it owns and controls some of the leading insurance companies.

Only one non-life insurer - with market share (in terms of asset base) of less than one percent of the combined non-life & General Takaful sector - is a wholly owned subsidiary of a foreign investment firm. While an international development agency has significant shareholding in one non-life insurer, which has market share of 7.98 percent, two other small-sized non-life companies (i.e. a non-life insurer and a General Takaful company) also have significant foreign shareholdings.

In the life sector, an insurer having 11.56 percent market share is the subsidiary of the same international development agency, which owns significant shareholding in the non-life insurer. In addition, one Family Takaful company - having limited market share in the combined Life & Family Takaful sector - has significant foreign shareholding.

Thus, risk of cross-border spillovers remain minimal for the industry.

The life insurance sector remains concentrated, as the largest public sector insurer dominates in terms of both asset base and premiums earned …

The Life sector consists of eight conventional life insurers including two public life insurers, with one[173] of these being granted license by the regulator recently.

The sector is heavily concentrated with the larger public life insurer constituting 74.85 percent and 55.03 percent of Total Assets and Gross Premiums of the sector, respectively.

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[172] The analysis in the chapter (barring sections on concentration and foreign ownership) is based on the data of 5 life insurers and 24 non-life insurers covering approximately 97 percent and 81 percent of the life and non-life insurance sectors' assets, respectively. The analysis also covers the two Family Takaful companies, two General Takaful companies, and the sole reinsurer, thus, covering the entire insurance industry. The analysis covers data up to period ending December 31, 2020. Data has been estimated, where necessary. The financial close for insurers is December of the corresponding year. All growth ratios for flow items are on year-on-year basis.

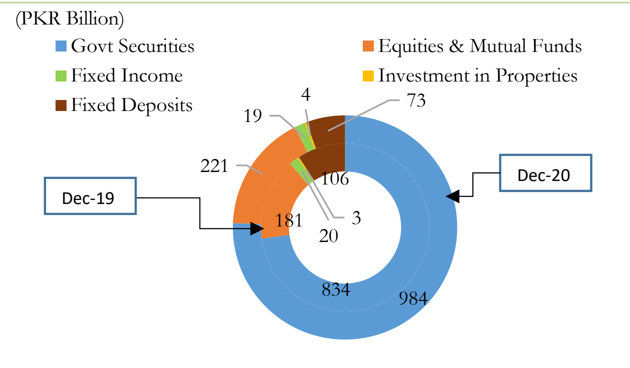
[173] Postal Life was granted license to undertake ordinary life business under Insurance Ordinance, 2000. Its financials are not available yet.

The concentration goes up if the top three life insurers are considered; they form 95.65 percent and 88.64 percent of Total Assets and Gross Premiums of the sector, respectively.

Life sector adjusted its assets and investment portfolios to changing risk dynamics and conditions of financial markets…

The Life sector became more risk averse during the year as indicated by growth in Investment in Government Securities, which grew by PKR 150 billion to PKR 984 billion in CY20. At the same time, the sector increased its Investments in Equities and Mutual Funds by PKR 40 billion to PKR 221 billion while decreasing its Deposits by PKR 33 billion to PKR 73 billion. Life insurers moved away from Term Deposits towards Equities and Mutual Funds in order to take advantage of the large dip in Pakistan Stock Exchange (**PSX**) in March 2020, which occurred immediately after the imposition of a nation-wide lockdown. This may also be an indication of evolving investment strategies as insurers seek better returns from their existing portfolios in a low interest rate environment (**Chart 5.3.1**).

Chart 5.3.1: Life Sector Investments & Properties



Source: Unaudited/ audited accounts of insurers

Overall, Total Investments increased by 13.72 percent to PKR 1,302 billion for the life insurance sector as of December 31, 2020.

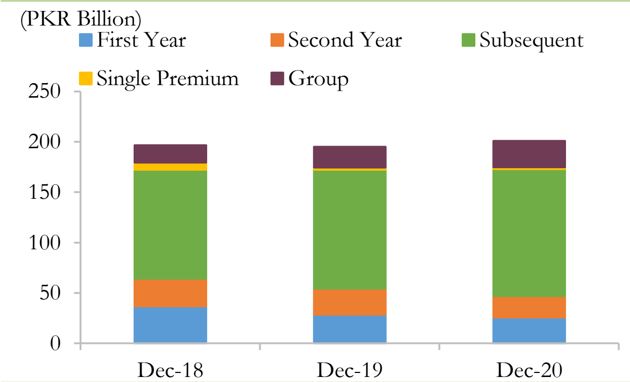
This helped boost the asset base for the sector by 13.58 percent to PKR 1,563 billion for the corresponding period.

Group Premiums were the main driver of growth in Life Premiums …

Despite the onset of the pandemic, Gross Premiums for the life insurance sector managed to increase by 2.94 percent (PKR 6 billion) to PKR 201 billion during CY20. A disaggregated analysis indicates that the impetus was provided by growth in Group Premiums, which increased by PKR 5 billion to PKR 26 billion in CY20. This 25.59 percent YOY increase in Group Premiums occurred on the back of expansions carried out by the public life insurer in the National Health Insurance Program and Khyber Pakhtunkhwa's Sehat Sahulat Program.

Individual Premiums remained more or less stable at PKR 175 billion in CY20. The breakdown of Individual Premiums show that barring Subsequent Year Premiums, which increased by PKR 8 billion, there were significant decreases in the remaining components of Individual Premiums **(Chart 5.3.2).**

Chart 5.3.2: Gross Premiums for Life Sector



Source: Unaudited/ audited accounts of insurers

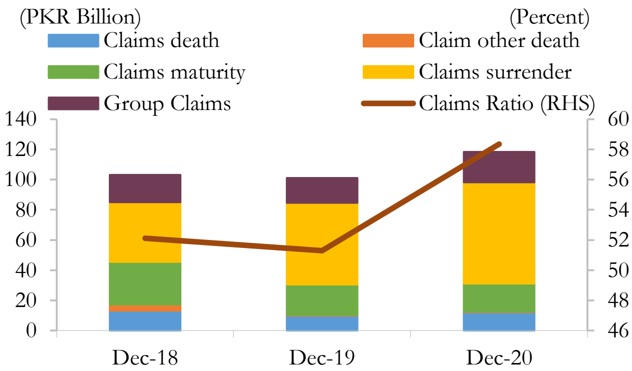
Overall, the sector witnessed a decline in the sale of new Individual Life policies…

First Year, Second Year, and Single Premiums under Individual Life policies decreased by PKR 3 billion (9.62 percent), PKR 5 billion (18.38 percent), and PKR 0.2 billion (9.40 percent), respectively, during the year under review. The public Life insurer restructured and consolidated its business distribution channel to control renewal expense ratio, which contributed to the decline in Second Year Premiums. The restructuring occurred in the previous year; thus, the decrease (of PKR 5 billion) in Second Year Premium in CY20 was in line with the significant decline (of PKR 8 billion) in First Year Premium in CY19. Overall, the sector witnessed a decline in the sale of new Individual Life policies (First Year and Single premiums) due to the imposition of the lockdown as distribution channels were unable to reach out to clients e.g. Bancassurance was affected due to limited banking activities.

Claims ratio rose indicating that customers faced strain in their disposable income while pandemic also marked its effects…

The Gross Claims increased by 17.02 percent to PKR 118 billion during CY20. The main driver for the significant uptick was the increase in Surrender Claims, which increased by PKR 13 billion to PKR 67 billion over the corresponding period. Further, there was a 23.07 percent (or PKR 2 billion) increase in Death Claims to PKR 12 billion, which may be directly associated with COVID-related deaths **(Chart 5.3.3).**

Chart 5.3.3: Gross Claims for Life Sector



Source: Unaudited/ audited accounts of insurers

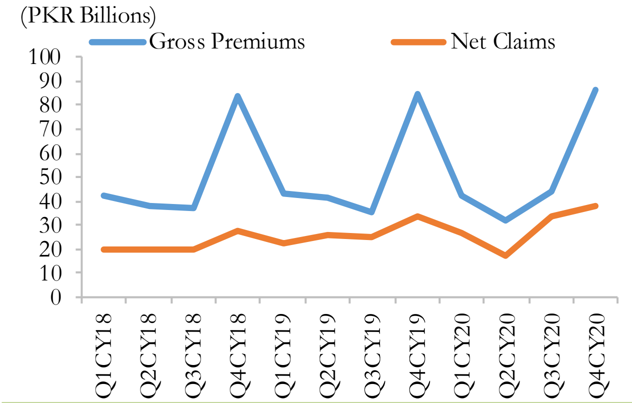
The contraction in sales of new Individual policies along with increase in Surrender Claims indicates the possibility that policyholders faced constraints in disposable income that led them to not buy new policies or surrender existing policies. The findings of the Pakistan Bureau of Statistics (PBS) Survey to Evaluate Socio Economic Impact of COVID-19 confirm that income for many households decreased due to COVID-19.

Currently, the increase in Claims is within the mortality fluctuation tolerance levels set by insurers. However, COVID-19 can be considered as a significant health catastrophe, which may reverse Pakistan's improving mortality rate trend for a few years. This could lead to increasing Claims over the next few years, which may worsen the Underwriting Results of life insurers.

QOQ Analysis indicates that the pandemic has affected the growth trajectory of life Premiums and Claims …

The Quarter-on-Quarter (**QOQ**) analysis of past years indicates elements of seasonality in Gross Premium and Net Claims for the life insurance sector. The analysis of CY20 data shows that that this pattern of seasonality has been affected, which can be ascribed to the pandemic **(Chart 5.3.4).**

Chart 5.3.4: Quarterly Change in Gross Premiums and Net Claims of Life Insurers



Source: Insurance Association of Pakistan (IAP) data

Life Premiums traditionally witness a significant uptick in Q4 of each calendar year. This may be partly because agents obtain Renewal Premiums in the last quarter of each year as next year's premiums become due. This suggests that most policies' year-end falls in the last quarter as indicated by upswings in First Year and Renewal Premiums in Q4 of each year suggesting an increase in sales push by agents to prospective and current clients. In CY20, the distribution channels were unable to reach out to retail clients due to imposition of lockdown in Q2 and Q3; however, the sales force was able to make a positive recovery in Q4 as lockdown was lifted.

Quarterly analysis of Net Claims indicates that usually there is an uptick in Claims in Q4 of each calendar year. However, in CY20, Net Claims first experienced a dip in Q2 and then started a relatively sharp rise in Q3 followed by a more gradual increase in Q4. This phenomenon coincides with the implementation and lifting off lockdown in Q2 and Q3, respectively. This may be partly due to fact that, generally, households possibly did not feel the strain in their disposable incomes until Q3, which led to these households encashing their savings then (resulting in an increase in Surrender Claims associated with unit-linked products and short-term investments). In addition, due to the abrupt nature of the first lockdown at the end of March 2020, the reporting/ processing of some claim cases may have been delayed to the next quarter. However, the continuing increase in payments to policyholders in Q4 points to COVD-related claims (death and otherwise). These dynamics resulted in a sharp increase in the Claims ratio at the end of CY20.

Profit before Tax increased for the life sector on the back of impressive growth in Investment Income…

Despite the increasing Claims ratio, profitability (Profit after Tax) for the life insurance sector increased by 62.64 percent to PKR 9 billion for the year ended December 31, 2020 on the back of impressive growth in Investment Income. This coincides with the significant increase in Total Investments & Properties mentioned earlier. Despite the decrease in policy rate, Investment Income from government securities was the main driver for growth in Total Investment Income on the back of the 18.01 increase in Investments in Government Securities in CY20.

Table 5.3.1: Soundness of Life Insurance

	Dec-18	Dec-19	Dec-20
		Percent	
Claims Ratio	52.1	51.3	58.3
Equity to Assets	2.0	2.0	1.70
Expense Ratio	26.6	25.8	22.2
Return on Equity	41.3	31.3	45.3

Source: Unaudited/ audited accounts of insurers and IAP data.

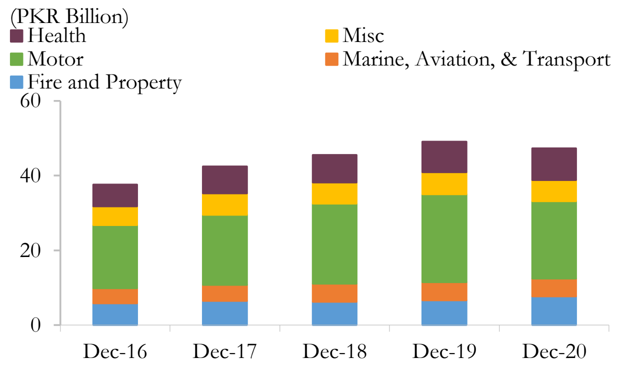
Despite pressures on sales and claims, life sector posted improvement in ROE as Management Expense was curtailed…

Consequently, the life sector showed improvement in Return on Equity (**ROE**) as the Management Expense ratio also went down. This efficiency was partly due to the public life insurer's efforts to curb the renewal expense ratio. Moreover, the leverage (i.e. liabilities to total assets ratio) of the sector slightly increased that also prompted the ROE **(Table 5.3.1).**

The pandemic led to a decrease in Premiums and Claims for the non-life sector…

Due to the imposition of lockdown, Net Premiums for non-life sector declined by a small margin i.e. by PKR 2 billion to PKR 47 billion for the year ended December 31, 2020; mainly driven by a decline in Motor Premiums.

Chart 5.3.5: Net Premiums for Non-Life Sector



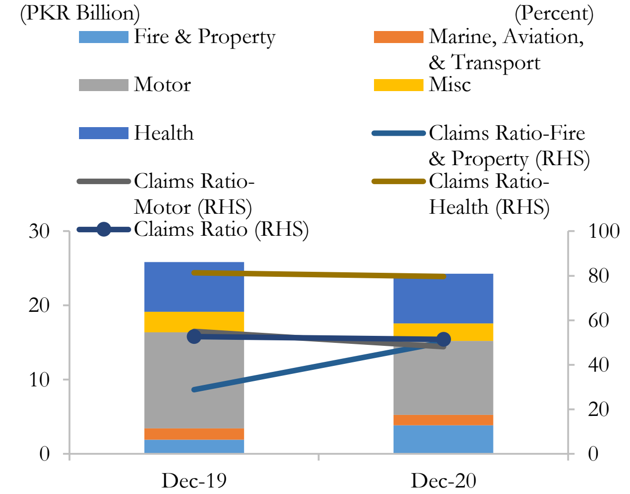
Source: Unaudited/ audited accounts of insurers

Due to lockdowns and slowdown in economic activity, there was a slowdown in both production and sale of vehicles, and lesser volume of import of high-value vehicles that resulted in lower demand for Motor Premium coverage. Accordingly, Motor Premiums decreased from PKR 24 billion in CY19 to PKR 21 billion in CY20 (a 12.10 percent YOY decline) – being the main driver of the decline in overall Net Premiums. Further, the economic slowdown resulted in lower trading activities and steep fall in oil and commodity prices, which affected the Marine, Aviation & Transport portfolio **(Chart 5.3.5).**

Unexpectedly, Fire & Property Premiums registered a YOY increase of 15.90 percent (PKR 1 billion) in CY20, which somewhat reduced the decline in Net Premiums. In addition, Health Premiums increased by 2.56 percent to PKR 8 billion as entities concerned with the medical cost implications of COVID-19 obtained coverage during the year.

Net Claims stood at PKR 24 billion in CY20 on the back of significant decline in Motor Claims, which decreased by PKR 3 billion to PKR 10 billion. As stated above, there was a fall in the business underwritten for the Motor segment, which led to lower Motor Claims. In addition, due to the implementation of mobility restrictions there was low road traffic density resulting in fewer traffic accidents, which may have led to lower claim lodgments. However, Fire & Property Claims registered a massive increase of 102.06 percent to PKR 4 billion in CY20, partly due to the damage caused by torrential rains and floods in Karachi and other areas in August 2020, however, the quantum of these claims remains relatively low. Health Claims, however, remained stable in CY20 at PKR 7 billion **(Chart 5.3.6).**

Chart 5.3.6: Net Claims and Claims Ratio



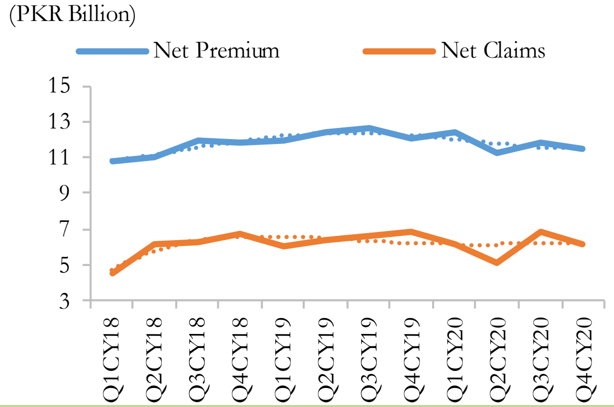
Source: Unaudited/ audited accounts of insurers

Quarterly Analysis points to a dip followed by a surge in Net Claims for the non-life sector in Q2 and Q3, respectively …

Quarterly analysis indicates that Net Premiums and Net Claims for the Non-Life sector tend to follow a pattern over the quarters with Net Claims generally witnessing a slight uptick in Q4 of each calendar year **(Chart 5.3.7).**

However, in CY20 - like Net Claims for the life sector - the Net Claims for non-life sector witnessed a dip in Q2 before witnessing an increase in Q3 of CY20. Here the similarity ends as Q4CY20 registered another dip. The fluctuation may be the result of the imposition of lockdown at the end of Q1, which resulted in slowdown of economic activity (both at global and local levels) and mobility restrictions. The mobility restrictions led to e.g. less Motor Claims due to decrease in business underwritten and low road traffic density in Q2. However, the lifting of lockdown (which led to increased economic activity) and the urban flooding in Sindh in Q3 led to an increase in the amount of Net Claims (particularly for the Fire & Property segment) during the quarter. In Q4, provincial governments once again imposed lockdown in certain parts of the country resulting in another dip in Net Claims.

Chart 5.3.7: Quarterly Growth in Net Premiums and Net Claims of Non-Life Insurers



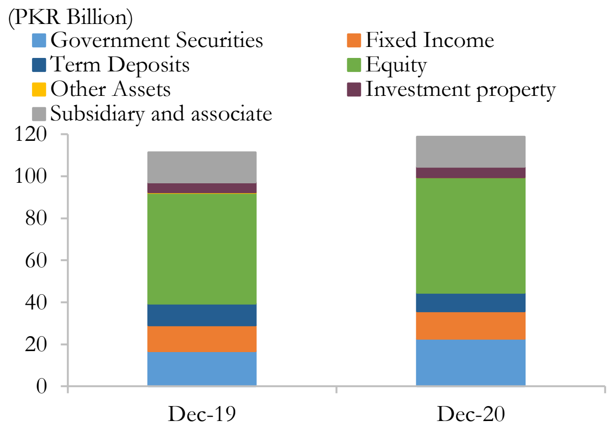
Source: Insurance Association of Pakistan (IAP) data

Underwriting results slightly slackened…

In the backdrop of changes in flow of premiums and claims, the overall Claims ratio slightly decreased from 52.59 percent in CY19 to 51.37 percent at the end of CY20. Segment-wise, Claims ratio for Fire & Property increased from 28.77 percent in CY19 to 50.16 percent in CY20 while Claims ratio for Motor decreased from 54.97 percent in CY19 to 48.07 percent in CY20 **(Chart 5.3.6).**

Consequently, Underwriting results (i.e. premium earned minus claim costs and expenses) for the Non-Life Insurance sector have decreased from 4.3 billion in CY19 to PKR 4.0 billion in CY20, as the subdued Net Premiums were also burdened by an increase in Commission Expense by 12.78 percent to PKR 4 billion.

Chart 5.3.8: Non-Life Investments and Properties



Source: Unaudited/ audited accounts of insurers

Non-Life insurers adjusted their investment portfolios in the wake of low interest rate environment and heightened risks …

The balance sheet footing of the non-life insurers increased by 10.74 percent to PKR 232 billion during the year under review. Investment & Properties which constitute major part of Non-Life insurers' asset base increased by PKR 7 billion (a 6.67 percent overall increase) to PKR 119 billion. In the backdrop of uncertain and low interest rate environment, non-life insurers recalibrated their investments portfolio to balance the returns with underlying risks and liquidity requirements. They reduced their investment in Term Deposits (which offer lower returns) by PKR 1.43 billion during the year, while increasing their investments in Equities (increase of PKR 2 billion) and Government Securities (increased of PKR 6 billion). (**Chart 5.3.8**). Equities, whose relative share in investment portfolio has slightly decreased from 47.36 percent in CY19 to 46.27 percent in CY20, still constitutes the major proportion of Investments followed by Government Securities, which has increased from 15.07 percent to 19.13 percent in CY20.

Besides increase in total Investments & Properties, Insurance/Reinsurance Receivables and Prepayments contributed to the increase in Total Assets of the non-life sector. The former increased by PKR 6 billion (25.04 percent increase) to reach PKR 31 billion while the latter increased by PKR 5 billion (a 26.61 percent increase) to reach PKR 24 billion at the end of CY20.

While the Insurance/ reinsurance receivables represent potential future cash flows, the longer the pandemic lasts (along with the ensuing uncertainty and economic slowdown) the greater is the risks for an increase in impairment of these receivables.

With adjustments in investments, non-life insurers managed to slightly increase their investment income though macro-financial environment remained challenging…

Investment Income has increased slightly by PKR 0.4 billion (a 4.91 percent increase) to PKR 8 billion in CY20, though the prospect of investment income were dampened due to decline in policy rate of 625 basis points and a slowdown in dividend income on some equity investments as distributions from the investee firms slackened during the year.

Table 5.3.2: Soundness of Non-Life Insurance

	Dec-17	Dec-18	Dec-19	Dec-20*
		Percent		
Capital to Assets	12.6	12.6	11.8	11.0
Claims Ratio	51.4	52.0	52.6	51.4
Combined Ratio	89.1	88.6	91.0	91.3
Premium Retention	55.1	54.4	54.0	50.4
Return on Assets	6.7	6.5	6.6	6.0

Source: Unaudited/ audited accounts of insurers.
*Estimated Figures

The key financial indicators represent quite stable performance of non-life sector…

Though the Claims ratio slightly came down during CY20, the overall Combined ratio[174] slightly inched up during the year. This slight increase was due to an increase in Commission Expense. However, this increase in Combined ratio is not necessarily a worrisome trend as it may indicate increasing competition in the sector. Besides, there is still sufficient cushion available for the non-life insurers in their underwriting business **(Table 5.3.2).**

Other soundness indicators have slightly deteriorated in CY20, but are still not cause for significant concern. For instance, the Premium Retention ratio decreased as one significant non-life insurer underwrote the PIA fleet business for the first time resulting in a 67.57 percent YOY increase in overall Gross Premiums for the Marine, Aviation and Transport segment. This particular insurer's general practice is to cede (i.e. to yield business to reinsurers/insurers) a significant portion of its premiums, which does not result in as significant a jump in its Net Premiums.

Nevertheless, there are financially weak insurers, which could represent a buildup of systemic risk in the sector. However, given their small size in comparison to the overall non-life sector (constituting approximately 1.77 percent of total assets), they do not pose any significant risk. Besides, most of these insurers have been directed by the regulator to cease from entering into new insurance contracts, thus limiting their share in Net Premiums and containing any possible contagion to the financial system that, incidentally, is quite minute due to small size of these insurers.

Non-Life insurance sector remained concentrated in terms of market share and earnings …

Despite the presence of more than thirty non-life insurers, the sector is heavily concentrated with the top three insurers, which hold around half of total asset base of this sector and contribute half of its total Net Premiums in CY20. Similarly, the top five insurers hold 70.29 percent of total Assets and contribute 61.22 percent of total Net Premiums.

This includes the public sector non-life insurer, which is a significant insurer at the domestic level; the public non-life company needs to publish its financials for recent years in the interests of market discipline and transparency to gauge its financial health.

The Takaful segment has expanded in recent years …

The Takaful segment over the years has emerged as a promising sector and first choice for Shariah-observant businesses and households. The Family

174 Claim Ratio means claims cost as percent of premium earned, while Combined Ratio represents both claims costs and operating expenses as percent of premium earned.

Takaful and General Takaful segments now hold 13.31 percent and 13.52 percent market share in Net Premiums/ Net Contributions for the overall Life sector (including Family Takaful) and Non-Life sector (including General Takaful), respectively. In terms of market structure, there are five dedicated (or full-fledged) Takaful companies - two Family Takaful and three General Takaful companies[175]. In addition, about twenty-nine (29) Window Takaful Operators or WTOs (i.e. registered conventional insurers authorized under Takaful Rules to carry on Takaful business as window operations in addition to conventional insurance business) operate in the segment.

Family Takaful posted increase in income, which was mainly driven by the WTOs …

The Family Takaful segment comprises two Dedicated Takaful Operators (**DTOs**) and seven Window Takaful Operators (**WTOs**).[176]

Net Contributions for the Family Takaful segment has increased by PKR 2 billion (increase of 8.09 percent) to PKR 28 billion in CY20 on the back of significant increases in the Renewal Contributions for the WTOs. This signifies the growing importance of the WTOs.

Net Claims ratio further increased during the year …

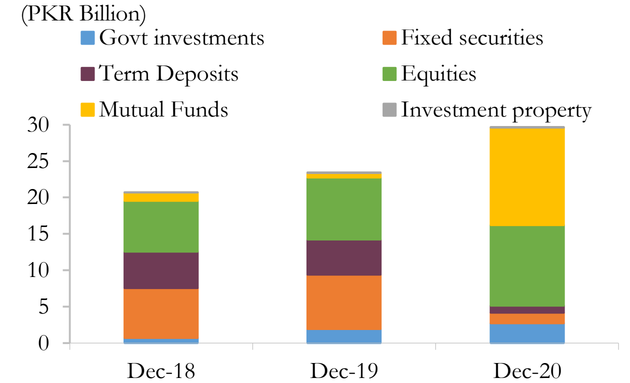
Net Claims for the Family Takaful segment increased by PKR 2 billion to PKR 10 billion in CY20, due to an increase in Net Claims for WTOs; thus, the Claims ratio for the Takaful segment rose to 35.02 percent in CY20 from 29.98 percent in CY19.

Both WTOs and DTOs helped boost the asset base of the Family Takaful segment …

On the back of robust growth in both WTOs and DTOs, the balance sheet footing of the family Takaful segment increased by 26.65 percent during CY20 to PKR 75 billion.

On a standalone basis, the two full-fledged Takaful operators, which hold around half of the segment's assets, increased their asset base by PKR 6 billion to PKR 37 billion at the end of CY20. This growth was driven by investments which increased by PKR 6 billion, while other assets contracted. In an easy monetary policy environment, the Takaful companies recalibrated their assets and investment portfolios, i.e. by divesting majority of investments in Fixed Income securities (decrease of PKR 6 billion) and Term Deposits (decrease of PKR 4 billion), and increasing investments in Mutual Funds (increase of PKR 13 billion) and Equities (increase of PKR 3 billion) which offered higher returns, particularly towards the end of CY20. **(Chart 5.3.9)**

Chart 5.3.9: Dedicated Familty Takaful Operators' Investments



Source: : Unaudited/ audited accounts of DTOs

In the Policyholders' Fund, the Surplus reserve for the year increased by 4.82 percent to PKR 0.3 billion in CY20 on the back of a significant increase in Net realized gains on investments, which covered the increases in Net Takaful Benefits and other Expenses.

[175] However, new business of one dedicated General Takaful company is ceased.

[176] This section cover the two full-fledged Family Takaful companies and WTOs of the five life insurers covered earlier to keep the financial analysis consistent with the rest of the chapter.

Profits of the Family Takaful improved as fee incomes supported the bottom line…

On the other hand, the Profit before Tax for the Shareholders' Fund increased by PKR 0.2 billion to PKR 0.3 billion in CY20; this was mainly due to increases of PKR 0.1 billion each in Wakala Fees and Takaful Operator Fees. Consequently, ROE for the DTOs has jumped from 7.55 percent in CY19 to 16.01 percent in CY20.

General Takaful segment witnessed a decline in Net Contributions on the back of contraction in WTOs' receipts …

Net Contributions for the General Takaful Segment[177] decreased from PKR 7.5 billion in CY19 to PKR 6.6 billion in CY20. A detailed analysis shows that while Net Contributions for the full-fledged General Takaful companies or DTOs increased by PKR 0.6 billion in CY20, the same decreased by PKR 1.5 billion for WTOs. Thus, the decrease in Net Contributions for the WTOs resulted in an overall decrease for the segment. On the other hand, Net Claims for the segment have increased from PKR 4.8 billion to PKR 5.2 billion in CY20 on the back of increased Health claims (by PKR 0.4 billion) for a DTO.

As a result, the Claims ratio for the General Takaful segment has increased from 63.66 percent in CY19 to 78.65 percent in CY20, which is a significant increase.

DTOs in the General Takaful segment have expanded their investment portfolios…

With the new business of one dedicated General Takaful company being ceased, only two Dedicated Takaful Operators are actively underwriting business in the General Takaful segment. In addition, around 22 insurers have been authorized to undertake Takaful business as WTOs.

On a standalone basis, the two full-fledged Takaful companies have increased their asset base from PKR 2.8 billion in CY19 to PKR 3.6 billion in CY20 – an increase of 27.77 percent. The increase was driven by increases in Investments (of PKR 0.3 billion), Deferred Wakala Fees (of PKR 0.2 billion), and Cash and Bank (of PKR 0.2 billion), among others.

Net Contributions contributed to Underwriting Profits of Dedicated General Takaful Operators…

After registering an Underwriting loss in the previous year, the sub-segment posted an Underwriting Profit of PKR 26 million in their Participants' Takaful Fund (**PTF**) on the back of substantial gains in Net Contribution Revenue.

However, due to increases of PKR 91 million and PKR 66 million in Management Expense and Commission Expense, respectively, the sub-segment's Shareholders' Fund registered lower profits (at PKR 35 million) in CY20 (CY19: PKR 44 million). Consequently, ROE for the two Dedicated General Takaful Operators decreased from 4.87 percent in CY19 to 4.09 percent in CY20.

The reinsurance company posted healthy Underwriting Profits in CY20…

The domestic reinsurance sector comprises a public non-life reinsurer.

Despite a YOY decrease in Gross Premium, the company posted healthy Underwriting results (with an increase of 89.81 percent), partly due to a decrease in the Claims ratio **(Table 5.3.3).**

177 This section cover the two active full-fledged General Takaful companies/ Dedicated Takaful Operators and Window Takaful Operators (WTOs) of the 24 non-life insurers covered earlier to keep the financial analysis consistent with the rest of the chapter.

Table 5.3.3: Snapshot of Reinsurance Company

	Dec-17	Dec-18	Dec-19	Dec-20	growth
			PKR millions		
Equity	10,506	9,408	9,829	10,242	4.2%
Investment	9,223	8,634	10,942	12,035	10.0%
Total Assets	24,341	24,459	35,807	35,765	-0.1%
Gross Premium	8,036	10,734	17,655	16,896	-4.3%
Net Premium	5,006	5,464	6,905	6,709	-2.8%
Net Claims	3,740	2,990	4,259	3,924	-7.9%
Underwriting Results	(677)	583	628	1,192	89.8%
Profit Before Tax	2,876	1,730	2,189	1,972	-9.9%
			Percent		
Claims Ratio	**74.71**	**54.72**	**61.68**	**58.49**	

Source: Unaudited/ Audited financial statements of reinsurance company.

However, the healthy increases in Underwriting Profit, Investment and Rental Income and contraction in Claim Ratio, could not stop the decline in Profit before Tax of 9.91 percent in CY20 as the amount of Other Income remained lower than last year. Incidentally, last year's Other Income comprised substantial one-off gains, which bolstered the profits in that year. Accordingly, the deceleration in profitability during CY20 may not reflect deterioration in operating efficiency.

Direct linkages between the insurance sector and the banking sector are minimal…

Besides having WTOs, some insurers are interconnected with other insurers and banks. The relationships for the subject insurers can range from being a bank's associate, to another insurer's subsidiary, to being part of the same financial group/ conglomerate along with other financial institutions.

Detailed assessment of insurance sector's intra- and inter-sectoral interlinkages indicates that no life or non-life insurer can be classified as a bank's subsidiary as it not permitted under the law. Barring one bank (having 18.50 percent shareholding in one life insurer), banks do not have significant shareholdings in the life sector; however, around six banks have material shareholdings (of 9% to 30%) in non-life insurance companies.

While one life insurer is a subsidiary of its associated non-life insurer, five life insurers are subsidiaries/ associates of their parent companies' financial groups (along with their non-life counterparts). The public life insurer also has shareholding of 24.41 percent in the non-life reinsurer. Two non-life insurers have significant shareholdings (more than 20 percent shareholding) in their associated life insurers. At least two non-life insurers have material shareholdings in each other's share capitals (approximately 8% and 14%).

Besides direct equity participation in the share capital of insurance firms, banks have provided financing of PKR 6 billion to the insurance sector in CY20, which constitutes only 0.06 percent of total gross loans of the banking sector.

Given the small size of bank's ownership and exposure in the insurance sector, the risk of contagion from this channel may be considered minimal. However, many banks and insurers are associated entities belonging to the same financial groups and can be a conduit for transfer of contagion risks due to reputational issues. Moreover, any overall weakening of group's financial standing could impair the sponsors' ability to support the prudentially regulated firms. In addition, a moral hazard exists that the banks may prefer their associated insurance firms while insuring assets obtained as collateral against loans and financing. Although, in such cases, banks' primary exposure is on the borrowers and the same exposure is well diffused; further, the banks are required to deal at arm's length basis and have adequate risk management policies to address any concentration issues.

Growth and performance in near future will depend upon the dynamics of pandemic and general economic conditions…

Given the uncertainty surrounding the domestic vaccination campaign and the emergence of new strains of COVID-19, it is expected that economic activity (and thus, insurance growth) will remain dependent upon the situation of the pandemic and nature of precautionary measures. Since COVID-19 is a significant health catastrophe, Net Claims are expected to remain elevated in life insurance, in the near future. Moreover, in the wake of any surge in the pandemic and lockdowns, the insurance markets are expected to harden resulting in higher premium rates, particularly for the non-life sector. The increase in combined ratio for the non-life sector substantiates this claim.

Section C: Performance and Risk Analysis of Other Sectors

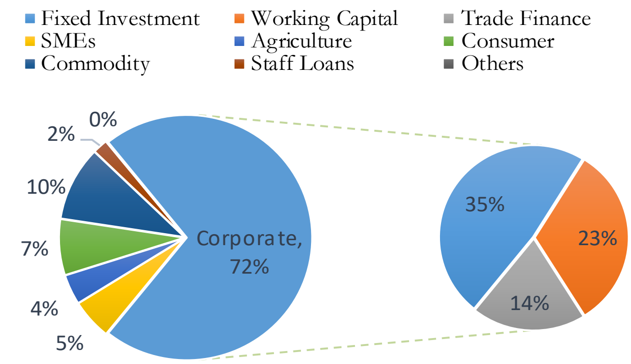
Chapter 6: The Corporate Sector

The overall performance and standing of non-financial corporate sector remained positive in CY20 though the ongoing pandemic posed significant challenges in terms of operating environment and supply chain constraints. A sample of top-100 listed firms witnessed improvements in their profitability, liquidity and solvency indicators while sales and business turnover indicators slackened due to weakened demand. Disaggregated analysis highlighted that automobiles, energy and oil & petroleum sectors faced notable contractions in sales. The investors' perception about the corporate sector oscillated with the outbreak of pandemic but confidence was restored by the year-end. Besides, the probability of default of selected firms slightly subsided and its levels in general remained on the lower side. The concerted efforts of the policy makers, however, may further improve the environment related to ease of doing business. Going forward, the dynamics of the ongoing COVID-19 pandemic and both coverage and effectiveness of vaccination drive will be the strong determinants of the corporate sector's performance.

Strong relationship between the corporate sector and the banking sector continues…

Banking sector remains the major financier of non-financial corporate sector of the country as the depth and outreach of capital market remains on the lower side. Amidst the pandemic, the interconnectedness between the corporate and the banking sectors further deepened as 71.58 percent (PKR 6.08 trillion) of the banks' domestic loan portfolio at the end of CY20 constituted non-financial corporations (**Chart 6.1**). Therefore, adverse shock in any of the economic sectors, which has significant borrowing from banks, can adversely affect the operating performance and solvency of the banking sector. Even deterioration in a sector, which otherwise is not a major borrower, can affect the overall economy due to its various linkages and may create stability issues for the banking sector.

Chart 6.1: Segment wise distribution of domestic advances, as of end December 2020



Source: SBP

As per the prevailing market practices, only the financial statements of the listed entities were publicly available, thus, this detailed assessment of the corporate sector's financial soundness and performance is based on the financial statements of selected top 100 listed non-financial firms representing companies from different economic sectors. In aggregate, these entities comprise 73.42 percent share in the asset base of all the listed companies. The listed companies have more formal and organized corporate governance structures and share their financials with external stakeholders and represent different sectors of the economy. The insights gained from the analysis of this sample firms presents a fair view of the standing and performance of overall corporate sector.

Despite pandemic, the overall performance of corporates recovered in CY20…

During the period under review, the pandemic posed a paramount health challenge across the globe. To curtail its impacts, almost all the nations introduced lockdowns, mobility restrictions measures and social-distancing protocols, bringing the world economic activity to a halt. As a result of these measures, supply-side issues spawned, cost of inputs surged and demand for goods and services sapped. Thus, the cash generation and debt servicing capacity of household and corporate sector endured significant pressure **(Chapter 1 and Chapter 3.1)**. Like most of the jurisdictions, the SBP introduced a host of measures to mitigate adverse impact on economic activity and employment in the economy, facilitate the liquidity of the borrowers and support the flow of bank credit and liquidity in the market.[178] Such support measures acted as the cushion to absorb downsides of the pandemic.

There was deceleration in the growth of corporate sector's assets (8.82 percent growth in CY20 against 12.41 percent in CY19) and domestic sales went down by 0.08 percent **(Table 6.1)**[179]. However, owing to cut in interest rates and policy measures to support the long-term credit and investment, corporate sector long-term borrowings increased, though it reduced current portion of long-term loans due to deferment and rescheduling relief given by SBP.

Nevertheless, , the corporates were able to improve profits after tax, primarily, backed by cut in interest expenses, which particularly started to reduce in the latter part of the year, and efficiency in administrative expenses and cost of goods sold (COGS).[180] Improved profits coupled with SBP support measures eased the pressure on the debt repayment capacity of the firms and compensated for the weakened demand, which also reflects in lower asset turnover for CY20.

Moreover, the liquidity indicators (e.g. current ratio) improved due to short-term investments and reduction in short-term borrowings and liabilities. The increase in short-term investments and assets hints at the tendency of the firms to maintain higher liquidity in the face of economic uncertainties during the pandemic.

Overall, the assessment indicated preservation of financial soundness and stable operating performance by the top 100 corporates.

Performance of various sectors remained mixed…

A few sector-specific risks and probable threats were the highlight of CY20. Cement sector faced risk of price hikes for coal, which is a major input for cement industry. Energy and oil sectors confronted with the challenges associated with circular debt issues. Auto sector faced rise in competition and threat to profit margins as the international players entered the market. Textile sector faced the exchange rate risk due to rise in imports of cotton to fill in the gap created by declining local production of cotton.

While the investors' confidence remained intact…

Market sentiments mainly reflected the changing macro-financial dynamics as indicated by high volatility in KSE-100 index during the year **(See Chapter 2)**. As a result, by the end of CY20, the credit worthiness of firms stabilized as reflected in improved credit ratings of selected firms, while investors' confidence reflected in improved market-based indicators.[181]

[178] Besides the govt. various schemes and packages, State Bank of Pakistan cut the policy rate by 625 bps and allowed payment holiday on principal amount of loans, rationalized prudential standards for restructuring of pandemic-stricken loans, and introduced different concessionary refinance schemes e.g. temporary economic refinance facility, refinance facility to combat covid-19 for hospital etc., Rozgar scheme to preserve the employment.

[179] For CY20, the detailed financial position and performance of the selected companies are based on their financial of September 2020 quarter. The data of earnings and expenditure was projected/annualized to arrive at annualized indicators of returns e.g. ROE, etc.

[180] Interest expense makes up 18.8 percent share of after gross profit costs of the corporates including administrative expenses, interest, financial expenses and tax expenses.

[181] Further, most firms fell under investment grades.

Table 6.1: Financial Statements of PSX Listed Companies and Ratio Analysis

	Q3 CY18	Q4 CY18	Q1 CY19	Q3 CY19	Q4 CY19	Q1 CY20	Q3 CY20	*growth YoY*
				PKR billions				
Balance Sheet								
Non-Current Assets	3,043	3,115	3,187	3,344	3,501	3,534	3,676	*9.9%*
Net Operating fixed assets	*2,372*	*2,413*	*2,491*	*2,591*	*2,722*	*2,751*	*2,814*	*8.6%*
Intangible assets	*165*	*162*	*160*	*160*	*172*	*171*	*166*	*3.8%*
Long term investments	*383*	*410*	*411*	*453*	*460*	*450*	*515*	*13.7%*
Other non-current assets	*124*	*130*	*125*	*141*	*147*	*162*	*181*	*28.3%*
Current Assets	3,350	3,438	3,534	3,754	3,866	4,041	4,048	*7.8%*
Cash & bank balance	*202*	*190*	*210*	*198*	*218*	*218*	*219*	*10.3%*
Inventories	*704*	*701*	*748*	*728*	*735*	*739*	*637*	*-12.5%*
Trade Debt / accounts receivables	*1,366*	*1,405*	*1,402*	*1,577*	*1,641*	*1,733*	*1,767*	*12.1%*
Short term loans and advances	*122*	*120*	*131*	*116*	*129*	*134*	*134*	*15.9%*
Short term investments	*202*	*208*	*200*	*182*	*165*	*189*	*328*	*79.6%*
Other current assets	*753*	*814*	*843*	*952*	*978*	*1,028*	*963*	*1.1%*
Total Assets	6,393	6,553	6,721	7,098	7,366	7,575	7,724	*8.8%*
Shareholders' Equity	3,032	3,032	3,118	3,211	3,290	3,309	3,497	*8.9%*
Issued, Subscribed & Paid up capita	*547*	*552*	*553*	*554*	*562*	*575*	*567*	*2.5%*
Reserves	*2,312*	*2,307*	*2,393*	*2,474*	*2,546*	*2,570*	*2,724*	*10.1%*
Surplus on revaluation of fixed assets	*174*	*174*	*172*	*183*	*182*	*164*	*206*	*12.1%*
Non-Current Liabilities	843	878	924	968	1,050	1,088	1,191	*23.1%*
Long term borrowings	*412*	*466*	*483*	*482*	*558*	*594*	*680*	*41.1%*
Subordinated loans / Sponsor's loans	*4*	*7*	*8*	*7*	*7*	*6*	*5*	*-18.5%*
Debentures/TFCs (bonds payable)	*2*	*1*	*1*	-	-	-	-	*0.0%*
Employees benefit obligations	*70*	*79*	*75*	*80*	*87*	*85*	*84*	*4.2%*
Other non-current liabilities	*355*	*325*	*357*	*398*	*399*	*403*	*422*	*5.8%*
Current Liabilities	2,518	2,642	2,679	2,919	3,026	3,178	3,036	*4.0%*
Trade credit & other accounts payabl	*1,463*	*1,464*	*1,499*	*1,639*	*1,696*	*1,746*	*1,851*	*13.0%*
Short term Borrowings	*668*	*808*	*769*	*869*	*915*	*994*	*728*	*-16.2%*
Current portion of non-current liabilit	*166*	*170*	*176*	*167*	*181*	*164*	*164*	*-1.8%*
Other current liabilities	*221*	*200*	*235*	*245*	*235*	*274*	*292*	*19.4%*
Total Equity & Liabilities	6,393	6,553	6,721	7,098	7,366	7,575	7,724	*8.8%*
Income Statement								
Sales	1,523	1,561	1,439	1,525	1,566	1,365	1,523	*-0.1%*
Local sales (Net)	1,509	1,551	1,429	1,505	1,549	1,351	1,504	*-0.1%*
Export sales (Net)	14	9	10	19	17	14	19	*-1.1%*
Cost of sales	1,257	1,304	1,185	1,271	1,307	1,143	1,243	*-2.2%*
Gross profit / (loss)	266	257	253	254	259	223	280	*10.3%*
General, admin. & other expenses	167	181	101	104	122	101	101	*-2.8%*
Other income / (loss)	29	52	32	38	43	43	39	*2.6%*
EBIT	127	127	184	188	180	164	218	*16.0%*
Financial expenses	27	37	36	46	51	57	34	*-25.5%*
Profit / (loss) before taxation	101	90	149	142	129	107	184	*29.4%*
Tax expenses	48	41	43	43	50	38	46	*4.7%*
Profit / (loss) after tax	53	49	106	99	79	69	139	*40.2%*
Financial Ratios								
Gross Profit Margin (%)	17.46	16.44	17.62	16.65	16.53	16.30	18.38	
Net Proft Margin (%)	3.49	3.16	7.37	6.49	5.04	5.09	9.10	
Return on Equity (%)	7.02	6.51	13.60	12.32	9.59	8.39	15.86	
Return on Assets (%)	3.33	3.01	6.31	5.57	4.28	3.67	7.18	
Current Ratio (units)	1.33	1.30	1.32	1.29	1.28	1.27	1.33	
Asset Turnover (%)	95.31	95.26	85.63	85.93	85.04	72.09	78.90	
Capital to Total Assets(%)	60.61	59.68	60.14	58.87	58.92	58.05	60.70	
Debt Equity Ratio (units)	1.11	1.16	1.16	1.21	1.24	1.29	1.21	
Debt to Capital Employed (units)	0.87	0.90	0.89	0.93	0.94	0.97	0.90	
Interest Coverage Ratio (units)	4.80	3.42	5.18	4.11	3.53	2.88	6.40	
Financial Leverage (units)	2.11	2.16	2.16	2.21	2.24	2.29	2.21	

Source: SBP

*Data of 100 companies were used that represent 73% of total assets of all listed non-financial entites

Corporates managed their costs effectively in the wake of difficult operating environment…

The consolidated financial statements exhibited augmented profits, despite dip in both local sales and exports. However, the corporate firms benefited from the significant cut in interest rates. In addition, corporates managed to make a marked reduction in their administrative and general expenses along with lower COGS. This reduction in costs led to improvement in profit margins and bottom line, as the after-tax profit of the selected large firms for Q3CY20 was 40.20 percent higher than the corresponding quarter of last year and ROE improved to 15.86 percent. The higher earnings and EBIT further augmented the debt repayment capacity for these corporate firms to 6.40 times in Q3CY20 (from 4.11 times in Q3CY19).

Growth in assets base decelerated during the year …

The growth of the asset base of the corporate sector decelerated to 8.82 percent in CY20 compared with 12.41 percent growth in CY19. Primarily, the current assets caused the slowdown, as the firms needed lesser amount of working capital in the wake of the pandemic. Inventory levels dropped significantly due to demand and supply constraints as well as the efforts of the firms to optimize the use of inventory in the face of uncertainties.

On the other hand, long-term borrowings augmented owing to drop in interest rates and funds borrowed under refinance schemes to support the long-term investment. Whereas, short-term borrowings declined due to lesser demand for inventories, inputs, and possibly better management of working capital in times of crisis. This phenomenon also reflects in the marked acceleration in banking sector's domestic lending to corporate sector for fixed investments, and decline in working capital loans (**see Chapter 3.1**). However, trade credit and other account payables increased by 12.73 percent in CY20 (11.47 percent in CY19). Thus, corporates replaced short-term borrowings with trade debts and payables. This ability of the high-end corporates to shift the funding to interest-free trade credit also reflects their bargaining power in the supply chain of production process.

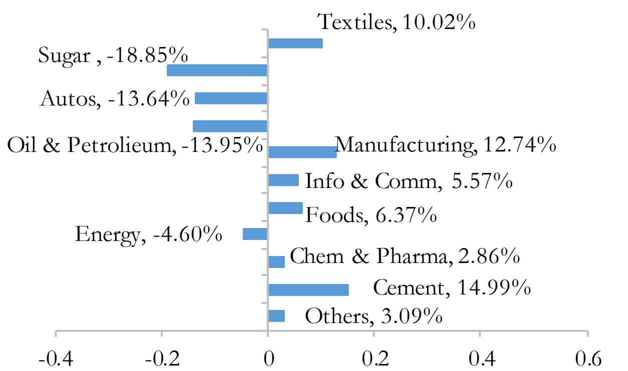
While the domestic focused firms witnessed decline in sales, the export-oriented ones benefited…

Prevailing pandemic worsened the macroeconomic dynamics, which adversely influenced the sales performance of the corporations during CY20. The total domestic sales in Q3CY20 were lower by 0.08 percent as compared to Q3CY19. During the first half of CY20, the domestic sales to fall by 5.14 percent. However, during Q3CY20 economic activities were restored with precautionary measures and various support measures started to mark their impact; accordingly, the output and sales started to recover. However, this recovery was not enough to make for the earlier hit during the first wave.

On the other hand, the alignment of exchange rate with market fundamentals increased the export competitiveness. Though, the pandemic-induced disruption in international trade was more severe the early resumption of business activities enabled the firms to capture the exports orders. Accordingly, the export demand made a quick recovery and exporters started to gear up their efforts to capitalize on this opportunity. However, because of the significant disruptions in supply chain and production process, the aggregate export sales of these firms for Q3CY20 were marginally (1.14 percent) lower than in the corresponding quarter of last year. However, detailed analysis and latest market information shows that the exports of these firms are following upward trend.

Chart 6.2: Sector-wise Sales Growth, CY20

(Percentages)



Source: SBP

The divergence in sales was quite visible among various economic sectors as well. Sugar, oil & petroleum, automobile and energy sectors experienced more stress. Together, they accounted for around 51.04 percent of the total corporate sector sales. On the contrary, firms in sectors like textiles, manufacturing, cement etc., which serve both domestic and foreign markets observed rise in sales **(Chart 6.2)**.

Debt repayment capacity improved towards the end of year and remained in comfortable zone…

Due to higher Earnings before Interest and Taxes (EBIT) and lower financing costs, the debt repayment capacity of the corporate sector started to improve markedly in the latter part of the year and remained in comfortable zone. The interest coverage ratio inched up from 4.11 in Q4CY19 to 6.40 in Q3CY20 **(Table 6.2)**. The solvency indicator, in terms of capital to total assets, appreciated marginally during the reviewed year, as the growth in capital levels was greater than rise in asset base. Accordingly, the debt equity ratio remained stable despite significant increase in long-term borrowings.

Table 6.2: Key Financial Indicators

	CY18	CY19	CY20
Profitability; Return on Equity (%)	7.02	12.32	15.86
Liquidity; Current Ratio (units)	1.33	1.29	1.33
Operational Effeceincy; Asset Turnover (%)	95.31	85.93	78.90
Solvency; Capital to Total Assets (%)	60.61	58.87	60.70
Leverage; Debt Equity Ratio (units)	1.11	1.21	1.21
Debt Repayment Capacity; Interest Coverage Ratio (units)	4.80	4.11	6.40

Source: SBP

Profitability improved due to enhancement in operating margin and reduction in financial costs and taxes…

The Return on Equity (**ROE**) of selected large firms increased from 12.32 percent in CY19 to 15.86 percent in CY20 **(Table 6.3)**. The Extended DuPont analysis revealed that improvement in operating profit margin partially absorbed the dampening impact of deterioration in the asset-usage efficiency, which deteriorated due to subdued sales. Moreover, decease in tax burden and financial costs led to the improvement in ROE.

Table 6.3: Extended DuPont Analysis

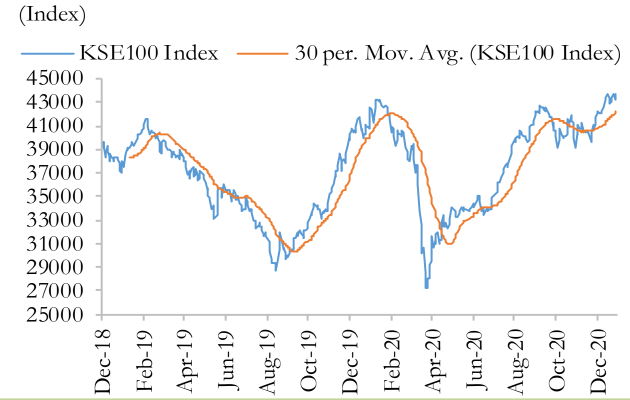
	CY18	CY19	CY20
Tax Burden (A)	0.53	0.69	0.75
Interest Burden (B)	0.79	0.76	0.84
Operating Profit Margin (C)	0.08	0.12	0.14
Asset Use Effeciency (D)	0.95	0.86	0.79
Financial Leverage (E)	2.11	2.21	2.21
Return on Equity (ROE) % (AxBxCxDxE)	**7.02**	**12.32**	**15.86**

Source: SBP

Market sentiments reflected the changing economic conditions…

KSE-100 index and its dynamics are used as proxy to gauge the market sentiments about the current and future performance of the corporate firms operating in Pakistan **(Chart 6.3)**. The CY20 commenced on a strong note witnessing approximately 41 percent recovery in the index from its low witnessed back in August 2019. At the end of February 2020, the pandemic surfaced in Pakistan and soon became a significant health and economic challenge for the nation. This slowdown also reflected in KSE-100 performance and the index lost 34.23 percent of its value in March 2020 compared with its level at the beginning of the year. Various economic support packages and relief measures helped the equity market to make V-shape recovery and the CY20 ended on the positive note with 60.70 percent increase in KSE-100 index from the lowest mark of March 2020. **(See Chapter 2)**.

Chart 6.3: KSE-100 Index



Source: PSX, SBP

Cement sector's overall performance and prospects turned positive by the end of CY20…

As the situation improved in Pakistan, the government allowed the resumption of construction activities quite early on. Moreover, the government announced incentive packages, which included, construction package, housing schemes and lower FED on cement. Cumulatively, these reforms have multiplied the gains for the cement sector entities in terms of local demand. Government policies focused on the construction sector and SBP's instruction to banks for allocating at least 5% of their domestic loan book for financing of housing and construction related projects positively contributed towards demand in cement sector.

On the export front, anti-dumping duty by South African authorities on exports from Pakistan were scheduled to end in the mid of December 2020.[182] While producers in South Africa are pursuing continuation of the imposed anti-dumping duties, in case these duties expire, it is expected to re-open a door for Pakistan cement exports. The exchange rate adjustment supported the price competitiveness of the sector; however, exports were only a nominal part of the aggregate cement sales during CY20. The outlook of the sector seems positive amidst the upbeat construction activities in the country. The hike in prices of inputs especially of coal could pose a threat to cement sector margins as it accounts for 40 to 50 percent of cost of goods sold, while increase in interest rates can also burden the bottom line of the sector.

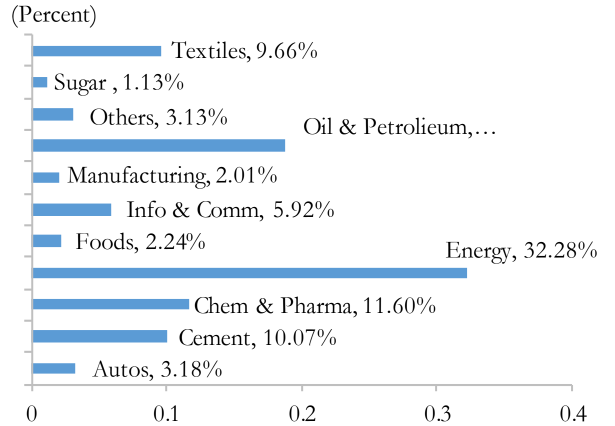
Power sector is likely to resolve trade debt…

Power sector continued to hold the major share of asset in corporate sector during CY20 among the sampled firms **(Chart 6.4)**. Though the operational performance of the power sector improved, it remained susceptible to the constraints posed by the rising circular debt.[183] The circular debt has reached PKR 2.33 trillion in CY20 (5.54 percent of GDP) starting from PKR 1.88 trillion by the end of CY19.[184] Increasing level of circular debt created liquidity crunch for the power sector entities and led to borrowing and additional financial costs.

To counter the liquidity issues, government and Independent Power Producers (**IPPs**) have signed MoUs to alter existing working arrangements (Power Purchase Agreements) and tariffs in order to reduce the burden of annual capacity payments and clear outstanding receivables of power producers. The government expects significant amount of savings in tariffs over the remaining life of these plants after these MoUs are converted into agreements. IPPs will benefit as they receive their outstanding trade debts.

While adjustments in electricity tariffs may help in curbing the buildup of circular debt, however, effective resolution of the issue require concerted efforts for curtailing the transmission and distribution losses.

Chart 6.4: Asset-wise break-up of sectors



Source: SBP

Oil & Gas sector remained under stress as well…

Oil & Gas is the leading sector in terms of both market capitalization as well as the quantum of borrowings from the banking sector. During the period under review, the local production of hydrocarbon failed to pick up despite the resurgence in oil demand and economic activity. Overall oil and gas production declined by 14 percent and 8 percent, respectively on year-on-year basis[185]. To counter the depleting reserves,

[182] South Africa was used to be a major destination of cement dispatches. South Africa imposed anti-dumping duties on Pakistan based cement on Dec 2015 due to allegations of 'dumping' by Pakistani cement producers. Currently, they are under review by International Trade Administration Commission of South Africa (ITAC). However, the producers in South Africa are pursuing the authorities to extend the duties on Pakistan cement imports to secure their industry and impose duty on China and Vietnam imports of cement.

[183]Rise in circular debt is due to recovery shortfall of electricity bills, structural issues in transmission and distribution network, delayed tariff adjustments and low usage of power plants.

[184] Ministry of Energy, Power Division http://mowp.gov.pk/userfiles1/file/CircularDebtReport21.pdf

[185] Optimus Capital Management, Market Strategy 2021

government has invited bids for 20 exploration blocks. It is anticipated that increase in exploration activity will help in enhancing the oil and gas production, and address the issues of depleting reserves.

Due to the closure of economic activities for few months in CY20, the petroleum sales witnessed overall decline in CY20. However, they registered improvement by the end of CY20 in sales figure. The recovery is mainly driven by uptick in passenger car sales, LSM growth and drop in international oil prices during the first half of CY20. High Speed Diesel (**HSD**) demand surged during the year due to government's efforts to curb the flow of smuggled cheaper Iranian products that drastically declined due to closure of border amidst pandemic and relaxation in transportation ban.

In CY20, government proposed new pricing mechanism of revising prices of Motor gas and HSD on a fortnightly basis in order to minimize the price volatility driven from exchange rate and international oil prices.

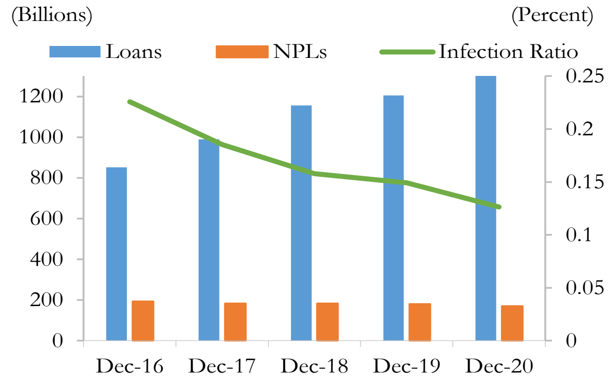
Textile sector enhanced their exports by the end of CY20…

Textile sector, being the major export-oriented sector, benefited most from the government's enabling policies, especially the subsidized utility tariffs, low interest rates and sales tax refunds. Besides higher credit offtake, the NPLs and infection ratio of the sector also witnessed declining trend **(Chart 6.5)**. Further, early easing in domestic lockdowns compared to regional countries and the US-China trade spat has enabled the sector to capture export orders and increase exports.

Given that domestic industry relies heavily on natural fiber whose local production is on the decline, the hike in the cotton prices, along with significant exchange rate appreciation against US dollar might hurt the profit margins of textile sector.

Nevertheless, new textile policy might play a pivotal role in improving exports and international competitiveness of the sector.[186] The policy includes subsidized borrowing rates, reduced power tariffs and support for SMEs.

Chart 6.5: Textile sector loans, NPLs and infection ratio



Source: SBP

Automobiles sector closed CY20 on a positive note in terms of sales volume…

Automobiles sector sales, which faced challenges during the first half of CY20 because of dwindling consumer demand, rebound in the second half. Among various supply-side and demand-side factors, auto financing remained the primary driver of increased demand and sales. Presently, auto financing comprises of approximately 35 to 45 percent of total auto sales.[187] Further, the prevailing low, single digit interest rate is expected to drive the sales volume and demand in positive direction.

Nevertheless, PKR depreciation led to massive hike in the vehicle prices over the last year that

186 Textile and Apparel Policy 2020-25, it will replace previous 2014-19 policy. The new textile policy contains subsidies and lower tax rates. The electricity and gas tariffs will be consistent during the period of the policy. The objective of the policy is to boost exports for textiles and apparels.

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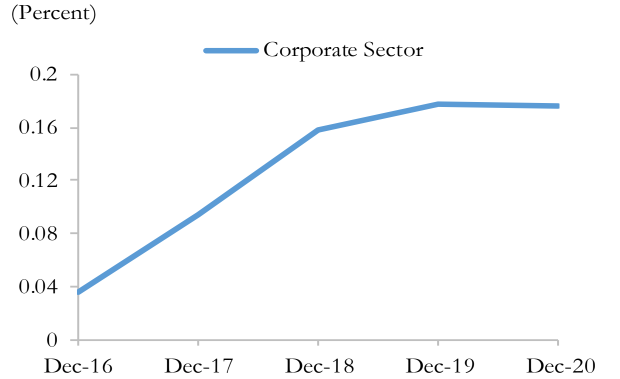
affected the demand. Further, supply chain issue originating from Asian ports has led to air shipping of parts, which involves higher input costs and cut in gross margins.[188]

Additionally, increase in competition due to new entrants, Kia, Hyundai, Changan and MG, and sanction of Electric Vehicles policy was expected to put downward pressure on the prices of vehicles. However, currency devaluation and changes in the interest rates remains important determinants of price and demand for vehicles and ensuing performance of the sector.

Probability of default for the corporate sector slightly declined …

The weighted average 1-year PD of selected firms of the corporate sector slightly declined to 0.176 percent in CY20 (0.178 percent in CY19) **(Chart 6.6).**[189] The fall was primarily due to the general improvement in the overall performance and outlook for these firms, which was mainly enabled by timely government reforms and policies to support the economic activity. Improvements in operating performance of these firms increased investors' confidence—bolstered by successful recovery of macro-economic variables— and contributed to the fall in default probabilities. Further, the level of PDs, itself, is at the lower side and does not pose notable default risk to the lenders. As such, these corporate firms maintained strong financial soundness and decent operating performance despite challenging macro-financial conditions.

Chart 6.6: Weighted avg 1 year PD of Corporate Sector



Source: Bloomberg, SBP

Repayment behavior and financial standing of the leading borrowers remains strong…

A brief analysis of banking sector's top 30 borrowing firms indicates that banks seem to have higher exposures on large groups due to their better credit worthiness (**Box 6.1**). The COVID-19 pandemic and consequent lockdowns during CY20 raised significant challenges for borrowing firms in terms of operating environment and demand and supply constraints. However, due to early resumption of economic activity during latter half of CY20 and enabling support measures from central bank and government, the firms have largely weathered the impact of the pandemic.

Credit rating culture showed improvement…

In recent years, the rating culture among large firms has shown improvement, as firms tend to get themselves rated. During the reviewed year, this trend got further traction as the number of rated firms further increased: out of 314 non-financial listed entities, about 80.9 percent of them were rated in CY20 as against 77.17 percent in CY19.[190] However, in the universe of all registered public companies, the rated companies were merely 14.37 percent, which is still on the lower side. This is because many companies in Pakistan rely on

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188 The supply chains issues included shortage of shipping containers, hike in freight charges, delay in shipments and port congestion due to lockdowns in various countries around the globe.
189The PD (1 Year PD) is mainly driven by the quality of firm's liquidity management and ability to honor short-term obligations. The PD is calculated using Merton Model, which uses value of equity and volatility of equity to measure default probability.
190 In CY19, out of 311 non-financial listed entities only 77.2 percent were rated.

indirect source of financing like banks or their internal sources (profit plough backs etc.) and rely less on capital market for their funding needs. Out of all the rated companies in the country, major chunk of the companies lies in investment grades (AAA to BBB-), which advocates high credit quality in terms of long-term ratings **(Table 6.4)**.

Table 6.4: Ratings of Companies in CY19 & CY20

Long-term			Short-term		
Ratings	**CY19 %**	**CY20 %**	**Ratings**	**CY19 %**	**CY20 %**
AAA	3.3%	3.1%	A1+	20.0%	20.1%
AA+	4.2%	4.3%	A1	26.3%	24.4%
AA	8.3%	9.1%	A2	40.0%	43.3%
AA-	7.5%	7.9%	A3	12.9%	11.4%
A+	7.5%	6.3%	Others	0.8%	0.8%
A	12.9%	13.0%			
A-	25.4%	26.0%			
BBB+	8.3%	8.3%			
BBB	10.4%	11.0%			
BBB-	5.8%	7.9%			
Others	6.3%	3.1%			

Source: PACRA, JCR-VIS

Whereas, in terms of short-term ratings, majority of the companies were rated as A2 that represent satisfactory capacity for timely repayment.[191] Companies rated in this category might be vulnerable to adverse changes in business, economic and financial conditions.

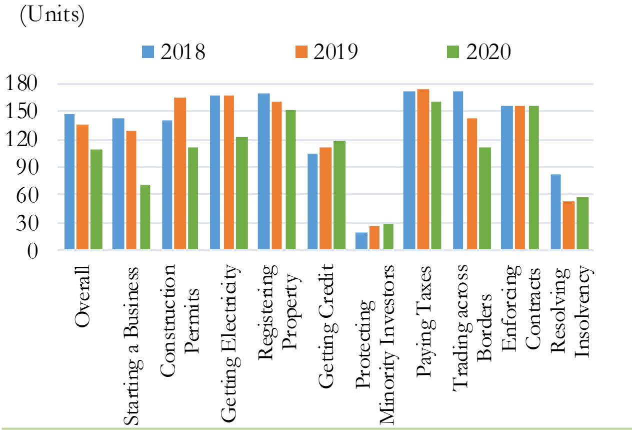
Ease of Doing Business ranking improved by 28 points…

Government of Pakistan has been making efforts to improve the ease of doing business. Over the last couple of years, there has been marked improvement in country's ranking on World Bank's "Ease of Doing Business" index. The country's ranking improved notably by 28 points from 136 to 108 on World Bank's Ease of Doing Business Index.[192] The score improved on account of getting electricity, trading across borders, construction permits and starting a business **(Chart 6.7)**.

Other areas where score improved included registering a property and paying taxes. Enhancement in the functionalities of the online one-stop shop by Government of Pakistan aided in starting a business segment. Furthermore, introduction of online payment of tax via internet banking, debit cards and Automated Teller Machines (ATMs) streamlined the tax payment process. Introduction of online mobile app further bolstered the filing of tax returns.

Moreover, integration of various agencies in the Web-Based One Customs (**WEBOC**) electronic system and processing of consignments through the Green Channel improved the score in the segment of trading across borders. Enhancement in the approval process and regular building quality inspections made procurement of construction permit relatively easier and safer. Additionally, the enforcement of service delivery time frames, launch of an online portal for new applicants and transparency in electricity tariffs enhanced the getting electricity segment.

Chart 6.7: Ease of Doing Business - Rankings



Source: World Bank, SBP

Improvements in the Doing Business rankings and establishing macroeconomic stability will send a

191 PACRA. (2020). Rating Scale. Pakistan, March. http://www.pacra.com.pk/uploads/doc_report/PACRA_Rating%20Scale_Corporate_FY18.pdf

192 World Bank. (2020). Doing Business 2020: Economy Profile Pakistan. Pakistan, March https://www.doingbusiness.org/content/dam/doingBusiness/country/p/pakistan/PAK.pdf

message to SMEs and large investors that Pakistan is open for business and will remain globally competitive. Furthermore, reforming regulations and procedures, improving ease of paying taxes and establishing an online business portal will improve the business environment in the country. Moreover, female entrepreneurship needs to be encouraged to establish business that will also aid in progressive formalization of the economy.

Outlook for the corporate sector rests on pandemic dynamics…

Due to the pandemic and dampened economic activities, the operating enviroment remained quite challenging for the corporate seector during the year under review. However, the corporate sector has successfully weathered these challenges and ultimately posted better operating performance. Going forward, the performance of the corporate sector will largely depend upon the dynamics of the pandemic, effectiveness of vaccination drive, and the associated impacts on macro economy.

Box 6.1: Repayment Behavior and Financial Standing of Leading Borrowing Group of Banking Sector

Introduction

The large private sector corporate firms have always been major borrowers from the banking sector. The SBP has set concentration limits on the banks' exposure to single borrower and borrowing groups as well as aggregate limit on large exposures. As of end CY20, 71.58 percent of the banking sector loan were extended to corporate segment. Among these, delinquencies in large corporate borrowers and borrowing groups could have systemic repercussions for banking sector due to the large size of the exposure and borrowings from multiple banks. Therefore, the financial health and performance of large borrowers and borrowing groups is quite crucial for the stability of the banking system. In this box, repayment behavior and capacity as well as overall financial health of large borrowers and borrowing groups of the banking system have been analyzed based on the following:

a. Banks' own assessment of large borrowers and borrowing groups' credit worthiness as captured through Obligor Risk Rating (ORR) of borrowers assigned by banks.
b. Borrowers' repayment behavior in terms of any overdue in the payment of their obligations to banks.
c. Latest financial indicators and market-based indicators of leading corporate borrowers of the banking system[193].

Assessment of Credit Worthiness

The credit worthiness was assessed for top 30 borrowing groups (comprising 249 firms) based on Obligor Risk Rating (**ORR**) assigned by banks. Identified firms of these groups hold around 22.99 percent of the corporate/commercial lending portfolio of the banks as on 31-Dec-2020.

ORR framework: SBP requires banks /DFIs to compile both ORR (a kind of credit rating which is assessed by the lending institution itself) of corporate borrowers and Facility Rating of each financing facilities availed by them[194]. The ORR reflects the credit worthiness of the borrower and is one possible predictor of borrower's default or otherwise. The rating continuum comprises 1 to 12, with 1 to 9 scales for performing categories and 10 to 12 for default categories.

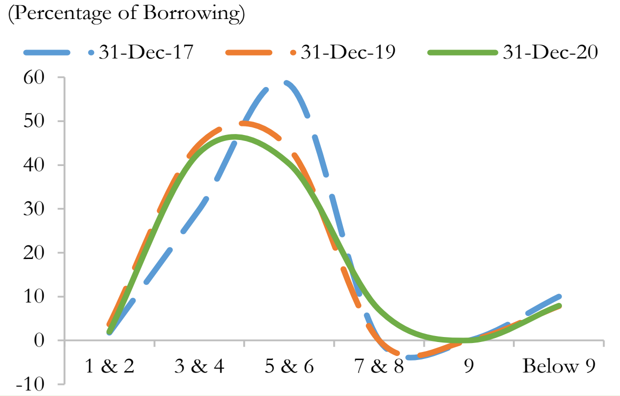
Assessment of Results

Based on ORR of different borrowing entities of the groups, overall average rating (weighted by size of loans) of each group was compiled to assess the strength of these groups. Our assessment indicated that most of the top 30 groups have medium or good quality ratings. It is important to note that during pandemic marked by lockdowns and slowdown in economic activity, especially during first half of CY20, top 30 groups of the banking sector largely maintained their credit worthiness in terms of ORR ratings. The internal credit rating profile of the large borrower groups improved over the period as reflected in the favorable shift in the frequency distribution curve of the credit rating (**Chart B6.1.1**)

[193] Fetched from Bloomberg utility which captures and compiles indicators of listed firms

[194] BSD Circular No. 8 of 2007 <https://www.sbp.org.pk/bsrvd/2007/C8.htm>

Chart B6.1.1: Internal Credit Rating of 30 Large Groups



Source: SBP Staff Calculations

The shift in ORR also reflects a conservative approach on the part of banks to lend to better quality borrowers. As discussed in the following paragraphs, the financial and market-based indicators show mixed performance in the financial and market position of the leading borrowing firms of the banking sector.

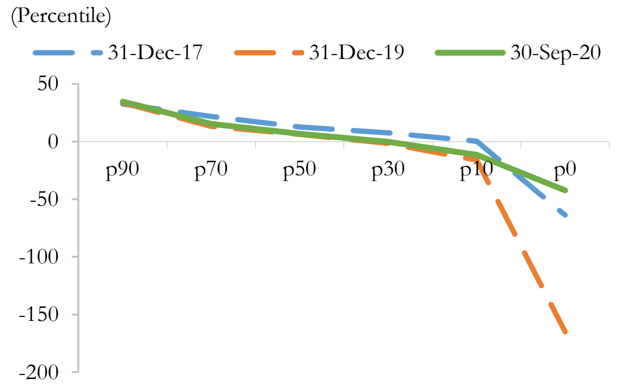
Financial Soundness and Market Performance of Listed Firms of Top 30 Borrowing Groups

As per Pakistan Stock Exchange (**PSX**) data, a total of 530 companies (including default companies) were listed in PSX as of end CY20. Out of these 530 listed companies, 176 listed companies belonged to top 30 borrowing groups of the banking system. To analyze the financial soundness of these firms and assess how they are valued by the market and general investors, a detailed assessment of these 176 listed firms was done using the financial and market-based indicators. Following analysis provide evaluation of various indicators of these firms including ROE, Interest Coverage Ratio (**ICR**), Current Ratio (**CR**), P/E ratio and Gross Margin (**GM**) ratio for the periods December 2017, December 2019 and September 2020.

The analysis of the data shows that despite pandemic and consequent lockdowns and slowdown in economic activity during CY20, most of the top borrowing firms exhibited satisfactory financial performance. Various indicators improved due to early revival of economic activity and different policy support measures that helped the real sector to weather the untoward impacts of the pandemic.

The ROE across the entire population of these firms does not show any sign of slackness during first three quarters of CY20 – it rather shows a slight improvement over Dec-2019. However, profitability levels remain lower as compared to CY17, which was marked with exuberance in economic activity **(Chart B6.1.2).**

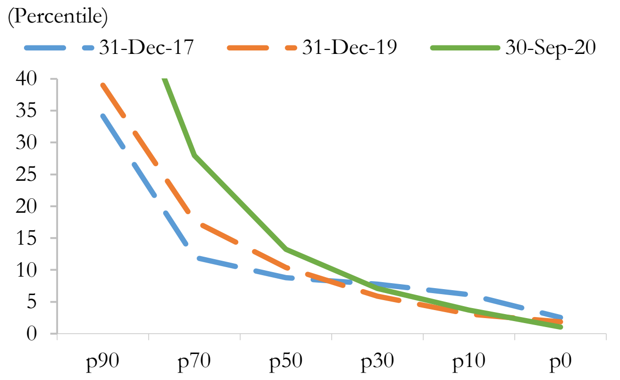
Chart B6.1.2: Percentile Distribution on ROE of Companies



Source: Bloomberg

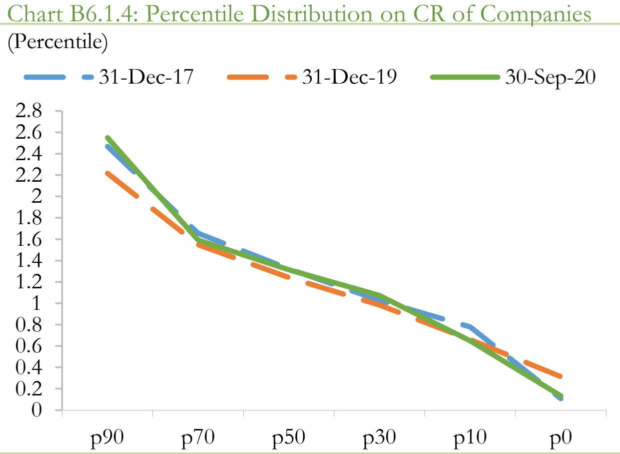
Better financial indicators and policy measures to mitigate the impact of pandemic also had favorable impact on the general investors' perception about the value and future earning potentials of top borrowing firms. The P/E ratio for most (around 70 percent) of the firms was higher in September 2020 as compared to both December 2019 and December 2017, while P/E ratio of 30 percent companies in September 2020 is the same as in December 2019 **(Chart B6.1.3).**

Chart B6.1.3: Percentile Distribution on P/E of Companies



Source: Bloomberg

Chart B6.1.4: Percentile Distribution on CR of Companies



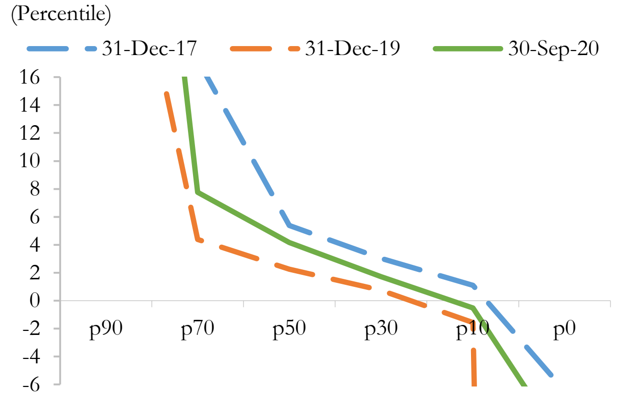
Source: Bloomberg

During CY20, the liquidity profile of the firms in terms of CR has improved as compared to December 2019 and almost reached the levels of December 2017 when business activity in the economy was quite munificent **(Chart B6.1.4).** The debt servicing capacity of the top borrowing firms in terms of ICR has also improved as compared to CY19, as the firms' earnings remained intact while financial costs decreased due to significant reduction in policy rate **(Chart B6.1.5).** The core earnings in terms of GM ratio has remained more or less stable over the four years period **(Chart B6.1.6)**.

Conclusion

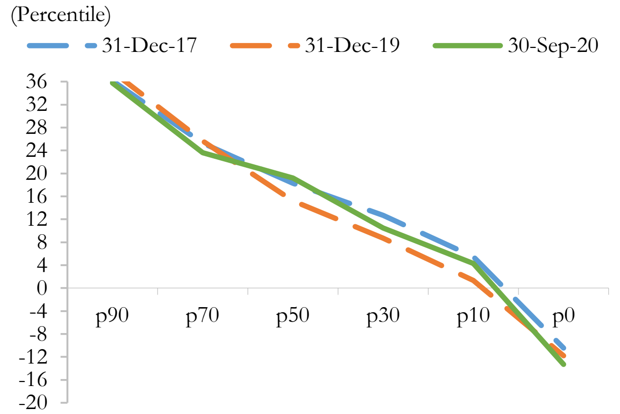
The comparative position of ORR of top 30 borrowing groups of the banking sectors shows that banks' have higher exposure on large corporates due to better credit worthiness.

Chart B6.1.5: Percentile Distribution on ICR of Companies



Source: Bloomberg

Chart B6.1.6: Percentile Distribution on GM of Companies



Source: Bloomberg

The COVID-19 pandemic and consequent lockdowns during CY20 raised significant challenges for borrowing firms in terms of operating environment and demand and supply constraints. However, due to early resumption of business activity during second half of CY20 and enabling support measures from central bank and government, the firms have largely weathered the impact of the pandemic. Their financial indicators show sign of resilience and investors maintained their confidence in the future prospects of these firms. Going forward, it is expected that if the impacts of the pandemic remain contained and it is satisfactorily curtailed, the general credit worthiness and financial performance of the large borrowing firms will improve. However, their performance will largely depend upon the evolving dynamics and impacts of the pandemic.

Chapter 7: Financial Market Infrastructures

Although the pandemic triggered some operational constraints, the performance and resilience of Financial Market Infrastructures (FMIs) remained intact during CY20. Pakistan Real Time Interbank Settlement Mechanism (PRISM)—with uninterrupted availability—handled an increased volume of transactions, though, the value of transactions declined. The customer's increased preference for digitization in the wake of the pandemic and policy measures of SBP gave a strong impetus to E-banking transactions. To realize the objective of a modern and efficient national payment system, SBP launched 'Raast'—an instant payment system for retail transactions—as a major step towards implementation of National Payment Systems Strategy. The implementation of the strategy is expected to contribute towards achieving the objectives of increasing digitization, convenient and affordable payments, and financial inclusion in the country.

Financial Market Infrastructure (**FMI**)[195] [196] has a crucial role in maintaining financial stability and the steady functioning of the economy. Its smooth functioning supports the efficiency in the flow of payments, effectiveness of financial intermediation process, and economic growth.

The FMI assists the market participants such as firms, individuals, financial institutions and government in carrying out their payment transactions efficiently. The national FMI[197] of Pakistan comprises (i) large value payment system (**LVPS**) i.e. Pakistan Real-Time Interbank Settlement Mechanism (**PRISM**), (ii) Retail Value Payment System (**RVPS**), (iii) an inter-bank switch (1-Link), (iv) a clearing house of paper-based instruments (National Institutional Facilitation Technologies (**NIFT**)), (v) a corporate securities settlement company (National Clearing Company of Pakistan Limited (**NCCPL**)), and (vi) a corporate securities depository i.e. Central Depository Company (**CDC**)).

7.1 Payment Systems and their performance

The sound and efficient functioning of the national payment and settlement systems that fall under its regulatory ambit is a primary objective of SBP. The Payment Systems and Electronic Funds Transfer (**PSEFT**)[198] Act, 2007 empowers SBP to regulate, operate and facilitate the national payment systems of the country.[199] SBP is playing its role in both the development and oversight of national payment system, and providing facilitation to the market with the objective of an efficient, inclusive and secure national payment system.

Reduced economic activity in the wake of the pandemic overshadowed the performance of Payment System …

The performance of payment systems moderated during CY20 in comparison to previous years, as the country remained mired with reduced economic activity (specifically in H1CY20) due to the adverse shock of the pandemic. Even so, PRISM showed consistent growth in terms of volume of transactions. In retail segment, paper based transactions are on the decline for some time, while growth in e-banking transactions are on the rise. During CY20, as SBP took measures

195 An FMI is defined as a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions. [Principles for Financial Market Infrastructures (2012)" by Committee on Payment and Settlement Systems of BIS].

196 FMI is broadly divided into Payment Systems, Central Securities Depositories (**CSD**), Securities Settlement Systems (**SSS**), Central Counter Parties (**CCPs**) and trade repositories.

197 For comprehensive functional overview of Pakistan's FMI, please see Box 5.1, FSR 2016.

198 This act provides the framework for regulation of national payment systems and electronic funds transfers.

199 The national payment system is broadly divided into LVPS and RVPS. The LVPS (i.e. PRISM) is a central platform for settlement of large value interbank fund transfers, government securities, retail clearing and customer transfers (over a certain lower limit), while RVPS is comprised of the various paper-based and electronic channels used for retail transactions.

to encourage digital payments, growing preference for electronic payment channels was further bolstered as customers actively avoided cash and paper based transactions to avoid the health hazards of the pandemic **(Table 7.1).**

Table 7.1: Profile of Payment System Mechanisms

Mechanism	CY17	CY18	CY19	CY20	Growth
	(Volume in millions and Value in PKR trillion)				(Percent)
a. PRISM					
Volume	1.4	2.2	2.4	3.4	39.24
Value	336.9	375.1	410.6	373.4	-9.06
b. Retail Payments (i+ii)					
Volume	1161.7	1281.6	1381.6	1382.7	0.08
Value	192.6	198.7	207.3	209.3	0.96
i. Paper based					
Volume	463.6	464.8	467.5	389.6	-16.65
Value	152.0	145.0	142.3	136.0	-4.43
ii. E-Banking					
Volume	698.1	816.8	914.2	993.0	8.63
Value	40.6	53.7	65.0	73.3	12.83

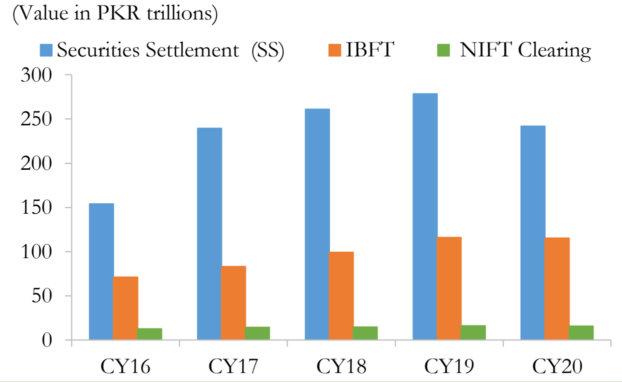
Source: SBP

PRISM efficiently handled higher volume …

PRISM handled higher volume of transactions; however, the total value of transactions declined from last year. The daily average volume of settled transactions rose to about 13,200 (2019: 9,500), while daily average value slightly declined to PKR 1,450 billion (2019: PKR 1,600 billion). In aggregate, 64.08 percent of total value of all transactions was settled through PRISM.

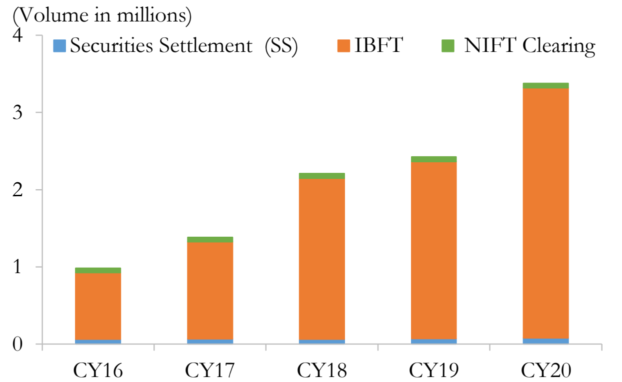
The decline in transacted value was attributed to the decrease in total value of securities settlement transactions **(Chart 7.1a)**. The growth in volume primarily stemmed from the significant increase in volume of Inter-bank Funds Transfers (**IFT**) transactions[200]. IFT transactions - with 41.35 percent increase - contributed the highest share in total volume of PRISM transactions during CY20 **(Chart 7.1b).**

Chart 7.1a: Value profile of PRISM transactions



Source: SBP

Chart 7.1b: Volume profile of PRISM transactions



Source: SBP

This was, in part, due to SBP's measure to waive transaction charges on interbank fund transfer (**IBFT**) and third-party customer transfers to promote the use of digital channels amid the pandemic.[201] Moreover, in view of the country-wide pandemic associated lockdowns, SBP and banks made additional efforts to create awareness among customers and promote the utilization of digital channels for efficient fund transfers.[202]

Additionally, increased foreign remittances inflow during CY20 contributed to growth in transactions of third-party fund transfers. As under the Pakistan Remittance Initiative (**PRI**), banks utilize PRISM for same-day settlement of domestic

[200] IFT transactions include bank-to-bank transfers and third party customer transfers. Third party fund transfers are processed via PRISM by direct participants on instructions of their customers/accountholders.
[201] PSD Circular No. 02 of 2020 https://www.sbp.org.pk/psd/2020/C2.htm

[202] PSD Circular No. 02 of 2020; https://www.sbp.org.pk/psd/2020/C2.htm

transfers of home remittances to their beneficiaries.[203]

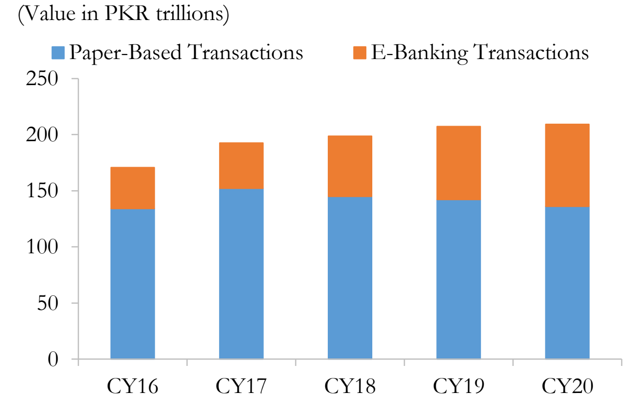
PRISM maintained continuous availability …

The uninterrupted availability of vital settlement mechanism, like PRISM, is essential for the smooth functioning of national payment system. Since its inception, PRISM maintained high level of system availability over the years. In CY20 too, despite the extraordinary difficulties created by the pandemic, SBP ensured the continuous availability of the PRISM system by utilizing its business continuity planning framework.

E-banking modes of payments are rapidly gaining preference over paper-based modes of payment …

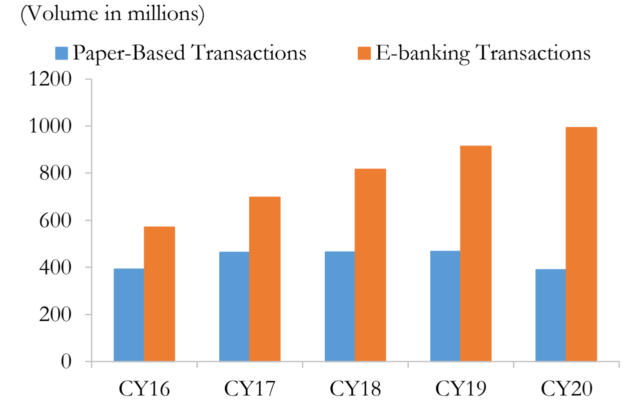
The retail payment system is divided into paper-based and electronic mode of transactions. In the overall retail segment, growth in volume and value of transactions largely remained unchanged during CY20. There was significant contraction in both volume and value of paper-based transactions, while electronic mode of funds transfer gained traction as shown by increasing volume and value of e-banking transactions **(Chart 7.2a and 7.2b).**

Chart 7.2a: Value profile of retail transactions



Source: SBP

Chart 7.2b: Volume profile of retail transactions

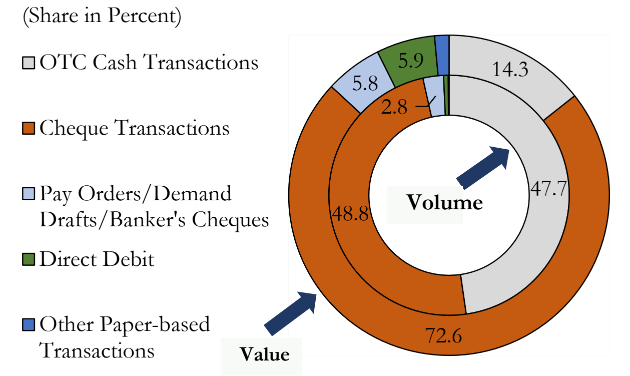


Source: SBP

Paper based transactions contracted across all segments…

In retail payments, paper based transactions in terms of volume and value fell during CY20, mainly because of the decline in footfall in bank branches due to the spread of pandemic and associated country-wide mobility restrictions. Overall transactions contracted by 16.65 percent in volume and 4.43 percent in value terms. Cheques dominated the paper-based transactions, contributing 48.77 percent in volume and 72.55 percent in value of these transactions **(Chart 7.3).**

Chart 7.3: Volume and Value wise share of paper-based retail transactions during CY20



Source: SBP

Within chequing transactions, the decline in volume of transactions was visible in all the categories – that includes, cash withdrawal, transfers and clearing - during CY20 in

[203] PSD Circular Letter No. 04 of 2015; https://www.sbp.org.pk/psd/2015/CL4.htm

comparison to previous year. Cash withdrawals held the majority share in terms of volume of transaction, while fund transfers took up the highest share in total value of chequing transactions **(Table 7.2).**

SBP facilitated cheques utilization and clearing operations under COVID-19 relief measures …

In order to provide ease of services for customers during the pandemic, banks and microfinance banks (MFBs) were authorized to offer the facilities of direct-cheque deposit, and doorstep and drop box cheque collection to their customers.[204]

Moreover, SBP had issued comprehensive guidelines in 2017 for clearing and settlement mechanism of paper based transactions. In CY20, SBP revised them by allowing banks at locations, where clearing house services are unavailable, to utilize PRISM to meet their clearing obligations of paper-based transactions.[205] This facilitated customers by reducing the turnaround time for these transactions, and ensured a secured settlement of remote area clearing obligations among the banks.

Table 7.2: Chequing transactions in CY20

Type	Number	Amount	Volume share	Value Share
	(Million)	PKR billion	(Percent)	
Cash Withdrawals	153	21,501	54.51	14.80
Transfers	90	98,314	32.14	67.65
Clearing	38	25,511	13.35	17.55

Source: SBP

Growing e-banking transactions held the momentum …

Electronic modes of funds transfer gained increasing share in the retail segment in recent years. CY20 was also encouraging, as e-banking transactions witnessed growth of 8.63 percent in volume and 12.83 percent in value during CY20. This illustrates the customers' growing inclination towards more convenient, safer and efficient digital mode of payments.

Share of Internet banking and Mobile banking increased …

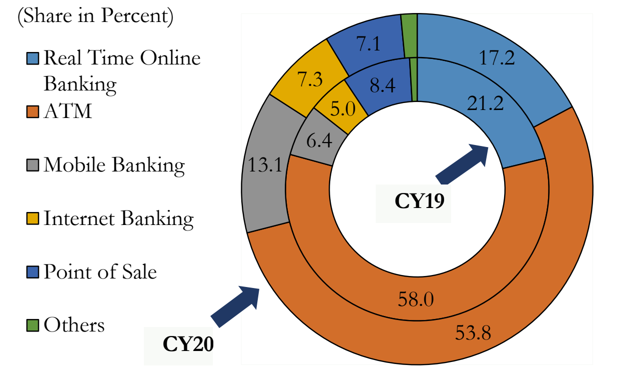
Within e-banking transactions, the significant development was the growing share of mobile and internet banking in total volume and value of transactions in CY20. In terms of volume, their share surged to 13.11 percent and 7.26 percent, respectively, while, in terms of value, they rose to 4.25 percent and 5.48 percent, respectively **(Chart 7.4a & 7.4b)**. During the year, the number of registered users of internet and mobile banking saw significant growth of 26.31 percent and 27.51 percent, respectively. Most of the growth took place in the second half of CY20 due to resumption of economic activities, SBP's enabling policies and banks' efforts to promote e-payments.

Moreover, the increasing utilization of mobile, and internet banking are leading to gradual decrease in share of Real Time Online Banking (**RTOB**) and Automated Teller Machines (**ATMs**) in both volume and value terms. Though RTOB transactions still holds the predominant share in value terms, its share slightly contracted to 80.12 percent in CY20 from 83.95 percent in CY19. ATM led with 53.78 percent share in volume terms, witnessing a decline from 58.02 percent in CY19 possibly due to tendency on the part of customers to avoid physical touch-based modes of payments in the wake of the pandemic **(Chart 7.4a & 7.4b)**.

[204] PSD Circular No. 04 of 2020; https://www.sbp.org.pk/psd/2020/C4.htm

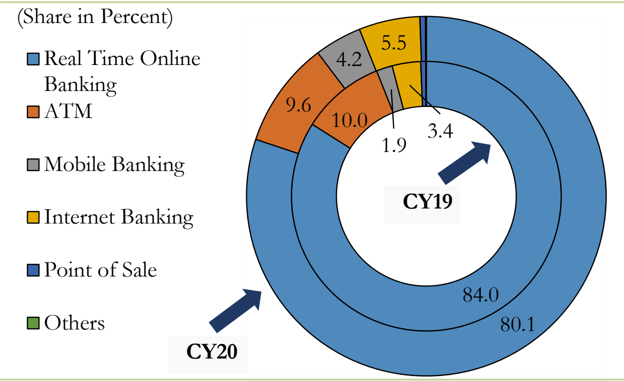
[205] PSD Circular Letter No. 01 of 2020; https://www.sbp.org.pk/psd/2020/CL1.htm

Chart 7.4a: Instrument wise share in total volume of E-Banking transactions in CY19 and CY20



Source: SBP

Chart 7.4b: Instrument wise share in total value of E-Banking transactions in CY19 and CY20



Source: SBP

SBP incentivized the utilization of digital financial services amid COVID-19 pandemic…

The spread of pandemic and the associated mobility restrictions especially during H1CY20 limited customers' ability to safely access the financial services offered through bank branches. Accordingly, SBP took various measures to incentivize the customers' utilization of financial services through digital channels.[206] The major steps taken comprised of: 1) waiver of all charges on customer funds transfers through PRISM, and intra- and inter-bank funds transfers; 2) enabling digital collection of all challan/invoice based payments; 3) relaxation in requirement of biometric verification for activation of internet and mobile banking services; and 4) awareness campaigns for promotion of digital financial services. Such measures played a significant role in promoting the use of digital modes of payments, particularly mobile and internet banking, during CY20.

E-banking infrastructure expanded in the wake of growing preference for digital financial services …

In order to cater to the shifting preference of banking customers towards electronic modes, the commercial and microfinance banks also invested to expand their e-banking infrastructure and services as evident from the growth in Online Branches, ATMs and Point of Sale (**POS**) machines during recent years. Likewise, the network of bank cards also experienced expansion as shown by the growth in credit cards and debit cards. **(Table 7.3)**

Table 7.3: E-Banking Infrastructure

Description	CY16	CY17	CY18	CY19	CY20
			Number		
Online Branches	13,926	14,610	15,346	15,930	16,165
ATMs	12,352	13,409	14,361	15,252	16,041
POS	52,062	52,506	49,621	47,567	62,480
			Number in Thousands ('000)		
Total Payment Cards	36,202	39,361	41,708	42,083	44,285
of which:					
Credit Cards	1,209	1,374	1,522	1,644	1,691
Debit Cards	17,470	19,848	23,303	26,440	27,592
ATM Only Cards	6,806	8,385	8,805	7,650	7,246
Social Welfare Cards	10,358	9,501	7,848	6,180	7,624
Pre-paid Cards	359	253	230	168	133

Source: SBP

SBP introduced measures to improve payment card acceptance infrastructure …

The digital payment infrastructure has achieved considerable growth in the recent years; however, growth in the number of POS terminals had remained somewhat restricted till CY19. To address this issue, SBP introduced new measures[207]

[206] PSD Circular No. 02 of 2020 https://www.sbp.org.pk/psd/2020/C2.htm

[207] These measures include, prescribed set range (1.5 to 2.5 percent) of Merchant Discount Rate (**MDR**) for all new and existing merchants, cap on Interchange Reimbursement Fee (**IRF**) for debit and pre-paid cards, and that, card issuers shall offer SBP approved

aimed at mitigating the challenges faced by the POS acquiring industry.[208]

These measures helped in improving the payment card acceptance infrastructure in the retail sector, which is also a key objective of the National Payment Systems Strategy (**NPSS**). As a result, the number of acquired POS machines in the country posted a robust increase of 31.35 percent during CY20, compared to reduction witnessed in both CY18 and CY19.

SBP has launched 'Raast' – an instant payment system for retail transactions …

To realize the objective of a modern and efficient national payment system, SBP has launched 'Raast[209]' – an instant payment system for retail transactions – at the start of 2021 as a first major step taken for implementation of NPSS.[210] This development would contribute towards achieving the policy objectives of increasing digitization, convenient and affordable payments, and financial inclusion in the country.

The 'Raast' system would enable faster and cost effective payments, increase payment system efficiency, and support interoperability across payment services operating in the country. It envisages providing access to all players in the financial services industry (banks, Electronic Money Institutions (**EMIs**), etc.) and acting as a secure medium for transactions between customers, businesses, and government entities. It would offer the features of real-time settlement of transactions, alias based payments, bulk transfer of funds, and the capability to on-board participants through Application Programming Interfaces (**APIs**).

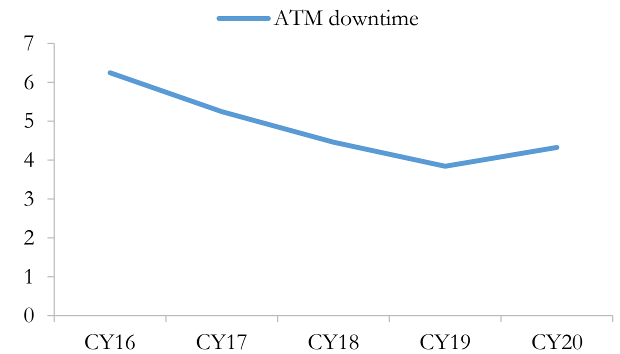
The system would be rolled out in a phased manner. Its full implementation would result in end-to-end digitization of payment transfers between individuals, government entities, and businesses. In the initial phase, bulk payment module will be implemented to digitize transfers including dividend payments, salaries and pensions of government departments, etc. Subsequently, the system would digitize person-to-person payments, and payments made to and among the businesses.

ATM efficiency remained within expectations despite pandemic-induced lockdowns and mobility restrictions …

The efficient functioning and upkeep of ATMs is of critical importance as in terms of volume, ATM transactions have the highest share in total e-banking transactions. ATM downtime can occur due to several reasons including system failure at bank's end, poor connectivity, power outages, and inadequate cash; consequently, outage of services can result in service interruption to customers and may contribute to reputational risk.

Chart 7.5: ATM Downtime

(Percent)



Source: SBP

During CY20, lockdowns, mobility restrictions and other pandemic related measures amplified the difficulties for banking staff to adequately cater to the upkeep of ATMs. Despite these challenges, the banking industry's efforts ensured that the ATM downtime remain minimal during the pandemic. Consequently, ATM uptime stood at 95.68 percent for CY20, slightly lower than the level observed in

Domestic Payment Scheme (**DPS**) Card as the default card at the time of issuance or renewal of debit cards.
[208] PSD Circular No. 01 of 2020 https://www.sbp.org.pk/psd/2020/C1.htm

[209] SBP's launched Raast in collaboration with Bill & Melinda Gates Foundation and Karandaaz, Pakistan.
[210] SBP Press Release, January 11, 2021; https://www.sbp.org.pk/press/2021/Pr-11-Jan-21.pdf

CY19, but still remained above the CY18 level (i.e. 95.53 percent) **(Chart 7.5).**

Branchless Banking showed higher growth …

Branchless banking offers tremendous opportunities for expansion of the financial services to the financially excluded populace of the country. Since its inception, branchless banking has consistently showed growth and played a key role in offering financial services to the financially underserved population.

During CY20, branchless banking performance rebounded in comparison to somewhat modest growth in CY19. The total branchless banking accounts surged by 36.12 percent, while, deposits touched an all-time high of PKR 52 billion. The total transactions in volume and value terms increased by 38.95 percent and 50.63 percent, respectively. This highlights both the increasing confidence of the customers in branchless banking as well as the high potential of growth in branchless banking.

Table 7.4: Key Highlights of Branchless Banking

Description	CY18	CY19	CY20	Growth (percent)
No. of Agents	425,199	437,182	481,837	10.21
No. of Accounts (thousands)	47,165	46,103	62,755	36.12
No. of Active Accounts (thousands)	19,800	24,530	37,020	50.92
Deposits at period end (PKR million)	23,678	28,770	51,671	79.60
No. of Transactions (millions)	955	1,309	1,819	38.95
Average Daily Transactions (thousands)	2,653	3,637	5,053	38.95
Value of Transactions (PKR billion)	3,659	4,505	6,786	50.63
Average Size of Transactions (PKR)	3,831	3,445	3,715	7.84
Average deposit in accounts (PKR)	502	624	823	31.89

Source: SBP

Encouragingly, the role and importance of branchless banking in offering convenient mode of payments to customers for their daily transaction needs have increased, which is evident from the increasing average daily transactions that have almost doubled in CY20 compared to CY18. Further, consumers' demand for financial services offered through branchless banking accounts also improved, as the share of number of active accounts in the total accounts reached 58.99 percent in CY20 from just 41.98 percent in CY18. Moreover, in the same period, the average deposit per account also increased to about PKR 823 from PKR 502 in CY18 **(Table 7.4).**

Enhanced measures to mitigate heightened cyber security risk in the context of the pandemic …

Financial institutions working in the country strive to have effective arrangements in place to cope with IT security risk and ensure the security of their network infrastructure. However, the spread of the pandemic compelled financial institutions to adjust their working processes, particularly, by allowing remote access to their IT systems and business applications from outside the trusted network. To maintain the resilience and robustness of cyber security measures, SBP introduced additional cyber/information security requirements for the financial institutions during CY20.[211] These measures helped to ensure the system-wide cyber security of the financial industry.

7.2 FMIs other than Payment Systems

NCCPL is a key part of the national FMI, performing the critical function of settlements of trade in the corporate securities market. During CY20, it took various measures to improve operational efficiencies and strengthen risk management regimes.

NCCPL overhauled its BCP in wake of the pandemic …

In March 2020, NCCPL overhauled its Business Continuity Plan (**BCP**) in view of the outbreak of the pandemic. Under the overhauling process,

211 PSD Circular No. 03 of 2020; https://www.sbp.org.pk/psd/2020/C3.htm

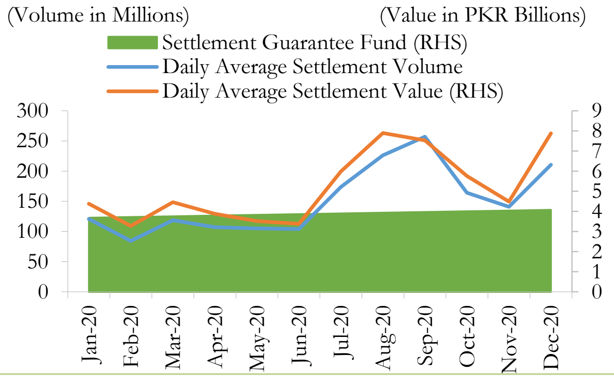
drills were conducted from operational business continuity alternative sites, which helped to ensure that NCCPL would be able to maintain the smooth functioning of the markets, and the provision of business services to clients.[212]

Mechanism to diminish Settlement Risk worked efficiently …

To mitigate the settlement risk arising from a potential default by the settlement party, NCCPL has in place mechanisms involving a Settlement Guarantee Fund (**SGF**). At the beginning, fund valued at PKR 3 billion were dedicated to SGF. Since then, the fund has been gradually increased over the years; it stood at PKR 4 billion by end December 2020.

In CY20, the daily average settlement value stood at PKR 5 billion. However, the SGF remained unutilized as the margins provided by clearing members, which are the first line of defense against default risk, worked efficiently **(Chart 7.6)**.

Chart 7.6: Comparison of settlement guarantee fund with daily average of settlement



Source: NCCPL

Simplification of account opening process with NCCPL …

Under its Centralized "Know-your-Customer" Organization (**CKO**) functions, NCCPL undertook various changes in its requirements for opening and maintenance of accounts to make the process more transparent and efficient[213]. Moreover, NCCPL has extended the scope of CKO regime to investors of Pakistan Mercantile Exchange Limited (**PMEX**) as well.[214] Securities and Exchange Commission of Pakistan (**SECP**) had granted license to NCCPL as CKO in CY19.

To facilitate digital onboarding of market participants, NCCPL introduced the feature of online account opening. This would help in attracting higher participation and liquidity in the market, which could be beneficial in mitigation of settlement risk.[215]

Implementation of clearing, settlement and risk management for newly introduced ETF products at PSX …

NCCPL introduced amendments to its regulatory and risk management frameworks for trading in products related to newly introduced Exchange Traded Funds (**ETFs**) at Pakistan Stock Exchange (PSX). ETFs products were launched by PSX for the first time, in March 2020.[216]

CDC performed efficiently…

CDC acts as the CSD of the country.[217] It performs a two-pronged function i.e. the facilitation of trade in securities and management of the custodial risk associated with it. During CY20, it continued to hold the trust of the public as evident by the increasing number of investor accounts, which stood at 59,919 at the end of CY20, an increase of 5.5 percent from CY19. The CDC handled 155 billion shares with a market capitalization of PKR 5 trillion during the reviewed period.[218]

212 NCCPL's Newsletters, January-March, 2020
213 In view of the pandemic situation, NCCPL provided relaxation in biometric verification and documentation requirement, under KYC process, for account opening.
214 NCCPL's Newsletters, January-March, 2020
215 NCCPL's Newsletters, October-December, 2020
216 NCCPL's Newsletters, January-March, 2020
217 It manages and operates the Central Depository System (CDS), which is an electronic book-entry system used to record and maintain securities and register their transfers.
218 CDC Newsletter, April-Dec 2020

CDC ensured business continuity despite pandemic …

CDC strengthened its business continuity plan under the challenging environment created by the pandemic during CY20. This ensured the continuous availability of key business services offered by CDC, including central depository system (**CDS**), and trustee and custodial services.

Moreover, CDC introduced various measures in order to facilitate the consumers and market that included the launch of zakat repository system, regularization of expired CNIC sub-accounts, e-dividend direct facility to improve investors' access to information, reduction in CDC tariff structure, and simplification in investors account opening process.[219]

National Payment Systems Strategy (NPSS) implementation remains a top priority …

SBP introduced the NPSS in November 2019. NPSS sets out a roadmap to structure the National Payments System on the principles of efficiency, accessibility and safety, and to provide an innovative market environment in the national payment landscape.

Under this vision, SBP set in motion various significant developments during CY20. One such key development in the area of retail payment segment has been the launch of "Raast" which will be a cornerstone of the national digital financial services ecosystem and can bring efficiency gains across all areas. Moreover, SBP made successful regulatory intervention in the national payment card acceptance infrastructure to increase the penetration of existing digital channels of payment under NPSS.

[219] CDC Newsletters, Jan-Mar 2020 and April-Dec 2020

Appendix A

Supervisory initiatives to strengthen stability of financial sector

The State Bank of Pakistan continuously strives to preserve and promote the financial stability in the economy. For this purpose, it has further upgraded its financial stability functions by strengthening the **Macro-prudential Policy Framework** (**MPPF**), and took various measures to address the emerging systemic risks and contain the vulnerabilities arising from cross-sectional dynamics and interconnectedness of the financial institutions.

Incidentally, the year under review was characterized by an unprecedented and paramount challenge of COVID-19 pandemic, which emerged as a global health crisis and posed multifaceted challenges, including implications for economic and financial stability. As the global community continues to suffer the severe impact of the COVID-19, many countries are seeing a resurgence of the infection rates even after over a year of the advent of the pandemic.

Under the policy support of government and regulators, Pakistan's financial sector has so far fared reasonably well, and showed resilience to the impact of coronavirus crisis. It has also managed to support the economy through continued lending and provision of financial services - including to the sectors most affected by the lockdown measures. SBP's Micro and Macro-prudential policy measures - alongside monetary, fiscal and other prudential policies - have helped to mitigate the short-term impact of the pandemic on Pakistan's economy. These pandemic-related measures are separately covered in the later part of this section.

Financial Stability- A Macro Perspective

As an initiative to improve the institutional arrangements of MPPF, the **National Financial Stability Council** (**NFSC**) was established in May 2020, which includes members from the SBP, the Securities & Exchange Commission of Pakistan (**SECP**) and the Ministry of Finance. The NFSC is expected to discuss issues related to systemic risks, particularly those having cross-market and stability implications and suggest a coordinated policy response to address the threats to the financial system stability.

The scope of **Stress Testing guidelines** was broadened to incorporate guidance on Scenario Analysis (i.e. Macro-stress Testing) and Reverse Stress Testing (RST)[220], while extent and coverage of sensitivity analysis were also enhanced. Besides conducting the regular sensitivity analysis, systemically important banks are required to conduct macro- and reverse stress test so that they can proactively identify their vulnerabilities to any adverse macro-economic developments.

SBP supported the government in introducing the **Naya Pakistan Certificate[221] (NPC)**, a new savings and attractive investment opportunity for overseas Pakistanis and residents with assets held abroad. In view of limited cross-border travel, this was one of proactive policy steps to spur inflows through formal channels, and add support to the current account. Naya Pakistan Certificates have attracted an investment of over USD 646 million. Further, Authorized Dealers are allowed to pledge the NPC, on the specific request of non-resident NPC holder, in favor of the Authorized Dealer's Overseas Bank Branches and Correspondents and issue guarantee/standby letter of credit in favor of their Overseas Bank Branches and Correspondents against pledge of NPCs.

In order to gauge and assess the views of market participants and independent experts about the

[220] FSD Circular No. 01 of 2020; https://www.sbp.org.pk/fsd/2020/C1.htm

[221] See Naya Pakistan Certificates; https://www.sbp.org.pk/NPC/index.html

various emerging risks and effectiveness of policy framework, SBP conducted 5th and 6th waves of the **Systemic Risk Survey** (**SRS**) during the year under review, while 7th one was done in January 2021 (results of the 7th wave are given in Box 3). Keeping in view the peculiarity and unprecedented nature of the pandemic, the pandemic and its systemic implications were exclusively covered as a special section in the 6th and 7th waves of the survey.

As part of its efforts to share information and contribute to various regional and international studies, SBP provided its feedback on various international **surveys** and **consultative documents**. In addition, SBP provided updates to the **Financial Stability Board** (**FSB**) on SBP's COVID-19 related polices and measures. SBP also participated in **FSB Regional Consultative Group for Asia** (**RCG Asia**) Conference Calls where vulnerabilities and financial stability issues affecting Asia were discussed, along with other financial stability issues such as cyber incident response and recovery and roadmap for enhancing cross-border payments.

Since 2017, SBP has been participating in the reform efforts to improve Pakistan's ranking in the "Getting Credit" indicator of **Ease of Doing Business Index** of the World Bank. SBP, in collaboration with **SECP**, **World Bank** and **Board of Investment**, proposed legal amendments in the Financial Institutions (Secured Transactions) Act 2016, which were issued through a Presidential Ordinance in April 2020 to improve the underlying framework for Getting Credit as this will help the borrowers to access credit by pledging their movable assets.

Deposit Protection Corporation (DPC)[222] launched its website as part of its broader communication strategy towards all its stakeholders, which focuses on making it easier for users to learn and locate valuable information about the roles and functions of DPC and its communiqués including circulars and guidelines[223]. DPC also made significant progress in guiding its member banks for the development of a comprehensive database for their protected depositors referred to as Single Depositor View (**SDV**). The information contained in this database shall be used for the reimbursement of guaranteed amount to protected depositors of a bank that would be declared as a failed institution by SBP.

Financial Stability- A Micro Perspective

Foreign Exchange Policy and Operations: External account stability is a key moot point for both financial and economic stability of the country. In an effort to facilitate the exporters and the manufacturers, SBP took a host of measures for streamlining the work processes of banks and simplifying the regulatory requirements and processes related to different foreign exchange matters.

SBP launched its **FX Regulatory Approval System** (**RAS**) for end-to-end digitalization of Foreign Exchange (**FX**) related case submission process with an aim to provide a fully digitalized platform to the business community and individuals in approaching banks for their foreign exchange related requests.[224]

SBP allowed exporters to dispatch the shipping documents of their exports' consignment to their foreign buyers without any limit, subject to the condition that the exporter's export over-dues are less than 1% and the exports of at least USD 5 million during the last three years[225].

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222 Deposit Protection Corporation (DPC) established under the DPC Act 2016 as a subsidiary of State Bank of Pakistan to establish and manage the deposit insurance system in Pakistan.
223 SBP Press Release, October 20, 2020; https://www.sbp.org.pk/press/2020/Pr-20-Oct-20.pdf
224 EPD Circular Letter No. 18 of 2020; https://www.sbp.org.pk/epd/2020/FECL18.htm
225 EPD Circular Letter No. 05 of 2020; https://www.sbp.org.pk/epd/2020/FECL5.htm

SBP introduced a new mechanism to enable companies in Pakistan to conveniently remit out **disinvestment** proceeds to their foreign shareholders with an objective to attract foreign investments by increasing investors' confidence and support ease of doing business[226].

In order to further the objectives of establishing the **Special Technology Zones** under the Special Technology Zones Authority Ordinance 2020, SBP issued special foreign exchange regulations for entities operating in Special Technology Zones in Pakistan[227].

To promote **Business-to-Consumer** (**B2C**) e-Commerce exports from Pakistan, a separate Module to implement e-commerce exports was also developed in **WeBOC** in collaboration with Pakistan Customs and other relevant stakeholders. Accordingly, a revised regulatory framework has been developed in view of the current business needs of e-commerce exports[228].

To further enhance **ease of doing business** for the companies in Pakistan, a new mechanism was introduced for payments to globally recognized digital service provider companies against acquisition of digital services by local companies[229].

Banking Conduct and Consumer Protection: An effective consumer protection and fair conduct regime is essential for preserving the trust in financial system and promoting its growth on sustainable basis. SBP conducted a **review of complaints** against Banks/ DFIs/MFBs from 2016 to 2019 to assess effectiveness of complaint management at banks and take policy measures in absence thereof. The salient features of the review are being published to emphasize SBP's narrative that responsible complaint handling is the core element of **Fair Treatment of Consumer** (**FTC**).

SBP in its endeavor to promote Responsible Banking Conduct and Fair Treatment of Consumers (FTC) developed **Key Fact Statement** (KFS) for deposit products. The standardized disclosures such as KFS increase consumer comprehension about a banking product's affordability and risks, leading to better decision-making, it also minimizes the risks of ineffective disclosures by standardizing the information provided to the consumer[230].

SBP decided to reduce the reflection period from 15 years to 10 years for written off/waived loans of corporate borrowers in the **Electronic Credit Information Bureau** (eCIB) of SBP[231].

Payment Systems: To further improve the **digital payment services landscape** in the country and promote financial inclusion, SBP issued instructions to the banking industry for improving the acceptance of payment cards in the country. Since the launch **National Payment Systems Strategy** in November 2019, SBP has taken a number of steps to promote digitization of payment transactions in the country[232].

Roshan Digital Account[233] for the Non-Resident Pakistanis (**NRPs**) was introduced in September 2020. Through this account, NRPs were facilitated to be fully integrated with Pakistan's banking and payments system. For the first time in the country's history, NRPs were able to open an account in Pakistan without requiring physical presence neither in Pakistan nor any embassy or consulate. Roshan Digital Account was also part of policies aimed at attracting foreign exchange into

226 FE Circular No. 05 of 2020; https://www.sbp.org.pk/epd/2020/FEC5.htm
227 FE Circular No. 08 of 2020; https://www.sbp.org.pk/epd/2020/FEC8.htm
228 FE Circular No. 07 of 2020; https://www.sbp.org.pk/epd/2020/FEC7.htm
229 FE Circular No. 04 of 2020; https://www.sbp.org.pk/epd/2020/FEC4.htm
230 BC&CPD Circular No. 02 of 2020; https://www.sbp.org.pk/cpd/2020/C2.htm
231 BC&CPD Circular Letter No. 02 of 2020; https://www.sbp.org.pk/cpd/2020/CL2.htm
232 National Payment Systems Strategy; https://www.sbp.org.pk/PS/PDF/NPSS.pdf
233 SBP Press Release, September 10, 2020; https://www.sbp.org.pk/press/2020/Pr-10-Sep-20.pdf

the country and it has helped rupee stabilize against dollar as well as supported current account. By end April 30, 2021, over 120,000 NRPs from 170 countries sent over a USD 1 billion to Pakistan through RDA. Investment in Stock Exchange through RDA crossed PKR 1.6 billion, whereas **Naya Pakistan Certificates** attracted an investment of over USD 646 million.

Islamic Banking:: With a view to further strengthen Shariah compliance framework and harmonize the Shariah practices in Islamic banking industry, the **AAOIFI** Shariah Standards No. 19 (Loan (Qard)), No. 23 (Agency and the Act of an Uncommissioned Agent (Fodooli)), No. 28 (Banking Services in Islamic Banks), and No. 49 - Unilateral and Bilateral Promise (SS – 49) were adopted.[234]

Supervisory and Regulatory Oversight: Systemic importance and interconnectedness of financial institutions have significant bearing on the financial stability in the economy. SBP announced the designation of **Domestic Systemically Important Banks** (**D-SIBs**) for the year 2020 under the Framework for Domestic Systemically Important Banks (introduced in April 2018). The framework introduced by State Bank is consistent with the international standards and practices and takes into account the local dynamics. It specifies the methodology for the identification and designation of D-SIBs, enhanced regulatory and supervisory requirements for D-SIBs, and implementation guidelines. These enhanced requirements aim to further strengthen the resilience of the systemically important banks against shocks and augment their risk management capacities[235].

The development of **Risk Based Supervision** (**RBS**) framework was completed during the year under review, and is set to be implemented by July 1, 2021 across SBP's Banking Supervision Group. Development of 'Risk Based Supervision Framework' was covered under Strategic Goal – 3 of SBP's Strategic Plan - Vision 2020.

Banks, DFIs and MFBs with majority foreign shareholding (Greater than 50%) were allowed to raise **Additional Tier 1** capital in the form of **Foreign Currency** (**FCY**) subordinated debt/ loan from their existing foreign sponsors subject to certain terms and conditions[236].

SBP and the banking industry joined hands to create **Pakistan Corporate Restructuring Company Limited** (**PCRCL**). **Corporate Restructuring Companies** (**CRCs**) are empowered under CRC Act 2016 to acquire, restructure and resolve the Non-Performing Assets (**NPAs**) of financial institutions and thereby reorganize and revive the commercially or financially distressed companies. It is expected that CRCs will evolve as vibrant economic agent, contributing towards the revival of sick industrial units and generating employment opportunities[237]. Consequent to the amendments in the Corporate Restructuring Companies Act 2016, SBP issued **guidelines for transfer and assignment of non-performing assets to CRCs**[238].

In order to preserve integrity and safety of the financial system, certain amendments were made in the **Anti-Money Laundering** (**AML**) **Act** to strengthen the overall AML/CFT/CPF regime in the country. The SBP accordingly issued the revised **Anti-Money Laundering, Combating the Financing of Terrorism & Counter**

[234] IBD Circular No. 01 of 2020; https://www.sbp.org.pk/ibd/2020/C1.htm
[235] SBP Press Release, September 03, 2020; https://www.sbp.org.pk/press/2020/Pr-03-Sep-20.pdf
[236] BPRD Circular No. 02 of 2020; https://www.sbp.org.pk/bprd/2020/C2.htm
[237] BPRD Circular No. 03 of 2020; https://www.sbp.org.pk/bprd/2020/C3.htm
[238] BPRD Circular Letter No. 40 of 2020; https://www.sbp.org.pk/bprd/2020/CL40.htm

Proliferation Financing (AML/ CFT/ CPF) Regulations for Reporting Entities[239].

Policy Response to COVD-19 Pandemic

The **COVID-19** pandemic involves severe ramifications for the health and economic wellbeing of humankind. It has also raised serious challenges and risks for the banking sector. These challenges mainly pertain to:

- Availability of bank credit and market liquidity to support economic activities during the pandemic as the seizure of bank credit and dry up of liquidity can affect economic and financial stability,
- Surety of the soundness of banks that could come under stress due to the pandemic,
- Provision of banking services in stable and safe manners, and
- Health, safety and physical wellbeing of banks' employees and general customers.

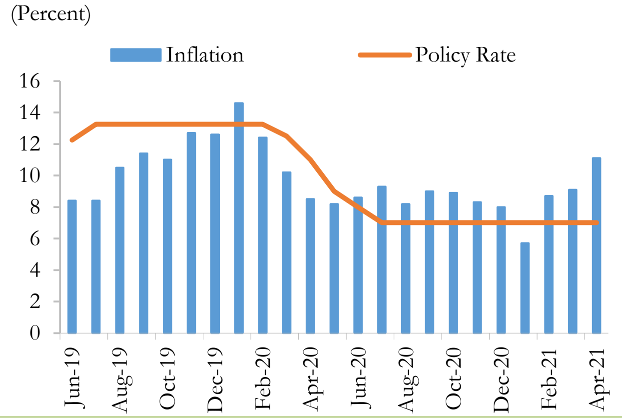
Though the coronavirus crisis originated outside the financial sector, the spillovers to financial institutions have so far been well contained partly due to extensive and prompt intervention by State Bank, the government, and other supervisory authorities. The strengthening of the supervisory framework in recent years has also helped the financial sector to be in more stable position than it was before the recent Global Financial Crisis of 2008.

The SBP took a host of contingency measures[240] in the spheres of monetary and regulatory policy to address the challenges posed by the pandemic and cope with the strong feedback / pro-cyclicality effects between the economic and financial fragility.

Reduction in Policy Rate

As a **monetary policy** measure, the SBP cut the policy rate by 625 basis points from 13.25 percent to 7 percent (from mid-March to June 2020) to alleviate the burden of financial cost on businesses and households which were facing significant impairment in their ability to generate income and cash flows. The reduction in the policy rate was one of the largest among the emerging economies as SBP shifted its focus of monetary policy toward economic growth and employment during the pandemic. **(Chart A.1)**.

Chart A.1: Inflation and Policy Rate



Source: SBP

Promotion of digital payments and Availability of uninterrupted financial services

SBP engaged with the industry to understand issues and challenges and formulate a policy response accordingly. In this vein, SBP conducted a **flash survey**[241] and based on the findings of the survey, advised banks/DFIs/MFBs to adopt different measures to **help fight the spread of COVID-19 pandemic.** SBP issued instructions/ guidelines to ensure continuity of business operations during the ensuing lockdowns and **availability of financial services.**[242] In view of increased use of e-banking services and work-

[239] BPRD Circular Letter No. 01 of 2021; https://www.sbp.org.pk/bprd/2021/CL1.htm
[240] COVID-19 Measures; https://www.sbp.org.pk/covid/index.html
[241] BPRD Circular Letter No. 06 of 2020; http://www.sbp.org.pk/bprd/2020/CL6.htm
[242] SBP Press Release, March 23, 2020; https://www.sbp.org.pk/press/2020/Pr-23-Mar-20.pdf

from-home arrangements and resultant increase in cyber threats, financial institutions were advised to exercise due diligence and implement stronger and robust cybersecurity measures to counter **cyber risks** associated with remote access functionality.[243]

SBP also strived to promote the digital payments and reduce the contact-based dealing amid the pandemic[244]. Banks were, inter alia, instructed to waive the fee on interbank fund transfer and facilitate the payment of fees, loans repayments etc. through internet/mobile banking.

Amid growing concerns about the potential impacts of the pandemic, SBP introduced a comprehensive **regulatory package** whose key highlights were:

- Reduction in banks' capital conservation buffer (**CCB**).[245]
- Deferment of payment of principal on loan obligations.
- Rescheduling/Restructuring of the financing facilities of such obligors, who are unable to service the mark-up amount or need deferment exceeding one year.
- Reduction in Cash Reserve Requirements against FE-25 Deposits.[246]
- Increase in the regulatory limit on extension of credit to SMEs.
- Increase in borrowing limits for individuals.
- Reduction in margin call requirements on bank financing against the security of shares.

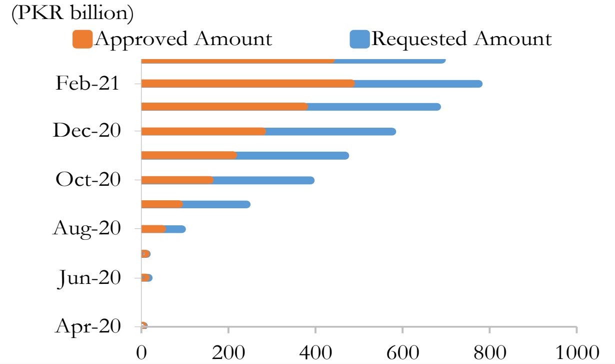
SBP Rozgar Scheme

In order to preserve the employment in the country, SBP introduced a concessional **refinance facility**[247] to fund the payment of salaries. In this regard, the Ministry of Finance also introduced a **risk-sharing facility** to support bank lending to SMEs and small businesses to avail SBP's Refinance Facility to support employment. Federal Government allocated PKR 30 billion under a credit risk sharing facility for the banks spread over four years to share the burden of losses due to any bad loans in future. This facility was aimed to incentivize banks to extend loans to collateral deficient **SMEs** and small corporates with sales turnover of up to PKR 2 billion to avail financing under SBP refinance scheme.[248] Further, the regulatory retail portfolio limit was enhanced from PKR 125 million to PKR 180 million to support the growth of credit to the retail sector and SME.

Facilitating New Investment

SBP introduced a concessionary **Temporary Economic Refinance facility**[249] to promote investment in both new projects and expansion or BMR of existing projects. At end March 2021, a total amount of PKR 436 billion was approved against the requested amount of PKR 690 billion since the introduction of the scheme in March 2020 **(Chart A.2).**

Chart A.2: TERF Performance



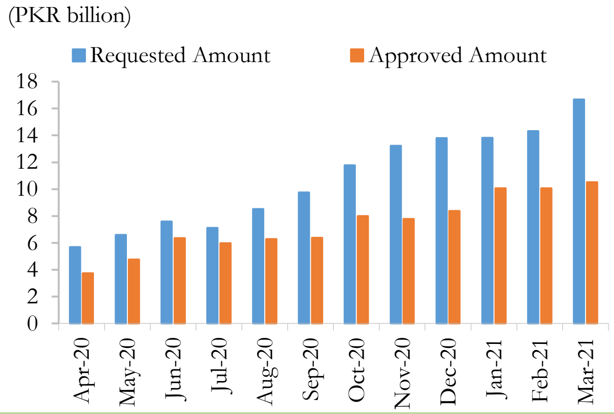
Source: SBP

243 PSD Circular No. 03 of 2020; https://www.sbp.org.pk/psd/2020/C3.htm
244 SBP Press Release, March 18, 2020; https://www.sbp.org.pk/press/2020/Pr-18-Mar-20.pdf
245 BPRD Circular Letter No. 12 of 2020; https://www.sbp.org.pk/bprd/2020/CL12.htm
246 DMMD Circular No. 08 of 2020; http://www.sbp.org.pk/dmmd/2020/C8.htm
247 IH&SMEFD Circular No. 06 of 2020; https://www.sbp.org.pk/smefd/circulars/2020/C6.htm
248 IH&SMEFD Circular No. 09 of 2020; https://www.sbp.org.pk/smefd/circulars/2020/C9.htm
249 IH&SMEFD Circular No. 01 of 2020; https://www.sbp.org.pk/smefd/circulars/2020/C1.htm

Support for the Health Sector

To support the **health sector** and enhance its capacity to fight the pandemic, SBP introduced a **refinance facility**[250] for the health sector. Moreover, all federal and provincial government departments, hospitals in public and private sectors, charitable organizations, manufacturers and commercial importers were allowed to make **Import Advance Payment** and **Import on Open Account**, without any limit, for the import of medical equipment, medicines and other ancillary items for the treatment of COVID-19.[251] Over the last 12 months, PKR 11 billion were approved against the requested amount of PKR 17 billion. **(Chart A.3).**

Chart A.3: RFCC Performance



Source: SBP

Loan Extension and Restructuring Package

SBP announced **Debt Relief Scheme**[252] to facilitate the borrowers in restructuring/rescheduling and deferment of their loans. It aimed to preserve the solvency of the borrowers and enable them to combat the temporary economic disruptions. All categories of customers – corporate, commercial, SME, agriculture and retail - benefited from the facility. The approval rate for the applications received under the scheme has been 97% as of April 16, 2021.

The major beneficiary of this scheme has been the individual borrower. Especially, the MFBs have significantly supported their 1.7 million small borrowers, extending the repayments on loans of PKR 121 billion, which approximately constitutes half of total loan portfolio of MFBs. Further, SBP expanded the scope of relief package for the borrowers of MFBs with additional measures to better enable them to deal with the adverse implications of the pandemic. Whereas an amount of PKR 718 billion, out of total PKR 911 billion, restructured and deferred loans related to corporate and commercial borrowers. The scheme expired on March 31, 2021 **(Table A.1)**.

Table A.1: Category wise applications and approved amount

Category	No. of Applications Received	No. of Applications Accepted	Amount Approved (in PKR Billion)
Corporate / Commercial	3,172	2,878	718
SME	10,835	10,406	28
Consumer Finance	100,519	65,161	22
Housing Finance	2,959	2,140	10
Agriculture Financing	29,954	27,216	12
Microfinancing	1,736,113	1,717,665	121
Total	**1,883,552**	**1,825,466**	**911**

Relief for Exporters and Importers

Due to the COVID-19 pandemic Pakistan's exporters were facing declining demand in overseas markets and problems in executing existing orders. To support exporters in these challenging circumstances and to prevent current liquidity problems from turning into solvency problems amongst exporters, SBP announced the following measures:[253]

250 IH&SMEFD Circular No. 03 of 2020; https://www.sbp.org.pk/smefd/circulars/2020/C3.htm
251 EPD Circular Letter No. 09 of 2020; https://www.sbp.org.pk/epd/2020/FECL9.htm
252 BPRD Circular Letter No. 13 of 2020; https://www.sbp.org.pk/bprd/2020/CL13.htm; BPRD Circular Letter No. 14 of 2020; https://www.sbp.org.pk/bprd/2020/CL14.htm; IH&SMEFD Circular Letter No. 3 of 2020; https://www.sbp.org.pk/smefd/circulars/2020/CL3.htm
253 IH&SMEFD Circular No. 05 of 2020; https://www.sbp.org.pk/smefd/circulars/2020/C5.htm

- Allowed Six months additional period for making shipment/performance under Export Finance Scheme (**EFS**) for FY 2019-20.
- Reduced export performance requirement under EFS Part-II from 2 times to 1.5 times against financing of FY20 and FY21.
- Relaxed eligibility criteria for availing finance under LTFF during January 01, 2020 to September 30, 2020 from USD 5 Million or 50% exports of total sales to USD4 Million or 40% exports of total sales. Under LTFF, one-year additional period was allowed for making projected exports in each category falling in calendar year 2020.

SBP extended time for settlement of foreign currency loans amid COVID-19 pandemic to facilitate the exporters and importers by allowing extension up to 180 days in settlement of their export and import loans under **FE-25 foreign exchange loan Scheme**[254]. SBP also eased 100 percent **cash margin requirement** on the import of certain raw materials to support manufacturing and industrial sectors and further enhance their capacity to contribute towards the recovery of the economy amidst the pandemic.

Moreover, SBP has enhanced the existing limit from USD 10,000 to USD 25,000, or equivalent in other currencies, per invoice allowed to banks **to make advance payment**[255] on behalf of manufacturing & industrial concerns and commercial importers for import of raw material, spare parts and machinery. These measures were in continuation of facilitating export-oriented industries and manufacturing concerns in the backdrop of ease of doing business and promoting exports' growth to contribute in improving economic outlook of the country.

SECP's Initiatives and Policy Response to COVD-19

The **SECP** is the financial regulatory agency whose objective is to develop a modern and efficient corporate sector and a capital market to encourage investment and foster economic growth in Pakistan. It regulates and supervises **non-banking financial firms** including insurance companies, securities firms and capital market, NBFCs, etc. The SECP took a number of initiatives to improve the performance, operations, systems, and supervisory monitoring of NBFCs during the year under review.

The SECP established a dedicated **Systemic Risk Wing** that is mandated to identify and mitigate threats to financial stability of the regulated financial markets. Further, **Systemic Risk Review Committee** was reorganized to ensure oversight of untoward developments with a potential to pose systemic risk shocks.

The **Private Funds Regulations, 2015** were revamped to catalyze growth in the private funds industry by offering increased flexibility, efficiency and ease of doing business.

Amendments in the **NBFC Rules 2003** and **NBFC Regulations, 2008** were made to create an enabling environment and eliminate regulatory bottlenecks through perpetual licensing, minimum documentation and lesser regulatory approvals to access credit lines from **PMIC**.

The first ever microfinance sector specific **Social Impact Fund** (**SIF**) was set up to provide enhanced liquidity to the nonbank microfinance sector.

To facilitate further growth of the mutual fund industry and to safeguard the investor's interest, the SECP took the following initiatives:

254 EPD Circular Letter No. 17 of 2020; https://www.sbp.org.pk/epd/2020/FECL17.htm

255 EPD Circular Letter No. 04 of 2020; https://www.sbp.org.pk/epd/2020/FECL4.htm

a. Approval granted for the launch of Pakistan's first Shariah compliant **Exchange Traded Funds** (**ETFs**).
b. Detailed guidelines issued for assessing suitability and standard risk categorization of **Collective Investment Schemes** (**CIS**), to curb miss-selling of mutual fund products to the investors.
c. Provision of digital platform for investment in mutual funds launched with the name "**Emlaak Financials**".
d. Prescription of detailed mechanism for **digital account opening** by Asset Management Companies (**AMCs**).
e. A number of amendments were made in **Voluntary Pension System** regulatory framework to revamp the regulatory structure and introduce relaxations for 'ease of doing business' and growth of the sector.

Policy Response to COVID-19[256]

- The maximum period of borrowing by mutual funds for redemption purposes extended from 90 days to 365 days.
- Extended time period for classification of non-performing securities from 15 days to 180 days.
- Allowed NBFCs to defer repayment of principal and reschedule the loans based on borrowers' request, without affecting the credit status of such borrowers;
- Allowed PMIC to defer principal repayments and reschedule its loans to NBMFCs.

Insurance and Takaful Sector

Centralized Insurance Repository was launched to store and share details of life insurance and family Takaful polices electronically.

The SECP notified the **Corporate Insurance Agents Regulations, 2020** to provide comprehensive regulatory framework for business undertaken through corporate insurance agents (including banks) and technology-based distribution channels.

The SECP issued **Guidelines on Cybersecurity Framework for Insurance Sector, 2020** to ensure security and resilience of IT infrastructure of insurance companies and warrant the privacy and confidentiality of the data.

Policy Response to COVID-19

The SECP advised insurance companies to:

- Waive non-mandatory requirements for claims processing and use alternative methods for verifying the authenticity of claims.
- Consider extension in grace period of payment of premiums, preferably through digital or online payment modes.
- Ensure electronic issue of pre-authorizations for treatment in on-panel hospitals, expand list of panel hospitals and consider claims incurred at non-panel medical institutions.

The SECP provided:

- Relaxation and relief to the insurance industry by extending the timeline for renewal of insurance brokers' and surveyors' licenses.
- Relief to the insurance sector by extending the regulatory reporting deadlines and relaxations from the IFRS – 16.
- Relief to companies/entities from the requirements of accounting standards in relation to their AFS Equity Investments by allowing them to show impairment loss as at March 31, 2020 in the statement of changes in equity.

[256] SECP Response to COVID-19; https://www.secp.gov.pk/sec-response-to-covid-19/

Appendix B

Indicators used to derive Financial Sector Vulnerability Index (FSVI)

FSVI was first introduced in FSR 2016, and since then it has been modified and regularly published in the subsequent reviews. In FSR-2018, few modifications were made in terms of coverage, indicators and methodology (See Appendix A in FSR-2018).

To recall, FSVI is a composite index derived from averaging the sub-indices of macro-economy, financial markets, banking sector, Non-Banking Financial Institutions, Development Finance Institutions, Insurance Companies and Corporate Sector. The complete list of indicators used within each dimension is given in the table below:

Table 1: FSVI and FSHM: Risk Areas, Risk Dimensions and Indicators

Sr. No.	Risk Area	Risk Dimension	Risk Indicator(s)	Impact on Financial Stability
1	Macro-economy $\frac{1}{n}\sum Ex, R, F, In$ n = 4	External Sector (Ex) $Ex = \frac{1}{n}\sum_{i=1}^{n} ex_i,$ $n = 3$	ex_1 = *Total Liquid Foreign Reserve Position (with SBP)* ex_2 = *Current Account Balance as Percentage of GDP* ex_3 = *Balance of Trade as Percentage of GDP*	Positive Positive Positive
		Real Sector (R)	*Real GDP Growth*	Positive
		Fiscal Sector (F)	Fiscal Deficit as Percentage of GDP	Negative
		Inflation (In)	CPI inflation	Negative
2	Financial Markets $\frac{1}{n}\sum FE, MM, CM$ n = 3	Foreign Exchange (FE)	*Mid-Weight Interbank Exponential Moving Weighted Average (EMWA) Volatility*	Negative
		Money Market (MM)	*Overnight Repo Rate Exponential Moving Weighted Average (EMWA) Volatility*	Negative
		Capital Market (CM)	*KSE-100 Index Exponential Moving Weighted Average (EMWA) Volatility*	Negative
3	Banking Sector $\frac{1}{n}\sum C, AQ, E, L, D, I$ n = 6	Capital Adequacy (C) $C = \frac{1}{n}\sum_{i=1}^{n} c_i, n = 3$	c_1= *Capital Adequacy Ratio(CAR)* c_2=*TIER 1 (CAR)* c_3=*Capital to Asset Ratio*	Positive Positive Positive
		Asset Quality (AQ) $AQ = \frac{1}{n}\sum_{i}^{n} aq_i,$ $n = 3$	aq_1 = *NPLs to Total Loans* aq_2 = *Net NPLs to Capital* aq_3 = *Loss to NPLs*	Negative Negative Negative
		Earnings (E) $E = \frac{1}{n}\sum_{i=1}^{n} e_i,$ $n = 6$	e_1= *Return on Assets Before Tax* e_2=*Return on Equity(Avg. Equity and Surplus) Before Tax* e_3 = *Net Interest Margin* e_4 = *Net Interest Income/Gross Income* e_5 = *Cost to Income Ratio* e_6 = *Trading Income to Total Income*	Positive Positive Positive Positive Negative Negative
		Liquidity (L) $L = \frac{1}{n}\sum_{i=1}^{n} l_i,$ $n = 3$	l_1= *Liquid Assets/Total Assets* l_2= *Liquid Assets/Total Deposits* l_3= *Liquid Assets/Short term liabilities*	Positive Positive Positive

		Deposits (D) $D = \frac{1}{n}\sum_{i=1}^{n} d_i,$ $n = 2$	d_1= *Deposits to Assets* d_2= *Deposit growth (YoY)*	Positive Positive
		Interconnectedness (I) $I = \frac{1}{n}\sum_{i=1}^{n} i_i,$ $n = 2$	i_1= *Call lending and borrowing/Total Assets* i_2= *Financial Liabilities (SBP exclusive)*	Negative Negative
4	Non-Banking Financial Institutions $\frac{1}{n}\sum A, E$ n = 2	Assets (A)	*Asset Growth (YoY)*	Positive
		Earnings (E)	*Net Sales*	Positive
5	Development Finance Institutions $\frac{1}{n}\sum C, AQ, E, L$ n = 4	Capital Adequacy (C) $C = \frac{1}{n}\sum_{i=1}^{n} c_i,\ n = 3$	c_1= *Capital Adequacy Ratio(CAR)* c_2=*TIER 1 (CAR)* c_3=*Capital to Asset Ratio*	Positive Positive Positive
		Asset Quality (AQ) $AQ = \frac{1}{n}\sum_{i}^{n} aq_i,$ $n = 3$	aq_1 = *NPLs to Total Loans* aq_2 = *Net NPLs to Capital* aq_3 = *Net NPLs to Net Loans*	Negative Negative Negative
		Earnings (E) $\mathrm{E} = \frac{1}{\mathrm{n}}\sum_{i=1}^{n} e_i,$ $n = 4$	e_1= *Return on Assets Before Tax* e_2=*Return on Equity(Avg. Equity and Surplus) Before Tax* e_3 = *Net Interest Income/Gross Income* e_4 = *Cost to Income Ratio*	Positive Positive Positive Negative
		Liquidity (L) $L = \frac{1}{n}\sum_{i=1}^{n} l_i,$ $n = 3$	l_1= *Liquid Assets/Total Assets* l_2= *Liquid Assets/Total Deposits* l_3= *Advances/Deposits*	Positive Positive Positive
6	Insurance Companies $\frac{1}{n}\sum Li, NL$ n = 2	Life (Li) $\mathrm{Li} = \frac{1}{\mathrm{n}}\sum_{\mathrm{i}=1}^{\mathrm{n}} \mathrm{li_i},$ $\mathrm{n} = 4$	li_1= *Claims ratio* li_2= *Return on Assets before tax* li_3= *Return on Investment before tax* li_4= *Capital to Assets*	Negative Positive Positive Positive
		Non-life (NL) $\mathrm{NL} = \frac{1}{\mathrm{n}}\sum_{\mathrm{i}=1}^{\mathrm{n}} \mathrm{nli_i},$ $\mathrm{n} = 5$	nli_1= *Claims ratio* nli_2= *Premium Retention* nli_3= *Return on Assets before tax* nli_4= *Return on Investment before tax* nli_5= *Capital to Assets*	Negative Negative Positive Positive Positive
7	Corporate Sector	Corporate Debt	*Debt Burden (average of asset/equity and debt/equity)*	Negative

Annexure A

Annexure I - Balance Sheet and Profit & Loss Statement of Banks

PKR million

BALANCE SHEET	Dec-16	Dec-17	Dec-18	Dec-19	Dec-20
ASSETS					
Cash & Balances With Treasury Banks	1,184,521	1,303,914	1,574,551	1,987,096	2,014,703
Balances With Other Banks	168,394	156,332	147,829	232,671	277,988
Lending To Financial Institutions	551,695	604,990	909,754	978,640	1,079,071
Investments - Net	7,509,164	8,729,019	7,913,923	8,939,438	11,934,634
Advances - Net	5,498,813	6,512,485	7,955,195	8,248,973	8,291,572
Operating Fixed Assets	336,376	395,246	437,235	596,924	626,251
Deferred Tax Assets	64,681	72,354	81,082	74,052	91,820
Other Assets	517,412	567,205	662,485	933,542	807,816
TOTAL ASSETS	**15,831,058**	**18,341,545**	**19,682,054**	**21,991,337**	**25,123,855**
LIABILITIES	-	-	-		
Bills Payable	182,858	218,588	243,237	231,178	313,827
Borrowings From Financial Institution	1,942,458	3,125,432	3,001,186	2,932,082	3,216,866
Deposits And Other Accounts	11,797,867	13,011,778	14,254,210	15,953,489	18,518,525
Sub-ordinated Loans	59,330	64,703	111,713	123,218	121,854
Liabilities Against Assets Subject To Finance Lease	41	21	7	7,446	7,534
Deferred Tax Liabilities	61,109	44,684	34,557	43,602	46,549
Other Liabilities	434,598	495,549	631,529	1,042,073	1,036,267
TOTAL LIABILITIES	**14,478,261**	**16,960,755**	**18,276,439**	**20,333,089**	**23,261,422**
NET ASSETS	**1,352,797**	**1,380,790**	**1,405,615**	**1,658,248**	**1,862,433**
NET ASSETS REPRESENTED BY:	-	-			
Share Capital	579,882	516,013	541,040	556,886	556,131
Reserves	205,314	271,448	315,570	349,529	392,599
Unappropriated Profit	344,615	410,371	433,205	521,807	642,965
Share Holders' Equity	**1,129,812**	**1,197,832**	**1,289,816**	**1,428,222**	**1,591,696**
Surplus/Deficit On Revaluation Of Assets	222,985	182,958	115,799	230,026	270,737
TOTAL	**1,352,797**	**1,380,790**	**1,405,615**	**1,658,248**	**1,862,433**

PROFIT AND LOSS STATEMENT	Dec-16	Dec-17	Dec-18	Dec-19	Dec-20
Mark-Up/ Return/Interest Earned	938,026	998,671	1,153,383	1,851,790	1,924,328
Mark-Up/ Return/Interest Expenses	453,232	499,819	608,309	1,156,062	1,071,898
Net Mark-Up / Interest Income	**484,793**	**498,851**	**545,074**	**695,727**	**852,430**
Provisions & Bad Debts Written Off Directly/(Reversals)	5,305	3,706	36,201	67,855	123,039
Net Mark-Up / Interest Income After Provision	**479,489**	**495,146**	**508,873**	**627,872**	**729,391**
Fees, Commission & Brokerage Income	90,266	102,898	112,852	123,895	118,322
Dividend Income	17,187	17,875	13,589	12,325	10,810
Income From Dealing In Foreign Currencies	14,015	14,308	25,981	26,269	21,854
Other Income	74,260	52,565	25,698	19,628	65,920
Total Non - Markup / Interest Income	**195,728**	**187,646**	**178,121**	**182,117**	**216,906**
	675,217	682,791	686,993	809,989	946,298
Administrative Expenses	356,183	387,878	430,375	495,018	521,253
Other Expenses	5,003	4,417	5,068	10,517	13,690
Total Non-Markup/Interest Expenses	**361,186**	**392,295**	**435,444**	**505,535**	**534,943**
Profit before Tax and Extra ordinary Items	314,031	290,496	251,550	304,454	411,355
Extra ordinary/unusual Items - Gain/(Loss)	0.27	23,717.35	9,015.91	48.78	-
PROFIT/ (LOSS) BEFORE TAXATION	**314,030**	**266,779**	**242,534**	**304,405**	**411,355**
Less: Taxation	124,117	108,987	93,194	133,656	167,315
PROFIT/ (LOSS) AFTER TAX	**189,914**	**157,792**	**149,340**	**170,749**	**244,039**

Annexure II - Financial Soundness Indicators of the Banking Sector

percent

Indicators	Dec-16	Dec-17	Dec-18	Dec-19	Dec-20
CAPITAL ADEQUACY					
Risk Weighted CAR^	16.17	15.83	16.19	17.00	18.56
Tier 1 Capital to RWA	13.02	12.94	13.24	14.01	14.85
Capital to Total Assets	7.80	7.15	7.14	7.21	7.24
ASSET QUALITY					
NPLs to Total Loans	10.06	8.43	7.97	8.58	9.19
Provision to NPLs	85.05	87.24	83.80	81.43	88.33
Net NPLs to Net Loans	1.64	1.16	1.38	1.71	1.17
Net NPLs to Capital^^	7.32	5.77	7.83	8.91	5.32
EARNINGS					
Return on Assets (Before Tax)	2.10	1.56	1.31	1.48	1.76
Return on Assets (After Tax)	1.27	0.93	0.81	0.83	1.05
ROE (Avg. Equity& Surplus) (Before Tax)	23.86	19.51	17.39	20.15	23.23
ROE (Avg. Equity &Surplus) (After Tax)	14.43	11.55	10.71	11.30	13.78
NII/Gross Income	71.24	72.67	75.37	79.25	79.72
Cost / Income Ratio	53.07	57.14	60.21	57.59	50.03
LIQUIDITY					
Liquid Assets/Total Assets	53.73	53.97	48.69	49.65	54.76
Liquid Assets/Total Deposits	72.10	76.08	67.23	68.44	74.29
Advances/Deposits	46.61	50.05	55.81	51.71	44.77

^ Data for Dec-13 and onwards is based on Basel III, and data from CY08 to Sep-13 is based on Basel II with the exception of IDBL,PPCBL, and SME Bank, which is based on Basel I.

^^ Effective from June 30, 2015, Regulatory Capital, as defined under Basel requirements, has been used to calculate Net NPLs to Capital Ratio. Prior to Jun-15, Balance Sheet Capital was used for calculation of this ratio.

Annexure III - List of Banks

Dec-19	Dec-20
A. Public Sector Com. Banks (5)	**A. Public Sector Com. Banks (5)**
1 First Women Bank Ltd.	1 First Women Bank Ltd.
2 National Bank of Pakistan	2 National Bank of Pakistan
3 Sindh Bank Ltd.	3 Sindh Bank Ltd.
4 The Bank of Khyber	4 The Bank of Khyber
5 The Bank of Punjab	5 The Bank of Punjab
B. Local Private Banks (20)	**B. Local Private Banks (20)**
1 AlBaraka Bank (Pakistan) Ltd.	1 AlBaraka Bank (Pakistan) Ltd.
2 Allied Bank Ltd.	2 Allied Bank Ltd.
3 Askari Bank Ltd.	3 Askari Bank Ltd.
4 Bank AL Habib Ltd.	4 Bank AL Habib Ltd.
5 Bank Alfalah Ltd.	5 Bank Alfalah Ltd.
6 BankIslami Pakistan Ltd.	6 BankIslami Pakistan Ltd.
7 Dubai Islamic Bank Pakistan Ltd.	7 Dubai Islamic Bank Pakistan Ltd.
8 Faysal Bank Ltd.	8 Faysal Bank Ltd.
9 Habib Bank Ltd.	9 Habib Bank Ltd.
10 Habib Metropolitan Bank Ltd.	10 Habib Metropolitan Bank Ltd.
11 JS Bank Ltd.	11 JS Bank Ltd.
12 MCB Bank Ltd.	12 MCB Bank Ltd.
13 MCB Islamic Bank Ltd.	13 MCB Islamic Bank Ltd.
14 Meezan Bank Ltd.	14 Meezan Bank Ltd.
15 SAMBA Bank Ltd.	15 SAMBA Bank Ltd.
16 Silk Bank Ltd	16 Silk Bank Ltd
17 Soneri Bank Ltd.	17 Soneri Bank Ltd.
18 Standard Chartered Bank (Pakistan) Ltd.	18 Standard Chartered Bank (Pakistan) Ltd.
19 Summit Bank Ltd	19 Summit Bank Ltd
20 United Bank Ltd.	20 United Bank Ltd.
C. Foreign Banks (5)	**C. Foreign Banks (4)**
1 Bank of Tokyo - Mitsubishi UFJ, Ltd.	1 Citibank N.A.
2 Citibank N.A.	2 Deutsche Bank AG
3 Deutsche Bank AG	3 Industrial and Commercial Bank of China Ltd.
4 Industrial and Commercial Bank of China Ltd.	4 Bank of China Limited
5 Bank of China Limited	
D. Specialized Banks (3)	**D. Specialized Banks (3)**
1 Punjab Provincial Co-operative Bank Ltd.	1 Punjab Provincial Co-operative Bank Ltd.
2 SME Bank Ltd.	2 SME Bank Ltd.
3 Zarai Taraqiati Bank Ltd.	3 Zarai Taraqiati Bank Ltd.
All Commercial Banks (30)	**All Commercial Banks (29)**
Include A + B + C	Include A + B + C
All Banks (33)	**All Banks (32)**
Include A + B + C + D	Include A + B + C + D

Annexure IV - Composition of Islamic Banking Institutions

	Dec-19		Dec-20
	Islamic Banks		**Islamic Banks**
1	AlBaraka Bank (Pakistan) Ltd.	1	AlBaraka Bank (Pakistan) Ltd.
2	BankIslami Pakistan Ltd.	2	BankIslami Pakistan Ltd.
3	Dubai Islamic Bank Pakistan Ltd	3	Dubai Islamic Bank Pakistan Ltd
4	MCB Islamic Bank Ltd.	4	MCB Islamic Bank Ltd.
5	Meezan Bank Ltd	5	Meezan Bank Ltd
	Conventional Banks having Islamic Banking Branches		**Conventional Banks having Islamic Banking Branches**
1	Askari Bank Ltd.	1	Askari Bank Ltd.
2	Allied Bank Ltd.	2	Allied Bank Ltd.
3	Bank Al Habib Ltd	3	Bank Al Habib Ltd
4	Bank Alfalah Ltd	4	Bank Alfalah Ltd
5	Faysal Bank Ltd.	5	Faysal Bank Ltd.
6	Habib Bank Ltd	6	Habib Bank Ltd
7	Habib Metropolitan Bank	7	Habib Metropolitan Bank
8	National Bank of Pakistan	8	National Bank of Pakistan
9	Silk Bank Ltd	9	Silk Bank Ltd
10	Sindh Bank Ltd	10	Sindh Bank Ltd
11	Soneri Bank Ltd	11	Soneri Bank Ltd
12	Standard Chartered Bank	12	Standard Chartered Bank
13	Summit Bank Ltd.	13	Summit Bank Ltd.
14	The Bank of Khyber	14	The Bank of Khyber
15	The Bank of Punjab	15	The Bank of Punjab
16	United Bank Ltd.	16	United Bank Ltd.
17	Zarai Taraqiati Bank Ltd.	17	Zarai Taraqiati Bank Ltd.
	Grand Total 22 (5+17)		**Grand Total 22 (5+17)**

Annexure V - List of Development Finance Institutions (DFIs)

Dec-19	Dec-20
1 House Building Finance Company Limited	1 House Building Finance Company Ltd.
2 PAIR Investment Company Limited	2 PAIR Investment Company Ltd.
3 Pak Brunei investment Company Limited	3 Pak Brunei investment Company Ltd.
4 Pak Libya Holding Company Limited	4 Pak Libya Holding Company Ltd.
5 Pak Oman Investment Company Limited	5 Pak Oman Investment Company Ltd.
6 Pak-China Investment Company Limited	6 Pak-China Investment Company Ltd.
7 Pakistan Kuwait Investment Company (Private) Limited	7 Pakistan Kuwait Investment Company (Private) Limited
8 Pakistan Mortgage Refinance Company Limited	8 Pakistan Mortgage Refinance Company Limited
9 Saudi Pak Industrial & Agricultural Investment Company Limited	9 Saudi Pak Industrial & Agricultural Investment Company Limited

Annexure VI - List of Microfinance Banks (MFBs)

Dec-19	Dec-20
1 Advans Pakistan Microfinance Bank Limited	1 Advans Pakistan Microfinance Bank Ltd
2 APNA Microfinance Bank Limited	2 APNA Microfinance Bank Limited
3 FINCA Microfinance Bank Limited	3 FINCA Microfinance Bank Limited
4 Khushhali Microfinance Bank Limited	4 Khushhali Microfinance Bank Limited
5 Mobilink Microfinance Bank Limited	5 Mobilink Microfinance Bank Limited
6 NRSP Microfinance Bank Limited	6 NRSP Microfinance Bank Limited
7 Pak Oman Microfinance Bank Limited	7 Pak Oman Microfinance Bank Limited
8 Sindh Microfinance Bank Limited	8 Sindh Microfinance Bank Limited
9 Telenor Microfinance Bank Limited	9 Telenor Microfinance Bank Limited
10 The First Micro Finance Bank Limited	10 The First Micro Finance Bank Limited
11 U Microfinance Bank Limited	11 U Microfinance Bank Limited

Annexure VII - List of Non-Banking Financial Institutions

Asset Management Companies (AMCs)/ Investment Advisors (IAs)

1 786 Investments Limited
2 ABL Asset Management Company Limited
3 AKD Investment Management Limited
4 Al Habib Asset Management Limited.
5 Alfalah GHP Investment Management Limited
6 Alliance Investment Management Limited
7 Al-Meezan Investment Management Limited
8 Atlas Asset Management Limited
9 AWT Investment Management Limited
10 BMA Asset Management Company Limited
11 Faysal Asset Management Limited
12 First Capital Investments Limited
13 HBL Asset Management Limited
14 JS Investments Limited
15 Kifayah Investment Management Limited
16 Lakson Investments Limited
17 Magnus Investment Advisors Limited
18 MCB-Arif Habib Savings And Investments Limited
19 National Investment Trust Limited
20 NBP Fund Management Limited
21 Pak Oman Asset Management Company Limited
22 Sarmuz Investments Limited
23 UBL Fund Managers Limited

Private Equity & Venture Capital Firms (PE&VC)

1 PNO Capital Limited
2 Ijarah Capital Partners Limited

REIT Management Companies (RMCs)

1 Arif Habib Dolmen REIT Management Limited
2 AKD REIT Management Company Limited
3 ISE Towers REIT Management Limited
4 SB Global REIT Management Limited
5 TPL Properties REIT Management Company Limited
6 Veritas REIT Management Company Ltd

Leasing Companies

1 Grays Leasing Limited
2 Pak Gulf Leasing Company Limited
3 Primus Leasing Limited
4 Saudi Pak Leasing Company Limited
5 Security Leasing Corporation Limited.
6 SME Leasing Limited

Investment Finance Companies (IFCs)

1 Escorts Investment Bank Limited
2 Finja Lending Services Limited
3 First Credit Investment Bank Limited
4 First Dawood Investment Bank Limited
5 Invest Capital Investment Bank Limited
6 LSE Financial Services Limited
7 Orix Leasing Pakistan Limited
8 Pakistan Microfinance Investment Co. Ltd
9 Security Investment Bank Limited
10 Pakistan Development Fund Ltd
11 Taleem Finance Company Limited
12 Trust Investment Bank Ltd

Non-Bank Microfinance Companies (NBMFCs)

1 Agahe Pakistan
2 Akhuwat Islamic Microfinance
3 AMRDO Foundation
4 Balochistan Rural Support Programme
5 CSC Empowerment & Inclusion Programme
6 Damen Support Programme
7 FFO Support Program
8 Ghazi Barotha Taraqiati Idara
9 JWS Pakistan
10 Kashf Foundation
11 Micro Options Support Program
12 Mojaz Support Program
13 NRSP
14 Organization For Poverty Reduction And Community Training Program
15 OPD Support Program
16 Punjab Rural Support Programme
17 RCDP
18 Saath Microfinance Foundation Pakistan
19 Safco Support Foundation
20 Sarhad Rural Support Programme (SRSP)
21 Sayya Microfinance Company
22 Shah Sachal Sami Foundation (SSSF)
23 Sindh Rural Support Organization
24 Soon Valley Development Program
25 Thardeep Microfinance Foundation
26 TEZ Financial Services Limited

Modaraba Companies

1 Allied Rental Modaraba
2 Awwal Modaraba
3 B.F. Modaraba
4 B.R.R. Guardian Modaraba
5 Elite Capital Modaraba
6 Equity Modaraba
7 First Al-Noor Modaraba
8 First Fidelity Leasing Modaraba
9 First IBL Modaraba
10 First Imrooz Modaraba
11 First Pak Modaraba
12 First Paramount Modaraba
13 First Punjab Modaraba
14 First Treet Manufacturing Modaraba
15 First Tri Star Modaraba
16 Habib Metro Modaraba
17 Habib Modaraba
18 KASB Modaraba
19 Modaraba Al-Mali
20 National Bank Modaraba
21 Orient Rental Modaraba
22 Orix Modaraba
23 Popular Islamic Modaraba
24 Prudential Modaraba
25 Sindh Modaraba
26 Trust Modaraba
27 UDL Modaraba
28 Unicap Modaraba

Annexure VIII - List of Insurance Companies

Non-Life Insurance Companies

1 Adamjee Insurance Company Limited
2 Alfalah Insurance Company Limited
3 Allianz EFU Health Insurance Limited
4 Alpha Insurance Company Limited
5 Asia Insurance Company Limited
6 Askari General Insurance Company Limited
7 Atlas Insurance Limited
8 Century Insurance Company Limited
9 Chubb Insurance Pakistan Limited
10 Continental Insurance Co. Ltd
11 Crescent Star Insurance Limited
12 East West Insurance Company Limited
13 EFU General Insurance Limited
14 Habib Insurance Company Limited
15 IGI General Insurance Limited
16 Jubilee General Insurance Company Limited
17 National Insurance Company Limited
18 New Hampshire Insurance Company Limited
19 PICIC Insurance Limited
20 Premier Insurance Limited
21 Progressive Insurance Company Limited
22 Reliance Insurance Company Limited
23 Security General Insurance Company Limited
24 Shaheen Insurance Company Limited
25 Silver Star Insurance Company Limited
26 Sindh Insurance Limited
27 SPI Insurance Company Limited
28 The Asian Mutual Insurance Company (Guarantee)
29 The Cooperative Insurance Society of Pakistan
30 The Pakistan General Insurance Company Limited
31 The Pakistan Mutual Insurance Company (Gte)
32 The United Insurance Company of Pakistan Limited
33 The Universal Insurance Company Limited
34 TPL Insurance Limited
35 Trafco Insurance Company Limited
36 UBL Insurers Limited

General Takaful Companies

1 Pak-Kuwait Takaful Company Limited
2 Pak-Qatar General Takaful Limited
3 Salaam Takaful Limited (Formerly Takaful Pakistan

Life Insurance Companies

1 Adamjee Life Assurance Company Limited
2 Askari Life Assurance Company Ltd. (Previously East West Life Assurance Company Limited)
3 EFU Life Assurance Company Limited
4 IGI Life Insurance Limited
5 Jubilee Life Insurance Company Ltd.
6 State Life Insurance Corporation of Pakistan
7 TPL Life Insurance Limited (Previously Asia Care Health & Life Insurance. Company Ltd.)
8 Postal Life Insurance Company Limited

Family Takaful Companies

1 Dawood Family Takaful Limited
2 Pak Qatar Family Takaful Limited

Reinsurance Companies

1 Pakistan Reinsurance Company Limited

Acronyms

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADCs	Alternate Delivery Channels
AEs	Advanced Economies
AFS	Available for Sale
AM	Asset Management
AMCs	Asset Management Companies
AML	Anti-Money Laundering
APIs	Application Programming Interfaces
ATMs	Automated Teller Machines
AUMs	Assets Under Management
B2C	Business-to-Consumer
BCP	Business Continuity Plan
BIS	Bank for International Settlements
BMR	Balancing, Modernization and Replacement
BPRD	Banking Policy & Regulation Department
bps	Basis Points
BSD	Banking Surveillance Department
BSSM	Banking System Stability Map
CAR	Capital Adequacy Ratio
CCB	Capital Conservation Buffer
CDC	Central Depository Company
CDNS	Central Directorate of National Savings
CFT	Combating the Financing of Terrorism
CiC	Currency in Circulation
CIS	Collective Investment Scheme
CISO	Chief Information Security Officer
COD	Certificate of Deposit
COI	Certificate of Investment
COM	Certificate of Musharaka
COVID	Coronavirus disease
COVID-19	Corona Virus Disease-2019
CPF	Countering Proliferation Financing
CR	Current Ratio
CRCs	Corporate Restructuring Companies
CRI	Climate Risk Index
CRWA	Credit Risk Weighted Assets
CSPs	Card Service Providers
DFIs	Development Finance Institutions
DPC	Deposit Protection Corporation
DRP	Disaster Recovery Plan
DRRL	Deferment and RRL
D-SIBs	Domestic Systemically Important Banks
DSSI	Debt Service Suspension Initiative
DTO	Dedicated Takaful Operator
E&P	Exploration & Production
EBIT	Earnings before Interest and Taxes
EC	Eligible Capital
e-CIB	Electronic-Credit Information Bureau
ECL	Expected Credit Loss
EFF	Extended Fund Facility
EFS	Export Finance Scheme
EMDEs	Emerging Market and Developing Economies
EMIs	Electronic Money Institutions
EMs	Emerging Markets
EPD	Exchange Policy Department
ETFs	Exchange Traded Funds
ETGRMF	Enterprise Technology Governance & Risk Management Framework
EU	European Union
FATF	Financial Action Task Force
FCA	Federal Committee on Agriculture
FCY	Foreign Currency
FE-25	Foreign Exchange-25
Fed	Federal Reserve
FED	Federal Excise Duty
FMI	Financial Market Infrastructure
FRR	Fixed Rental Rate
FSB	Financial Stability Board
FSR	Financial Stability Review

FTC	Fair Treatment of Consumer
FX	Foreign Exchange
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GFSR	Global Financial Stability Report, IMF
GHC	Global Health Crisis
GHG	Greenhouse Gas
GM	Gross Margin
GNPLR	Gross Non-Performing Loans Ratio
GOP	Government of Pakistan
HF	Housing Finance
IAs	Investment Advisors
IBD	Islamic Banking Department
IBFT	Inter Bank Funds Transfer
IBI	Islamic Banking Institution
IBWs	Islamic Banking Windows
ICR	Interest Coverage Ratio
IERS	Islamic Export Refinance Scheme
IFCs	Investment Finance Companies
IFRS	International Financial Reporting Standard
ILTFF	Islamic Long Term Financing Facility
IMF	International Monetary Fund
IPO	Initial Public Offering
IPP	Independent Power Producer
IRC	Interest Rate Corridor
ITAC	International Trade Administration Commission of South Africa
KFS	Key Fact Statement
KIBOR	Karachi Interbank Offered Rate
KSA	Kingdom of Saudi Arabia
KSE	Karachi Stock Exchange
LCR	Liquidity Coverage Ratio
LIBOR	London Interbank Offered Rate
LIPI	Local Investors Portfolio Investment
LSM	Large Scale Manufacturing
LTCE	Long Term Country Engagement
LTFF	Long Term Financing Facility
LVPS	Large Value Payment System
MFBs	Microfinance Banks
MoU	Memorandum of Understanding
MPPF	Macroprudential Policy Framework
MRWA	Market Risk Weighted Assets
MTB	Market Treasury Bill
MTS	Margin Trading System
NAPHDA	Naya Pakistan Housing and Development Authority
NARC	National Agriculture Research Centre
NBFCs	Non-Banking Finance Companies
NBFIs	Non-Bank Financial Institutions
NBMFCs	Non-Bank Microfinance Companies
NCCPL	National Clearing Company of Pakistan Limited
NFSC	National Financial Stability Council
NFSR	Net Stable Funding Ratio
NIFT	National Institutional Facilitation Technologies
NII	Net Interest Income
NIM	Net Interest Margins
NMM	Net Mark-up Margin
Non-II	Non-Interest Income
NPC	Naya Pakistan Certificate
NPF	Non-Performing Financing
NPL	Non-Performing Loan
NPSS	National Payment Systems Strategy
NRPs	Non-Resident Pakistanis
NSS	National Savings Schemes
OAEM	Other Assets Especially Mentioned
OMCs	Oil Marketing Companies
OMOs	Open Market Operations
ONR	Overnight Repo Rate
OPEC	Oil Producing and Exporting Countries
ORR	Obligor Risk Rating
ORWA	Operational Risk Weighted Assets
P/E Ratio	Price Earnings Ratio
PAT	Profit after Tax
PBS	Pakistan Bureau of Statistics

PCI-DSS	Payment Card Industry-Data Security Standard
PCR	Provisioning Coverage Ratio
PCRCL	Pakistan Corporate Restructuring Company Limited
PD	Probability of Default
PE	Private Equity
PES-II	Pakistan Energy Sukuk-II
PIB	Pakistan Investment Bond
PKR	Pakistani Rupee
PMEX	Pakistan Mercantile Exchange Limited
PMI	Purchasing Managers Index
PMIC	Pakistan Microfinance Investment Company
PRISM	Pakistan Real-Time Interbank Settlement Mechanism
PSC	Private Sector Credit
PSEFT Act	Payment Systems and Electronic Funds Transfer Act
PSX	Pakistan Stock Exchange
PTF	Participants' Takaful Fund
RAS	Regulatory Approval System
RBS	Risk Based Supervision
RCG Asia	Regional Consultative Group for Asia
REITs	Real Estate Investment Trusts
RFCC	Refinance Facility for Combating COVID-19
RFI	Rapid Finance Instrument
RMCs	Real Estate Investment Trust (REIT) Management Companies
ROA	Return on Assets
ROE	Return on Equity
RRL	Restructure and Reschedule Loan
RST	Reverse Stress Testing
RVPS	Retail Value Payment System
RWAs	Risk Weighted Assets
SBP	State Bank of Pakistan
SC	Steering Committee
SECP	Securities & Exchange Commission of Pakistan
SIF	Social Impact Fund
SLR	Statutory Liquidity Requirement
SME	Small and Medium Enterprise
SNCR	Shariah Non-Compliance Risk
SOPs	Standard Operating Procedures
SRS	Systemic Risk Survey
STZ	Special Technology Zones
SVaR	Stressed Value at Risk
TDR	Term Deposit Receipt
TERF	Temporary Economic Refinance Facility
TFC	Term Finance Certificate
TSA	Treasury Single Account
TT	Telegraphic Transfer
UAE	United Arab Emirates
UK	United Kingdom
USA	United States of America
VaR	Value at Risk
VAR	Vector Auto-Regressive
VC	Venture Capital
VIX	Chicago Board Options Exchange Volatility Index
VRR	Variable Rental Rate
WeBOC	Wed-Based One Customs
WEF	World Economic Forum
WEO	World Economic Outlook
WFH	Work-from-Home
WHO	World Health Organization
WTI	West Texas Intermediate
WTO	Window Takaful Operator