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).**

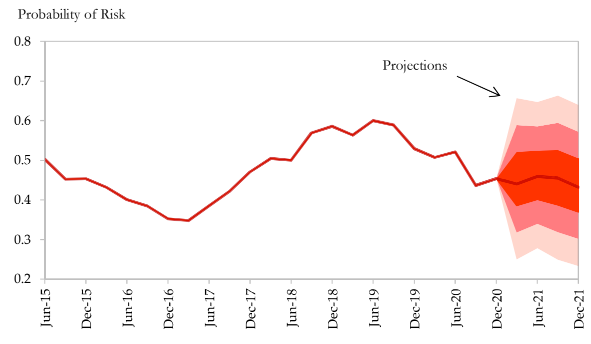
The **Insurance and Takaful industry** maintained its performance as the asset base expanded by 13.03 percent during CY20. Both, the life and non-life sectors demonstrated risk-averse behavior by increasing their exposure in government securities. Nonetheless, growth in premium of insurance industry 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)**.

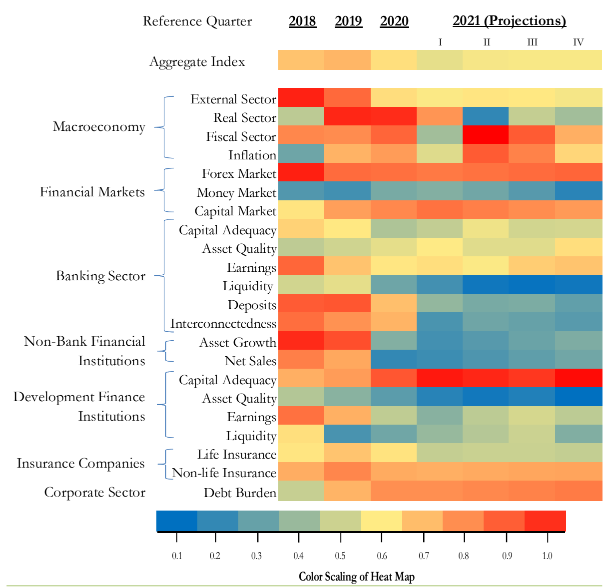
The consolidated picture of the state of financial stability indicates that vulnerabilities increased during Q2CY20 due to the COVID-19 shock. However, the risks subsided afterwards owing to swift and robust policy measures, contained impact of COVID-19, and economic recovery as reflected in estimated 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 S**BP 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)