Box 3.3: COVID-19 and the Banking Sector: SBP measures, lessons learnt and way forward

Global banking industry remained resilient…

COVID-19 pandemic profoundly affected the global economy and tested the resilience of the global financial system. Despite the fact that COVID-19 presented the severe shock, resilience of the global banks remained intact as they entered the pandemic crisis with higher capital and liquidity buffers than 12 years ago at the time of Global Financial Crisis (**GFC**). Though provision expenses of the global banking industry surged during 2020 anticipating deterioration in re-payment capacity of borrowers, substantial rise in NPLs remained absent owing to central banks' policy measures such as payment holidays, loan guarantees and job support programs. Nonetheless, these support measures were scheduled to expire in 2021.

With revival in economic activity across the globe, the corporate balance sheets have generally strengthened, revenues have risen, with profitability surpassing pre-pandemic levels in several economies. Importantly, substantial pickup in bankruptcies, which was being feared in the wake of expiry of supportive policy measures, has not materialized.[81]

SBP took a wide range of measures to support economy and financial system….

SBP acted swiftly to contain the economic and macro-prudential risks associated with the pandemic. Broadly, SBP took the following measures:

- SBP adopted a quite proactive approach in assessing the evolving situation around the globe and within the country. It did extensive discussions with the banking industry through both formal and informal channels and engaged other stakeholders for understanding the issues and challenges and the extent of impact on the banking customers. Besides, **a number of surveys** were conducted that provided timely assessment of vulnerabilities associated with the pandemic and helped in formulation and recalibration of relevant policy responses.
- **Aggressive monetary easing** with a 625 bps cut in policy rate during March 17-June 25, 2020 to ease the financial burden on economic agents. As a result, it reduced interest cost of around PKR 470 billion.
- **Macro prudential** measures to support the solvency of borrowers and preserve and to enhance the capital position of banks so as to maintain the flow of credit in the economy.
- Commencement of **various concessionary financing schemes** such as Rozgar scheme (to support employment), Temporary Economic Refinance Facility (to promote new investments and BMR), and Refinance Facility for Combating COVID-19 (to enhance the capacity of health sector). Also, financing limits under existing concessionary refinance schemes (EFS, LTFF) were enhanced. Moreover, to support the provision of Rozgar Scheme credit to priority sectors, credit guarantee scheme for SMEs was introduced in cooperation with the federal government.
- Measures to ensure **continuity of financial services** and promote the use of safe modes of financial services including digitization of financial services.

The estimated financial impact under these measures was equivalent to 5 percent of GDP.

[81] IMF (2021). Global Financial Stability Report. *October*

Moreover, it is noteworthy that above measures were taken to address liquidity stress, avoid insolvencies and to support economic recovery. Afterwards, SBP moved towards normalization in the wake of robust recovery, higher international commodity prices and inflationary pressures along with ebbing impact of the pandemic waves and effective handling of the pandemic. For instance, policy rate was increased by 275 bps to 9.75 percent[82] as well as macroprudential measures were enacted to curb auto financing during CY21.

SBP's policies had material macro-financial impact...

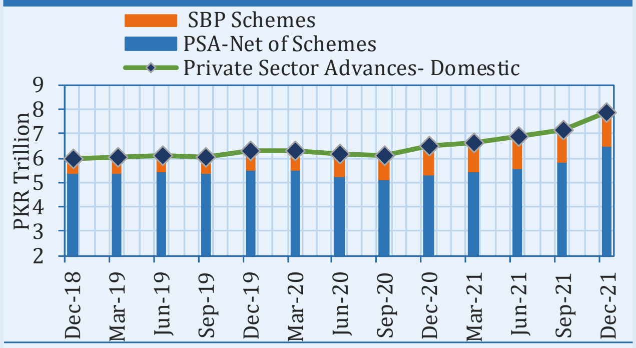
SBP policy measures helped lessen the intensity of pandemic shock. For example, effective communication strategy helped calm the market during the elevated stress phase of the outbreak. Under loans deferment/restructuring scheme, PKR 911 billion worth of loans were deferred/restructured. Counterfactual analysis reveals that there could have been a steep rise in banks' NPLs had the deferral on principal and rescheduling/ restructuring not been allowed. Assuming complete losses against the loans deferred and restructured/rescheduled, gross NLP ratio could have risen to 18.2 percent (against 9.2 percent recorded at end Dec-20) — still well below the estimated critical level of this infection ratio. Similarly, CAR could have declined to 15.7 percent (18.3 percent recorded at end Dec-20), and banks might have experienced negative pre-tax profitability of PKR 227 billion in CY20. These estimated negative results had the strong potential to spark systemic risk of pro-cyclicality between deterioration in banks' solvency and contraction of credit.

Besides, financing under Rozgar scheme—amounting to PKR 212 billion—helped prevented lay-off of 1.7 million employees including 383 thousands employees of SMEs and small corporates. Moreover, various economic sectors including textiles, cement, and auto availed substantial financing of PKR 283 billion under TERF for capacity expansion. In addition, the spillover impact of disbursements under TERF—in the form of additional working capital financing—have started to materialize and is likely to be seen further going forward.

It is noteworthy that **PSA** remained under stress during CY20 owing to the pandemic. However, SBP schemes introduced during the pandemic played a major role in supporting PSA (**Chart 3.3.1)**. Encouragingly, asset quality indicators also continued to improve manifesting the conducive role of SBP actions to support borrowers' solvency and stimulate economic activity (**Chart 3.3.2**).

On digitization front, SBP policy drive to waive the bank charges on online transactions commonly known as Inter Bank Funds Transfers (**IBFT**) fee and moral suasion to banks to promote the use of digital finance led to significant increase in the use of digital banking services. However, this measure was revised in the month of Jun-21, withdrawing fee waiver for transactions exceeding PKR 25,000 per month per account. During CY21, E-banking transactions increased by 40.5 percent (YoY basis).

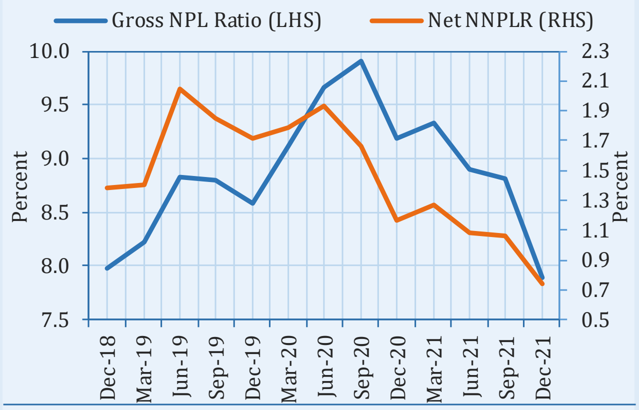
Chart 3.3.1: Bifurcation of Outstanding Domestic Private Sector Advances (PSA)



Source: SBP

82 Policy rate increased by a cumulative 400 bps to 13.75 percent after review period up till May CY22.

Chart 3.3.2: Asset quality continued to improve



Source: SBP

Pandemic shock has introduced valuable lessons...

While the COVID-19 pandemic is not yet over, its shock has revealed certain lessons for financial system regulators and central banks across the globe. As a way forward, these lessons can help in dealing with any resurgence in the pandemic as well as any other similar stress situation.

The COVID-19 crisis has affirmed the significance of a resilient financial system especially the banking sector of the economy the pandemic posed some serious stability challenges for the banking sector. However, due to the resilience built over the years in the form of capital and liquidity buffers under the Basel framework and operational capabilities, the banking sector has largely emerged as a part of solution against the pandemic.

An associated lesson to financial system resilience is the need to regularly assess the supervisory, regulatory and legal frameworks in terms of the international standards and best practices to identify gaps for possible improvements.

The crisis has revealed that timely and targeted actions coupled with effective signaling proved key to navigating through uncertainty. Moreover, active coordination with industry and candid communication is pivotal for successful policy interventions.

Also, for devising and executing effective policy interventions, availability of adequately detailed and high frequency data with minimum lag is an important element. A related lesson is that it is also important to identify the relevant facts and understand how they are interconnected. Moreover, the flexibility on the part of policy makers is essential so that they must be prepared to adjust their views and actions as underlying facts change amid imperfect information.

In the wake of pandemic, the emphasis has emerged on a balanced policy mix (e.g. monetary, macroprudential and fiscal policies) to mitigate the risks.

Since pandemic has accelerated the pace of digitization across the world, cybersecurity risks have also risen in tandem. Accordingly, financial institutions need to enhance resilience by investing more in IT and human resources.

The crisis has underscored the significance of banks' Business Continuity Plan (**BCP**). Banks need to regularly update their BCP and also incorporate novel risks like pandemic scenarios in their plans.

The pandemic has not just posed challenges, it has offered opportunities to enhance the outreach of financial services as customers have become more receptive to innovative digital finance products. This change in paradigm is helpful in triggering the financial inclusion and quality and efficiency of financial services.

Finally, there is a need to proactively monitor the emerging situation and remain flexible in its response to challenges of the pandemic vis-à-vis macroeconomic dynamics. Further, a vast body of experience available domestically and elsewhere can be helpful should such a stressful situation occur in future.