The Overview

The performance of the financial sector of Pakistan improved as it continued to exhibit financial and operational resilience during CY21. Despite legacy economic challenges and uncertainties surrounding the path of pandemic, the sector supported the economic recovery with uninterrupted provision of credit and financial services. The consolidated asset base of the sector increased by 15.6 percent in CY21 compared to 14.0 percent growth in the previous year and the financial depth in terms of financial sector assets to GDP ratio stood at 63.9 percent. (**see Table 1**)

The environment in which the financial sector operated during CY21 was marked with a strong rebound in economic activity as the global output increased by 6.1 percent—in stark contrast to a 3.1 percent contraction in CY20, which was beset by wider disruptions in economic activities owing to mobility restrictions, lockdowns and heightened uncertainty driven by the pandemic.[1] Impressive economic recovery was driven by a surge in demand, effective diffusion of vaccine and the receding intensity of the pandemic with contained impacts of its new variants. Besides, sustained support from fiscal and monetary policies also provided necessary impulse to the economic recovery.

Along with spurt in economic activity, however, inflationary pressures also emerged across the globe and gradually got stronger towards the end of CY21. Amid policy stimulus activated during the COVID-19 outbreak, a surge in pent up aggregate demand coupled with supply chain bottlenecks mainly drove up global commodity prices and inflation levels.

Table 1: Assets Composition of the Financial Sector

PKR billion

	CY18	CY19	CY20	CY21
MFBs	328	380	494	582
DFIs	238	377	439	539
NBFIs	1,185	1,339	1,700	2,023
Insurance	1,472	1,693	1,931	2,143
CDNS	3,654	3,998	4,248	3,884
Banks	19,682	21,991	25,124	30,058
Total	**26,559**	**29,778**	**33,935**	**39,230**
YoY Asset Growth (Percent)				
MFBs	32.7	15.9	30.0	17.8
DFIs	4.6	58.1	16.5	22.6
NBFIs	3.1	13.0	27.0	19.0
Insurance	10.5	15.0	14.0	11.0
CDNS	5.3	9.4	6.2	-8.5
Banks	7.3	11.7	14.2	19.6
Overall Financial Sector	**7.2**	**12.1**	**14.0**	**15.6**
Percentage Share in Total Assets				
MFBs	1.2	1.3	1.5	1.5
DFIs	0.9	1.3	1.3	1.4
NBFIs	4.5	4.5	5.0	5.2
Insurance	5.5	5.7	5.7	5.5
CDNS	13.8	13.4	12.5	9.9
Banks	74.1	73.9	74.0	76.6
Assets as a Percentage of GDP*				
MFBs	0.8	0.8	1.0	0.9
DFIs	0.6	0.8	0.9	0.9
NBFIs	2.9	2.9	3.3	3.3
Insurance	3.5	3.7	3.7	3.5
CDNS	8.8	8.8	8.2	6.3
Banks	47.4	48.2	48.6	49.0
Overall Assets	**64.0**	**65.2**	**65.7**	**63.9**

Note: *GDP at market prices (2015-16=100)

Source: SBP, SECP, CDNS & PBS

Economic dynamics in Pakistan broadly remained in line with the global economic trends. After experiencing a 0.94 percent contraction in FY20, GDP posted a robust recovery of 5.7 percent in FY21. This momentum continued in FY22 as the economy is estimated to post a broad based growth of 6.0 percent. Marked revival in economic growth was attributed to a number of factors such as re-opening of the economy, effective management of the pandemic, timely and targeted

[1] IMF. (2022). World Economic Outlook Update. *April.*

policy interventions and continuation of pandemic support measures introduced in CY20.[2]

Nonetheless, as a result of robust recovery in demand and rising international commodity and oil prices, external account pressures re-emerged, and Current Account Deficit (**CAD)** gradually increased to USD 12.3 billion in CY21 (USD 0.65 billion in CY20). Though, exports performance improved and remittances inflows increased, upsurge in prices and volume of imports widened the external account deficit particularly in the second half of the year. Accordingly, PKR depreciated by 9.4 percent vis-a-vis USD, nudging the headline inflation even further up. Core inflation, which remained broadly stable, also started to inch-up towards the end of CY21.

Due to the deteriorating inflation outlook and rising risks to the external account, SBP took a number of stabilization measures to discourage imports and moderate domestic demand. For instance, policy rate was increased by 275 basis points (**bps**) in the last four months of the year, list of import items subject to 100 percent cash margin requirements (**CMR**) was expanded and macro-prudential measures were instituted to contain growth in consumer financing.[3] Furthermore, cash reserve requirement (**CRR**) was increased by one percentage point to 6 percent (see **Chapter 1**).

Amid changing macroeconomic dynamics, **financial markets** continued to function smoothly and exhibited relatively lower volatility and stress compared to last year. However, FX and equity markets experienced some increase in volatility during H2CY21. The volatility in FX market - driven by widening CAD - remained relatively contained owing to FX inflows from issuance of Euro bonds, enhancement of quota from IMF, receipts in Roshan Digital Accounts (**RDA**), and deposits' placement from a friendly country. Importantly, cumulative RDA inflows crossed USD 4 billion by end March-2022. After heading North in the first half of CY21, the equity market moderated in the second half of CY21. The slowdown was due to emerging macroeconomic pressures and economic stabilization measures. In the money market as well, the overnight repo rate experienced a brief period of increased volatility in the second half on account of rise in SBP policy rate and growing credit needs of the Government. The tightening in policy stance and rising inflation expectations also shifted the yield curve up. The market interest rates, however, remained within the interest-rate corridor due to effective liquidity management by SBP (**see Chapter 2**).

The **banking sector**—with 19.6 percent increase in asset base—maintained a strong growth trajectory in CY21 while its overall risk profile of remained satisfactory. The balance sheet expansion was supported by strong growth in both private sector advances and investment. Substantial growth in advances was backed by continued revival of economic activities, low interest rate environment, higher input prices, and SBP's Temporary Economic Refinance Facility (**TERF**). The assets expansion was well supported by substantial growth in deposits which was aided by a number of factors including sizable inflow in RDA, increased use of digital channels for banking transactions, higher workers' remittances, and rise in return on deposits towards the year end. Further, banks funded higher growth in assets by increasing reliance on borrowings from financial institutions.

Credit risk of the banking sector remained contained as asset quality indicators illustrated visible improvement. Most of the non-performing loans (**NPLs**) ratios declined below the pre-pandemic level. The timely debt relief measures introduced by SBP, prudent lending practices and improved repayment capacity of the borrowers as reflected in impressive corporate sector earnings

[2] Around 55 percent of the total population was fully vaccinated by first week of end May-22. Moreover, the pandemic waves experienced in CY21 were contained and less fatal and disruptive as compared to CY20. The country performed relatively better vis-à-vis peer countries in managing the pandemic.

[3] Later on, the policy rate was further increased by 400 bps until May-2022 to 13.75 percent.

were the key drivers of improvement. Even after expiry of the policy support measures, the overall recovery rate of loans deferred /restructured under debt relief schemes remained satisfactory. Besides, market risk dynamics remained satisfactory due to limited market-related exposures and adequate resilience of the banks.

Banks' profitability increased at a reasonable pace, and ROE improved to 14.1 percent in CY21 (13.8 percent in CY20). However, the baseline indicator of ROA slightly moderated owing to the low interest rate environment that prevailed during most of part of the year and volume led growth in income. Capital and liquidity buffers remained robust. The Capital Adequacy Ratio (**CAR**) at 16.7 percent as of end-CY21 was well above the minimum local and global regulatory requirements of 11.5 percent and 10.5 percent, respectively. Similarly, the Basel-III **Liquidity Coverage Ratio** (LCR) at 215 percent was well above the regulatory standard of 100 percent. Though CAR moderated somewhat owing to healthy growth in private sector advances, it also indicated better utilization of the banks' capital to support the economic revival as the flow of credit and banking services increased.

The performance of **Islamic Banking Institutions** (**IBIs**) was impressive in CY21 as the asset base grew by 30.6 percent. This growth came mainly from a surge in financing flows followed by investment in Government Sukuk. Strong growth in deposits funded most of the increase in asset base. Asset quality indicators of IBIs further improved, earnings remained steady, and CAR stood well above the regulatory minimum requirement **(see Box 3.1)**. Despite a significant share in total banking sector assets, the Islamic banking industry lacked Shariah compliant facilities to manage their short term liquidity. To address the liquidity management challenges, SBP has introduced *Shariah-Compliant Standing Ceiling Facility* and *Mudarabah-based Open Market Operations* (**OMO-Injections**) for IBIs **(see Annexure A).**[4, 5]

The asset base of **Microfinance Banks** (**MFBs**) exhibited 17.8 percent growth during CY21. The expansion was mainly contributed by advances followed by investments. In the wake of the pandemic, asset quality of the MFBs deteriorated as the mobility restrictions and precautionary measures severely impacted the repayment capacity of the MFBs' traditional low net worth borrowers and disrupted the institution-borrower relationships. As a result, the overall infection ratio inched up and earnings indicators deteriorated due to increase in provision charges. Though some of the MFBs faced challenges in maintaining the capital requirements, the overall CAR of MFBs stood at 18.3 percent, well above the minimum regulatory requirement of 15.0 percent (**see Chapter 5**).

Non-Bank Financial Sector manifested a mixed picture during CY21. Growth momentum of **Development Finance Institutions (DFIs)** continued as the asset base expanded by 22.6 percent as compared to 16.5 percent increase in CY20. Although advances observed strong growth, balance sheet expansion was mainly driven by investments. Short-term borrowings remained the major source of funding. Asset quality indicators improved owing to enhanced repayment capacity of the borrowers. Earnings, nonetheless, moderated while solvency profile remained strong. (**see Chapter 6.1**)

Non-Bank Financial Institutions (NBFIs) witnessed 19.0 percent growth in CY21 (compared to 27.0 percent growth in previous year). Money market funds primarily supported NBFIs growth. Moreover, NBFIs involved in the financing business, which particularly faced pandemic-related stresses in CY20, demonstrated improved performance during the reviewed year. Encouragingly, three housing finance companies were established in CY21 as a result of Government's initiatives to promote the housing

[4] DMMD Circular No. 24 of 2021

[5] DMMD Circular No. 25 of 2021

sector. Nonetheless, lending segment of NBFIs remained relatively concentrated as a few firms hold major market share, while liquidity risk remains an important factor for these firms as they generally have limited access to ready market funding for asset-liability management. Moreover, risks arising from interconnectedness between the banks and NBFIs remained contained, though the sectors have sizeable inter-sectoral exposures. (**see Chapter 6.2**).

The **Insurance and Takaful industry** grew by 11.0 percent during the reviewed year (14.0 percent in CY20). Both life and non-life segments observed a sharp rise in insurance premium which contributed to increased profitability. The acceleration of national health insurance program mainly uplifted the premium of life insurance sector. Life insurance sector in general continued to maintain most of their investments in government securities, while non-life sector increased its investments in equity stocks (**see Chapter 6.3**).

The performance of **Financial Market Infrastructures** (**FMIs**) further improved as their resilience remained intact in CY21. Electronic transactions, both in terms of value and volume, posted strong growth. SBP also took a number of measures to promote digital finance, including the introduction of person-to-person free instant payment through SBP's flagship initiative *Raast* for retail transactions, development of a licensing and regulatory regime for digital banks, and continuation of fee waivers on interbank fund transfers up to certain limits.

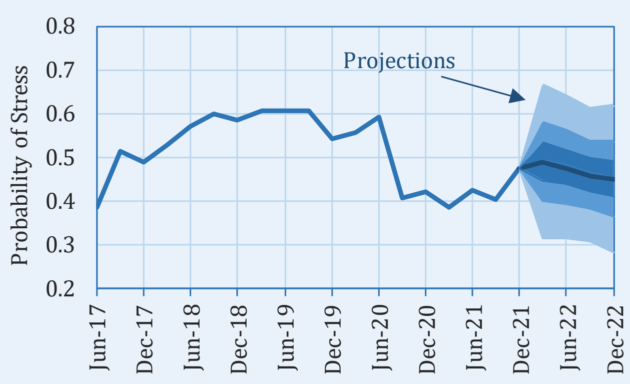
The increasing popularity of digital finance among customers and rise in digital transactions, however, have been accompanied by increase in cyber security risks. Besides a comprehensive regulatory and supervisory framework which supports the industry against cyber security risk, SBP took a number of further measures during the reviewed year to enhance the industry's resilience against the risk. For example it has linked approval of the new digital financial initiatives like digital banks with cyber readiness. (**see Chapter 8 and Box 8.1**)

Other than conventional economic and financial risks, climate change is a significant exogenous risk factor faced by the economy. Due to a unique geographical location, Pakistan is among the countries that are highly susceptible to the effects of climate change and extreme weather conditions. These changes have serious repercussions for financial stability as well as the economic and social wellbeing of the nation. To this end, SBP analyzes the climate-related risks caused by the extreme weather conditions as a part of its periodic macro stress testing exercise. Further, SBP is taking measures to mitigate these risks. For instance, to facilitate banks to effectively implement the green banking guidelines, SBP is developing the Environmental and Social Risk Management (**ESRM**) Implementation Manual. (**see Chapter 4 and Box 4.1**)

The **Non-Financial Corporate Sector** showed a marked improvement during CY21. Among the sectors, automobiles, textiles and petroleum sectors observed notable expansion in sales. The sample of top 100 listed firms witnessed improvements in their profitability, liquidity, business efficiency and turnover indicators. Particularly, after-tax profit surged by 46.5 percent. Consequently, debt repayment capacity observed healthy improvement. Moreover, financial standing and performance of top 30 borrowing groups of banking sector also improved during CY21 (**see Chapter 7 & Box 7.1**).

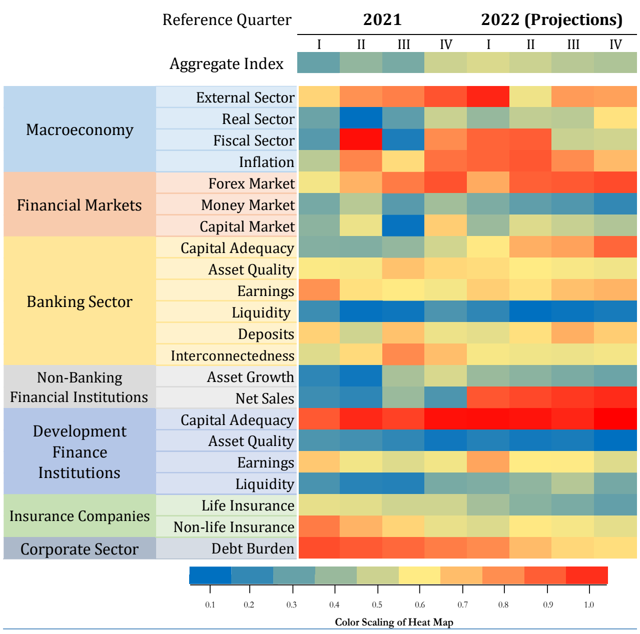
The **consolidated financial stability matrix** points to some increase in risks to stability of the financial sector towards end CY21, primarily driven by external account pressures and associated rise in inflation (**Chart 1A & 1B**). Accordingly, SBP proactively implemented necessary measures such as monetary tightening, increase in CRR, and adjustment in Macro prudential policy tools to narrow down the CAD and keep inflation in check.

Chart 1A: Financial Sector Vulnerbility Index (FSVI)



Source: SBP Estimates

Chart 1B: Financial Sector Heat Map



Source: SBP Estimates

Going forward, the state of financial stability largely depends on emerging macroeconomic dynamics in the context of trajectory of global commodity prices (particularly the oil prices), geo political tension in Eastern Europe, evolving domestic political scenario, and monetary policy stance in advanced economies.

The commodity prices index has been showing a staggering rise (**see Chart 2**), which has also been identified by market participants in the latest Systemic Risk Survey among the top risks facing the financial system (**see Box 1**). Moreover, IMF projects a significant slowdown of global economy to 3.6 percent in CY22 compare with 6.1 percent in CY21. These factors may influence the country's external account dynamics. A further increase in oil prices may exacerbate the CAD that may have adverse implications for financial markets and the real economy. On the other hand, continued tightening by Federal Reserve, for instance, may push up the external funding cost and add to pressures on exchange rate, impacting foreign trade and portfolio investments.

Chart 2: Global Commodity Price Index

Source: IMF

On the domestic front, preserving external sector stability, implementation of agreed reforms under IMF program—including fiscal discipline — and political stability will play a pivotal role in keeping the confidence in financial markets, maintaining financial system stability and addressing the emerging risks to macro economy.

The recent tightening of monetary policy may have differential implications for the banking sector. Usually such a rise impacts the debt repayment capacity of highly leveraged borrowers. However, the delinquency rates in banks' lending portfolio are expected to remain in check owing to improved debt servicing capacity of the corporate sector, decent recoveries on rescheduled /restructured loans under the debt relief scheme and continuing demand for bank credit due to higher input prices.

The consumer portfolio of banks may also face some strain due to both rate rise and general inflation levels. However, keeping in view household sector's low level of leverage, contained exposure of banks to this sub-sector, and risk management capabilities that banks have developed over the years for retail exposures, and the prudential requirement of making general provisions against consumer portfolio, it is expected that the banks may not face any significant strain on asset quality and earnings. The recent increase in interest rates will improve the banks' margins on growing earning assets. Also, the fiscal needs of the government may keep the level of banks' investments in government securities at elevated level. However, the mobilization of deposits and generation of adequate liquidity is likely to remain a key challenge for banks to finance the increased demand for bank credit from public and private sector.

The implementation of IFRS-9 may result in slight increase in provisioning expenses in respect of prospective losses; however, it has been observed that the banking industry in general has already raised the level of general provisions over the last few years.

Given that considerable uncertainties surround the projected path of financial stability, SBP regularly conducts scenario analysis (macro stress testing) to chart out probable outlook of banks' credit risk and solvency against the multiple domestic and global stress factors for informing its policy interventions. The latest results of the scenario analysis show that the banking sector has adequate resilience to withstand the severe but plausible macro-financial shocks, as its capital adequacy ratio remains significantly higher than both domestic and global benchmarks of solvency in the medium term. Reassuringly, the domestic systemically important banks particularly show stronger capital buffers and the banking sector in general is likely to continue supporting the economy by lending even during periods of economic stress (see **Chapter 4: Resilience of Banking Sector under Adverse Conditions**).

SBP has instituted a comprehensive micro and macro prudential policy framework to proactively monitor and address the emerging risks to financial stability. This framework is continuously being reviewed and updated to align with emerging international best practices and domestic market dynamics. In this connection, a number of measures were taken during the reviewed year, including institution of emergency liquidity assistance framework, implementation of risk-based supervision framework, amendments in the SBP Act to explicitly formalize SBP's financial-stability mandate and roles in respect of bank resolution and crisis management. Moreover, a key tool to manage liquidity crisis i.e. Lender of Last Resort facility (emergency liquidity assistance) has been further strengthened. In the past, SBP has effectively applied its supervisory and crisis management framework and its relevant tools in the face of various complex and dynamic stressed scenarios to ensure continued financial stability in the system. With these capabilities, experience and enhanced toolkit, SBP stands prepared to address near-term challenges to the resilience of the financial system and facilitate economic activity.