The Overview

The year 2022 was marked by a deterioration in domestic economic activity, reflecting partly the impact of slowing global growth, tightening in financial conditions, intensification of the domestic imbalances and political instability. In face of these challenges, however, the financial sector of Pakistan continued to exhibit operational and financial resilience. The consolidated asset base of Pakistan's financial sector increased by 18.3 percent in CY22, with major contribution coming from the banking sector. However, the financial depth in terms of assets-to-GDP ratio, which is already low among peer countries,[1] further declined to 61. 3 percent on the back of relatively higher inflation **(Table 1)**.

After a strong post-pandemic recovery of 6.3 percent in 2021, global economic growth moderated to 3.4 percent in 2022 because of various economic and geopolitical headwinds.[2] The continuous buildup of inflationary pressures and global supply chain disruptions were compounded by the conflict between Russia and Ukraine — two key players in the global supply chain of various food and energy items — and recurrent episodes of COVID-19 in China. Further, a reversal of monetary policy stance to fight inflation, especially by Advanced Economies (AEs), tightened the global financial conditions. In the face of stressed macro-financial conditions and heightened uncertainty, global financial markets remained increasingly volatile.

Table 1: Assets Composition of Financial Sector

	CY19	CY20	CY21	CY22
Billion Rupees				
MFBs	380	494	582	753
DFIs	377	439	539	1,431
NBFIs	1,339	1,700	2,023	2,563
Insurance	1,710	1,938	2,143	2,460
CDNS	3,998	4,248	3,884	3,390
Banks	21,991	25,124	30,058	35,796
Total Assets	**29,795**	**33,943**	**39,229**	**46,393**
YoY Asset Growth (Percent)				
MFBs	15.9	30.0	17.8	29.4
DFIs	58.1	16.5	22.6	165.7
NBFIs	13.0	27.0	19.0	26.7
Insurance	14.5	13.4	10.5	14.8
CDNS	9.4	6.2	-8.5	-12.7
Banks	11.7	14.2	19.6	19.1
Overall Financial Sector	**12.1**	**13.9**	**15.6**	**18.3**
Percentage Share in Total Assets				
MFBs	1.28	1.46	1.48	1.62
DFIs	1.27	1.29	1.37	3.09
NBFIs	4.49	5.01	5.16	5.52
Insurance	5.74	5.71	5.46	5.30
CDNS	13.42	12.51	9.90	7.31
Banks	**73.81**	**74.02**	**76.62**	**77.16**
Assets as a Percentage of GDP*				
MFBs	0.8	1.0	1.0	1.0
DFIs	0.8	0.8	0.9	1.9
NBFIs	2.9	3.3	3.3	3.4
Insurance	3.7	3.8	3.5	3.3
CDNS	8.8	8.2	6.3	4.5
Banks	48.2	48.6	49.1	47.3
Overall Assets	**65.2**	**65.7**	**64.1**	**61.3**

Note: * GDP= Nominal GDP at market prices (2015-16 =100)
Source: SBP, SECP, CDNS & PBS

These global developments accentuated the domestic macroeconomic challenges and put further pressure on building imbalances that are a consequence of domestic structural issues.

[1] Pakistan's financial deepening indicators are relatively low compared to regional countries. For further details, please refer Governor's Annual Report FY2021-22.
[2] International Monetary Fund. (2023). World Economic Outlook: A Rocky Recovery. *Washington, April.* For details, please visit https://www.imf.org/en/Publications/WEO/Issues/2023/04/11/world-economic-outlook-april-2023

Besides rising global commodity prices, high import demand, lower workers' remittances, and low export competitiveness and productivity kept external account balance under stress, while external financing also dried up due to delay in completion of the 9th review under IMF's Extended Fund Facility (EFF) program and tightening of global financial conditions. In the face of these pressures, PKR substantially depreciated over the year. This, coupled with higher international commodity prices and supply side shocks, which were also driven by unprecedented rains and flooding of Q3CY22, pushed average inflation to 19.9 percent in the year under review. On the other hand, fiscal balance also remained under pressure due to slowdown in tax revenue amid subdued economic activities and rising debt servicing costs that substantially increased government's reliance on bank borrowing. Amid these developments, Pakistan's sovereign credit rating was also downgraded by international credit rating agencies.

Keeping in view the rising imbalances, the policy tightening that ensued in later part of CY21 got further traction during CY22 and a number of policy interventions were instituted by SBP and the government. For instance, policy rate was further increased by 625 basis points during CY22 to 16.0 percent, and the hike continued in the post review period.[3] Other actions included macro-prudential measures pertaining to consumer financing and administrative measures to contain external imbalance.

As a result of policy tightening and demand contraction measures, current account deficit improved towards the year end and business activity started to slow down. For example, the Business Confidence Index (BCI) in H2CY22 declined to its lowest level since April 2020, and Large Scale Manufacturing's (**LSM**) average output for CY22 decelerated to 6.0 percent from 17.5 percent in CY21. Accordingly, the estimated economic growth for FY23 lowered to 0.29 percent, compared to 6.1 percent growth in FY22 (see **Chapter 1**).

Domestic **Financial Markets** experienced substantial volatility and stress during CY22. Particularly, FX market faced stress during second half of CY22 as external account came under pressure due to delay in the completion of IMF program reviews and drying up of external inflows. Also, money market witnessed stress owing to increase in government borrowings from banks and noticeable growth in private sector credit, while the pace of deposit mobilization decelerated. However, SBP's liquidity management kept PKR liquidity pressures under check. Similarly, bearish sentiments prevailed in equity market for the most part of CY22 and KSE-100 index fell by 9.4 percent (see **Chapter 2)**.

Despite challenging conditions**, banking sector** stability indicators largely remained steady during CY22. The asset base grew by 19.1 percent reflecting the growth momentum of previous years. However, a surge in investment in government securities principally supported this growth as banks' exposure to government reached 55.5 percent of the asset base. Private sector advances, despite slight moderation, increased at a notable pace as higher input prices augmented the growth in working capital finance. On the funding side, banks' reliance on borrowings rose further due to a significant deceleration in deposits.

The credit risk of the banking sector remained contained during CY22. Non-performing loans (NPLs) grew at a slower pace than advances; in addition, banks maintained adequate provisions to cover loan losses. The gross non-performing loans ratio (**GNPLR**) lowered to 7.3 percent in CY22 from 7.9 percent last year, while the net NPLs ratio (**NNPLR**) slightly inched up to 0.8 percent from 0.7 percent. The residual risk, i.e. NNPLR and NNPL to capital ratio however remained at one of its lowest levels of last two

[3] Policy rate has been increased by 500 bps in CY23 so far.

decades. The low delinquencies in the present stressed macroeconomic conditions can be ascribed to both a general tendency in banks' lending strategy to prefer firms having better credit worthiness and established track record, as well as corporate sector's ample liquidity and capital cushions that were also supported by their performance during last year.

Market risk profile of banking sector presented a mixed picture during CY22. While interest rate risk mainly drove the overall market risk, equity and FX risks remained subdued due to conservative regulatory standards. During the year, banks' holding of government securities significantly increased. However, banking sector was generally able to sustain the impacts of rising interest rates, as banks effectively managed the maturity mismatches and increased the holding of floating-rate instruments.

Banks' asset-based liquidity indicators remained satisfactory. The Basel-based liquidity indicators i.e. liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) stood at 216 percent and 166 percent, respectively at end CY22. However, market liquidity conditions remained under stress due to slower growth in deposits vis-à-vis higher demand for bank credit particularly from the government. While inflationary pressures and economic slowdown affected the depositors' saving capacity and credit demand, banks' asset-liability management (ALM) strategy and incentive to mobilize deposits could also have been influenced by the tax policy, which linked tax rate on income from government securities to banks' advances to deposits ratio (**ADR**).[4]

Banking sector's profitability increased during CY22, primarily due to rise in interest income on investments in government securities, which contributed around 60.0 percent of total interest income. The increase in bottom line was however kept in check by stronger growth in interest expenses and substantially higher tax charges.[5] Accordingly, ROA posted a fractional improvement to 1.01 percent in CY22 compared to 0.96 percent in CY21, while ROE improved to 16.9 percent from 14.0 percent in last year. With growth in capital base, capital adequacy ratio (CAR) improved to 17.0 percent, remaining well above the minimum regulatory requirement of 11.5 percent. Growth in earnings and contained delinquencies in loan portfolio backed by banks' prudent lending practices augmented the solvency of the banking sector (see **Chapter 3)**.

Islamic Banking Institutions (IBIs) continued their growth momentum as their asset base expanded by 29.6 percent in CY22, while their share rose to 22.0 percent. In line with sectoral trend, the expansion in the asset base was primarily driven by investments as Government allocated new assets for issuance of Ijara Sukuk. On the funding side, the deposit mobilization was robust while reliance on borrowings also remained sizable. Asset quality indicators of IBIs improved further and remained better than their conventional counterparts. Earnings growth rebounded from last year and augmented the bottom-line indicators as well. Accordingly, the solvency position further strengthened during CY22, manifesting the enhanced resilience of IBIs **(see section on Islamic Banking in Chapter 3)**. In line with the drive to transform banking system to Sharia-compliant mode, Islamic banking industry together with its market infrastructure and support mechanisms has come a long way over the years. Federal Shari'at Court in its judgment of April 2022 has ordered the full conversion of banking system to Islamic mode. In this connection, a brief review of historical perspective on Islamic banking, key challenges and opportunities of conversion to Islamic mode, and SBP's strategy thereon is given in **Box 3.2** "**SBP's Strategy to transform the banking sector to Islamic mode – key challenges and opportunities**".

[4] The ADR-linked tax policy entailed progressively higher tax rates for banks with lower ADR. However, the policy has been withdrawn for tax year 2024.

[5] Tax charges to pre-tax profit ratio increased to 52.1 percent in CY22 from 41.4 percent last year.

Microfinance banks (MFBs) remained under stress due to lingering effects of COVID that were further compounded by deterioration in macroeconomic conditions and flooding in third quarter of CY22. Asset quality indicators deteriorated as GNPLR rose to 6.7 percent in CY22 from 5.2 percent in CY21, while NNPLR inched up to 1.5 percent from 1.2 percent. The sector incurred (after tax) loss of PKR 17.2 billion due to high provisioning and operating expenses vis-à-vis contained incomes. Accordingly, the overall CAR of MFBs fell to 10.9 percent by end of CY22 (see **Chapter 5**).

Non-Bank Financial Sector demonstrated strong growth during CY22. **Development Finance Institutions' (DFIs)** balance sheet expanded by 165.7 percent compared to 22.6 percent growth in CY21. Investment in government securities primarily drove up this expansion on the back of borrowings from SBP and scheduled banks, while advances also observed noticeable growth. Due to an increase in advances and higher recoveries against NPLs, asset quality indicators also improved over the year. Earnings posted improvement while CAR, despite slight moderation, remained strong at 36.5 percent (see **Chapter 6.1**).

Non-Bank Financial Institutions (NBFIs) witnessed growth of 26.7 percent in CY22. This strong performance was mainly contributed by mutual funds industry, which also constitutes the major part, i.e. 61.4 percent of the sector. In the backdrop of high interest rate environment, money-market and income funds showed impressive growth while equity funds observed redemptions due to lackluster performance of the equity market. Moreover, Real Estate Investment Trust (**REIT**) segment showed significant growth during CY22 due to enabling policy environment and operationalization of new schemes. The lending segment of NBFIs also manifested strong expansion of 21.6 percent supported by investment finance companies (IFCs) and non-bank microfinance companies (NBMFCs). The latter, however, faced increased stress due to heavy flooding in Q3CY22. The interconnectedness between bank and mutual funds industry exists along different dimensions, but the associated risks remained manageable during the year under review (see **Chapter 6.2**).

Insurance sector posted 14.8 percent growth during CY22, mainly on the back of life insurance segment that also dominates the sector in terms of asset base and premium. Although, life segment witnessed increase in groups claims and individual surrenders, growth in investment income augmented the bottom line. The non-life segment, on the other hand, faced some deterioration in performance indicators as the claims increased due to flooding and natural calamities while cost of repairing fixed assets also increased due to inflationary pressures (see **Chapter 6.3**).

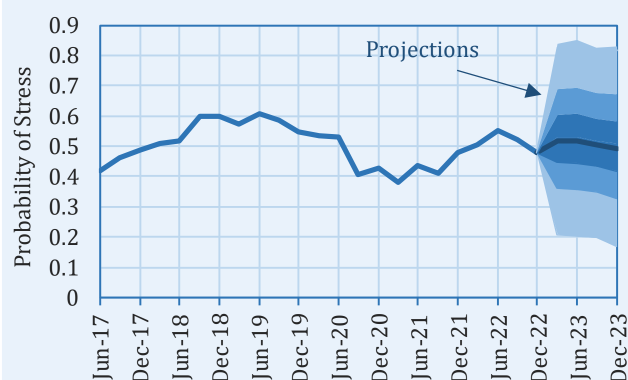
The **Financial Market Infrastructures (FMIs)** remained robust and resilient during CY22. E-banking transactions continued to gain traction and augmented the robust growth in retail payments while volume of paper-based transactions continued to decline, reflecting customers' increased preference for e-banking. The performance of PRISM – large value payment system – in terms of business activity moderated owing to economic slowdown. Importantly, SBP implemented the second phase of Raast during CY22, enabling instant and free Person-to-Person (P2P) fund transfers. At the same time, a comprehensive licensing and regulatory framework for digital banks was also issued with a view to promote digital financial services in a prudent manner. Moreover, a number of improvements were made in cybersecurity framework (see **Chapter 8**). It is important to note that the growth of digital financial services (DFS) has accelerated over the last few years. Realizing the significant role that technology and innovation can play in revolutionizing the provision of financial services, SBP and policymakers are strategizing to leverage the technology to promote policy objectives of

inclusion, efficiency and convenience of customers in a sustainable manner. However, as certain innovations like private crypto assets involve a number of implications for the economy, financial institutions and customers, SBP advised the regulated financial institutions to refrain from dealing in crypto assets, while cautioning the general public about the risks related to such assets and products (see **Special Section in Chapter 8**).

The **Non-Financial Corporate Sector** posted a moderate decline in earnings due to the elevated economic stress and an increase in taxation and financing costs. Nevertheless, the overall financial standing of top 100 listed companies remained steady and corporate sector in general continued to serve its obligations to financial institutions. Textiles, cement, and automobiles sectors experienced decline in sales while performance of other sectors such as petroleum (exploration and production), chemicals & pharmaceutical, and energy sectors remained robust. Also, the top 30 borrowing groups of the banking sector continued to show stable solvency position and adequate debt repayment capacity during the year under review, despite facing some deceleration in financial performance (see **Chapter 7** & **Box 7.1**).

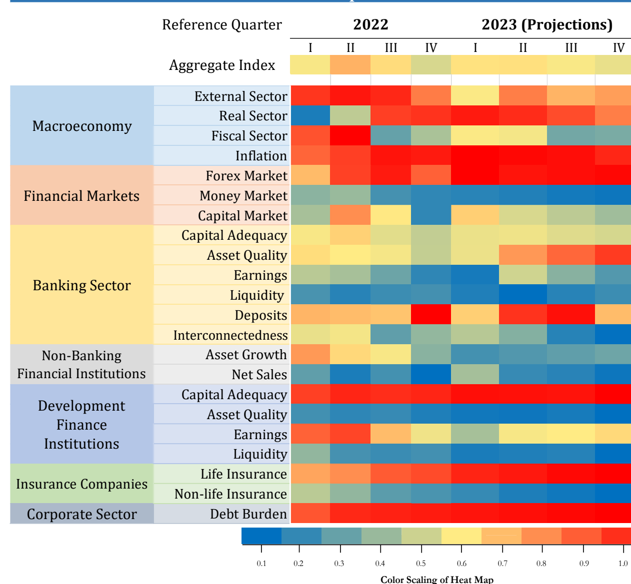
The **financial sector vulnerability index and heat map** reveal that risks to financial stability rose during H1CY22 due to rising macroeconomic imbalances.[6] In H2CY22, although the stress in macroeconomic variables persisted, the financial sector's key indicators posted improvements vis-à-vis their historical trends. Nevertheless, overall stress may remain relatively elevated in CY23 in face of tighter macro-financial conditions (**Chart 1A and 1B**).

Chart 1A: Financial Sector Vulnerability Index (FSVI)



Source: SBP Staff Estimates

Chart 1B: Financial Sector Heat Map



Source: SBP Staff Estimates

Going forward, financial stability dynamics would be contingent upon evolving conditions at international and domestic fronts. While the conflict is lingering between Russia and Ukraine, core inflation in many countries remains sticky though global headline inflation has declined. The global economy is likely to observe another year of low economic growth: it is expected to grow by 2.8 percent in 2023—down from 3.4 percent in 2022.[7] In this backdrop, any further aggravation in the geopolitical conflict or monetary tightening by

[6] Financial Sector Vulnerability Index (FSVI) represents the equal-weighted average risk arising from the key sectors based on their historical key *statistics*. It covers banking sector, DFIs, NBFIs, insurance sector, non-financial corporate sector, financial markets, and macro economy (for details please refer Appendix-B). The future path for the variables is model based and underlying assumptions are consistent with Baseline Scenario (business as usual) used for scenario analysis in Chapter 4.

[7] International Monetary Fund. (2023). World Economic Outlook: A Rocky Recovery. *Washington, April.* For details, please visit https://www.imf.org/en/Publications/WEO/Issues/2023/04/11/world-economic-outlook-april-2023

AE central banks could bear repercussions for external account, inflation and economic activity in Pakistan.

On the domestic front, the current account deficit has narrowed considerably due to sizable import compression; however, the overall external account position continues to remain under stress.[8] Furthermore, the record high inflation and prolonged delay in the completion of ninth review under IMF program are key challenges to the economic outlook. The pace of economic activities has decelerated; which is reflected in the lower estimated growth rate of 0.29 percent for FY23.

In the latest wave of Systemic Risk Survey **(SRS),** market participants have identified political uncertainty as one of the leading risks facing the financial system along with foreign exchange rate risk, inflation, and energy crisis (**see Box 1**).

The assessment of macroeconomic dynamics reveals a number of challenges for the banking sector. The repayment capacity of borrowers may come under stress, leading to asset quality concerns for the banks. Particularly, the business model of MFBs needs a review to improve performance of this important sector. Also, banks' earnings from advances and non-interest incomes are likely to moderate due to subdued economic activities and banks' increased risk aversion towards private sector credit. While the prevailing high return on government securities and strong government financing needs can augment banks' earnings, increased public sector exposure has a number of implications including crowding out of private sector credit and repricing/ revaluation risks, among others. Moreover, credit demand, especially from government, will require enhanced efforts for mobilization of deposits to meet the liquidity needs of the system. In this regard, there is also a need for the government to diversify its sources of funding and tap alternate sources including enhancing tax revenues to achieve fiscal consolidation. In addition, to revive economic activities, the government needs to take appropriate policy measures to improve productivity, export competitiveness and debt sustainability.

Dynamics of financial stability are subject to quite uncertain and complex factors; therefore, SBP regularly conducts scenario analysis on periodic basis to identify the likely path of banking sector's soundness indicators over next two to three years in different assumed hypothetical scenarios. The results of the latest macro stress tests suggest that in the face of continued hypothetical stress, the banking sector may experience increase in NPLs.

However, the banking sector in general and the large systemically important banks in particular, are expected to show sufficient resilience to withstand assumed severe macroeconomic shocks. The overall CAR of the sector is likely to remain above the minimum regulatory requirement under both business-as-usual scenario (which already contains elements of significant strain) and a stressed macroeconomic scenario (which augments baseline with hypothetical macro-financial shocks) over the projected three-year horizon (see **Chapter 4**).

The banking sector has ample capital and liquidity cushions as well as risk management capabilities which have been built over decades under a prudent regulatory framework and tested against a variety of severe stresses in the past. Nevertheless, recent turmoil in the US banking sector highlights a new perspective on vulnerabilities that could emerge in the context of rapid changes in financial conditions and weaknesses in firms' business models. Moreover, repeated episodes of severe weather events in Pakistan and heavy losses over the last few years highlight the significance of risks posed by climate change for both the economy and financial sector. Similarly, there is a global trend of rise in technology and cyber risks due to increased digitalization and growth in digital financial

[8] SBP, Monetary Policy Statement , April 2023.

services. While regulatory guidance and surveillance continue to focus on these emerging risks, financial institutions also need to improve operational resilience by proactively assessing and mitigating these emerging, as well as conventional, risks by appropriately strengthening risk management capacities and building necessary financial cushions.

Reassuringly, SBP's supervisory framework proactively monitors and assesses both firm-specific and system-wide risks to financial stability and takes corrective actions to address these risks. A comprehensive safety net framework is also in place to preserve the general confidence in banking system and safeguard the soundness of institutions against financial strains.[9] This framework is being regularly updated to remain consistent with market conditions and emerging best practices. During the year under review, SBP took a number of measures to improve its supervisory regime in key risk areas, especially in respect of climate risk, cyber security, contingency planning and crisis preparedness along with general supervisory capacity (see **Appendix-A**).

SBP is cognizant of the prevailing risks. With the available toolkit and capabilities, it stands prepared to take necessary and timely measures to preserve financial stability and support economic growth by ensuring smooth supply of credit and financial services in the economy.

[9] Please refer to Box 3.2 (Supervisory and crisis management framework of SBP) of FSR 2021 for further details.