Governor's Message

In recent years, financial stability has emerged in parallel with monetary stability as a key policy objective of central banks and public policy-makers. This is largely in recognition of the trends in financial globalization leading to a more inter-connected global economy, the emergence of innovative and complex financial instruments, and an astounding growth in the volume of financial transactions, all of which can potentially create greater risks and vulnerabilities in the financial system. Concurrently, adverse developments emanating from the domestic environment can also lead to potential threats to the stability of the financial system. Episodes of financial distress have also brought forth the realization of the costs of financial instability and of the ensuing turbulence in financial markets, especially as evidenced in mature economies in the most recent credit and liquidity crisis. These episodes have also demonstrated the close linkages and positive feedback mechanisms between financial stability and the health of the real economy.

Pakistan's economic performance in the last few years has been unprecedented, with the 5-year real GDP growth averaging at 7.0 percent. During this period of economic transformation, the financial sector has evolved into a more progressive and dynamic module of the economy, both in response to the ongoing financial sector reforms and to the mounting financing needs of a rapidly expanding economy.

In response to the growing demands of financial globalization, the financial system is starting to integrate with international financial markets. Financial integration was particularly expedited in FY07 in which record high foreign portfolio investment was made in equity securities, both through the issuance of GDRs and in the stock market. Additionally, with the rising strength of the corporate sector and vigorous expansion plans, the central bank is in the process of initiating external commercial borrowing (ECB), which at the moment is approved on a transactional basis. This liberalization measure will provide an opportunity to the corporate sector to raise external loans for project finance, bonds floatation, structured finance and Islamic products.

The composition of the financial sector gives credence to the concern that the overall dependence on the banking sector has increased in the last few years. Given the scope and requirements of private credit, growth in the banking sector is essential. Encouragingly, the outreach of the banking sector continues to improve, with diversified patterns in ownership, both foreign and local, and with the expanding network of commercial banks, microfinance institutions and Islamic banks in all parts of the country. Alongside these developments, ongoing financial sector reforms are paving the way for a more diversified financial sector, equipped to facilitate the economic growth process. Financial sector assets amounted to Rs 6.0 trillion at end CY06, with a YoY growth of 14.5 percent, whereas market capitalization of the Karachi stock exchange grew by 38 percent in FY07 to reach 46 percent of GDP. Strong growth of mutual funds – being managed by professional and reputable asset management firms – is largely attributed to the improved performance of the domestic financial markets and points to the gradual but steadfast process of diversification of the financial sector.

These developments augur well for financial stability as well as for meeting the goal of enhancing financial services penetration. While the financial sector continues to make advancements in response to ongoing implementation of financial sector reforms, SBP in its capacity as the central bank and the leading regulator of the financial sector strives to play a facilitating role in enhancing its growth. In this vein, the focus of SBP's inaugural Financial Stability Review is on assessing stability issues by analyzing the performance of the financial sector, the risks it faces as it continues to grow, and their potential impact on its stability.

The Financial Stability Review is being launched at a time when the global financial system is undergoing a severe liquidity crunch. As a result, global risk appetite has deteriorated substantially, leading to a widening of credit spreads. The distinct feature of the current upheaval is that its repercussions have so far been largely confined to mature economies,

with limited, if any, impact on emerging markets. Within the mature economies though, the ripples created by the fallout of the US sub-prime mortgage market are more far reaching as an emergent consequence of financial globalization.

These events, which have emerged primarily from the complex nature of financial innovations, bring forth concerns regarding the regulation of structured finance products, and the sweeping impact of their risks. The growing downside risks since mid-July prompted a wide-spread policy response from central banks, leading them to inject liquidity into financial markets to minimize the extent of the damage, a move which helped to stabilize the credit spreads. At the same time, the rescue of a mortgage based institution in UK has given rise to serious moral hazard concerns.

Even though the current financial turmoil in world markets rattled some markets in Asia, Pakistan's financial markets remained stable. The international financial markets may remain unsettled for a while as the vulnerabilities associated with excessive leveraging and risk exposures continue to unfold. If these developments result in an economic slowdown then it entails adverse demand consequences for economies exporting to United States and Europe. Furthermore, tight liquidity conditions in the US and Europe may affect capital flows to and from Asia.

While the financial sector in Pakistan continues to perform well, it is important to note certain emerging patterns.

Within the banking sector, the ownership structure which had gradually moved from public to private in recent years, now has a dominant share of foreign ownership due to increased inflows of FDI, attracted by the lucrative return on investment in the banking sector. At the same time, the process of consolidation, though pervasive in the entire financial sector, has been more pronounced in the banking sector. Banking sector stability and robustness is of critical importance to financial sector stability. In essence, the process of consolidation was driven by the need to bring to surface economies of scale and scope, and efficiencies driven by competition and innovation. The consolidation process was focused on three primary factors i.e. i) proactive M&As (both domestic and foreign-led), ii) moratorium on licensing of conventional banks, and iii) minimum capital requirements for banks and DFIs which have been stringently implemented by the SBP. While all three factors have helped, the impact of the consolidation process has been diluted somewhat by the liberal licensing of Islamic Banks and Microfinance institutions, which are being promoted as an active policy of the SBP with its focus on financial inclusion.

The efficiency of intermediation however, is such that potential risks can arise from banks' behavioral patterns characterized by their concentration on profit-making. High banking spreads, though contributed in large part by the existing structure of bank deposits which consists of a large proportion of non-remunerative accounts, is one such indication of the room for improved efficiency of financial intermediation.

Declining, but still relatively high concentration in the banking sector suggests that the stability of the sector primarily depends on few large banks with a dominant share of assets and deposits. It is encouraging to note that competition is gradually emerging with the growth of mid-sized banks and foreign acquisitions.

Although the range of financial services offered by the banking system has expanded with the passage of time, the credit portfolio of the banking sector is still dominated by loans to the corporate sector. There is a need for further diversification of bank's loan portfolio to support more retail, corporate and infrastructure financing.

Being cognizant of maturity mismatches in the asset and liability structure, SBP has introduced different cash reserves requirements for demand and time liabilities to encourage

banks to mobilize long term deposits. Specifically, while the demand liabilities (including time liabilities of less than one year maturity) attract cash reserve requirement of 7.0 percent, time liabilities of more than one year maturity are exempted from CRR.

Rapid growth of the banking sector alongwith increasing interdependencies and complexities of the banking business in recent years, has increased the incidence of operational risk in the sector. SBP has been actively pursuing the banking sector to improve their internal control systems. The on-going implementation of Basel II is likely to help in managing operational risks, as the capital charge for operational risk is explicitly recognized in this framework.

With the increasing focus on large, well-capitalised institutions, further growth of the non-bank financial sector is highly dependent on providing a conducive environment for growth of promising segments (collective investment schemes, including mutual funds), creating niche markets and products for mature industries (leasing and modarabas) and restructuring the under-developed components of the financial sector (pension funds and venture capital), and unleashing penetration in the insurance industry.

The challenges for the financial sector in the coming years would need to keep in view these challenges while building on the strengths and resilience of the financial institutions in maintaining the overall stability of the financial system.

In conclusion, I would like to express my appreciation for the efforts put in by the FSR team in bringing out this report.

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Governor
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