December 17, 2007

Size of Pakistan's progressive & dynamic financial sector reaches Rs 6.9 Tln (US $114.6 Bln)

The overall size of Pakistan's progressive and dynamic financial sector, which has grown rapidly particularly in the last few years in response to the mounting financing needs of the country, has increased by almost Rs 900 billion (32 percent growth over December 2005) to reach Rs 6.9 trillion up to June, 2007. Banks, with a share of 72 percent in total assets, continue to dominate the asset base of the financial sector.

This is stated in the "Financial Stability Review 2006" (FSR), a new annual publication released by the State Bank of Pakistan today. The FSR upgrades the analytical content of the "Financial Sector Assessment Report", published by the SBP since 2002. The FSR gives a candid perspective and analysis of financial stability, and provides an objective view on the developments in the financial sector. Providing an in-depth analysis of issues of relevance, the report offers an exhaustive overview of the financial institutions and markets. The ultimate objective is to suggest appropriate policy-direction for the financial sector as a whole. The Report endeavors to promote informed public debate on various aspects of the financial system.

In publishing its first FSR, SBP joins the league of central banks around the globe that analyze and comment on financial stability issues on a periodic basis, with the objective of highlighting the strengths as well as potential triggers for systemic risk. With the added objective of increasing the outreach of informed public debate, the report is being released in both English and Urdu.

A distinguishing feature of the FSR is the discussion on strategic thematic areas which are covered under two parts: Part I explores issues of efficiency of financial intermediation, consolidation and diversification of the financial sector, and financial savings and allocative efficiency of bank credit. Part II provides performance analysis of the components of the financial sector, covering banks, non-bank financial institutions, financial markets, and the insurance industry. As analytical content in the report is based on data for 2006, the report, where feasible, also updates analysis up to June 2007.

Key messages of the report are: structural transformation of the financial sector is significant and is owed to the dedicated implementation of the reform process. The financial sector has grown substantially both in size and qualitative terms in recent years. The reform process is paving the way for a more diversified financial sector, equipped to facilitate the economic growth process. The outreach of the financial sector, albeit slow, continues to gain ground with the expanding network of commercial banks, microfinance institutions and Islamic banks in all parts of the country.

On-going mergers and acquisitions (M&As) have exerted a profound impact on the ownership structure of the financial sector. The financial sector is predominantly led by the private sector, constituting of both domestic and foreign financial institutions, controlling 64.9 percent of overall assets. Within the banking sector, private ownership has grown to 78 percent of assets, and entry of foreign banks, Islamic Banks and microfinance banks are adding depth to the financial sector. In terms of asset holdings, the insurance sector is still dominated by public sector entities and lacks dynamism.

In the last three years, commercial banks have operated on a sound capital base with an enviable record of financial performance. The quality of the risk-based capital provides further comfort as the share of core capital in the overall risk-based capital has reached 80.3 percent by June 2007, compared to 73.7 percent in CY05. These changes in the capital adequacy ratio, together with the improved quality of capital, have enhanced the resilience of the banking sector to withstand unexpected shocks.

Banks have made inroads into the previously under-served segments. The diversification of bank credit in recent years is evident in the rise in share of SME, agriculture and consumer finance in outstanding credit to 15.4, 5.8 and 14.3 percent respectively at end-June 2007.

Efficiency of financial sector, gauged by the cost of financial intermediation, indicates that the structure of bank deposits (with 25 percent of total deposits in non-remunerative accounts) and the liquidity preference of depositors have a significant bearing on the level of banking spreads. With SBP's moral suasion, commercial banks have floated new high yielding deposits and Pakistan Banks' Association introduced the Enhanced Savings Deposit in November 2007. In addition, the process of a gradual shift towards fixed deposits has already started, as evidenced by the gradual narrowing of banking spreads. These will generate more pronounced impact on curtailing banking spread.

The NBFIs have been unable to create an impact as well-functioning, specialized financial intermediaries. As banks have made rapid inroads into business segments traditionally serviced by NBFIs, market share of NBFCs and Modarabas has eroded considerably, so much so that Investment finance and discounting are likely to disappear as stand-alone activities in the non-bank financial sector while leasing and Modaraba sectors are faced with the dilemma of 'diversify or die'. In addition, housing finance and venture capital industries have failed to take off despite significant demand potential. The success story among NBFIs is that of mutual funds.

The ownership structure of the insurance industry is in sharp contrast to the private sector-led nature of the rest of the financial sector. The insurance industry, comprising of 53 companies, is largely owned and operated by government-based entities. However, private sector entities in both the life and non-life insurance sector have a dominating share of the insurance business, with an 86.7 percent share of total premiums of the industry. Despite fewer companies in the life insurance sector, it accounts for 67 percent of total insurance assets. Concentration of business among the top

10 players, though still high, reduced by 9.0 percentage points in 2006, from 91.6 percent of gross premiums in 2005 to 82.6 percent in 2006.

Efficiencies of deep, liquid and open financial markets are a vital source of stability in the financial system. Financial markets in Pakistan comprise of fairly developed money market, foreign exchange market and capital markets, while the derivative market is still in a nascent stage of development.

Capital markets continue to perform well, with market capitalization at Rs. 4.0 trillion by end-June 2007, and the KSE-100 index at 13,772 points, a historically high level depicting a growth of 38 percent over end-June 2006. The salient feature of the year was the volume of capital inflows, and of foreign investment in the equity market. Foreign participation as measured by SCRA flows reached a level of 6.8 percent of the market capitalization by end-June 2007. KSE is one of the best performing markets in the region, and continues to trade at a discount in comparison with regional economies (average P/E at 15.1x), which is a reflection of its growth potential.

The report highlights that Pakistan continues to be categorized among the low savers of the world. The analysis suggests that the financial system now needs to focus on providing innovative liability products to give the investor and saver various options to choose from, according to his own risk/return preference. The role of Private Pension Schemes is particularly important as an incentive to smooth out consumption patterns over the life-cycle, by providing a forced saving mechanism aimed at overall social security.

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.

The report, both in English and Urdu, can be accessed from the website of State Bank of Pakistan, www.sbp.org.pk/publications

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