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Pakistan's banking sector remarkably resilient despite challenging economic environment: SBP's Financial Stability Review

Pakistan's banking sector has remained remarkably strong and resilient, despite facing pressures emanating from weakening macroeconomic environment since late 2007, according to the assessment of the State Bank of Pakistan's Financial Stability Review 2007-08 released today.

The Report said that given its bank-centric nature, the stability of the financial system is derived essentially from the banking system. An assessment of the performance of the banking sector from January 2007 to June 2008 shows that Pakistan's banking system has over the years nurtured itself such that it is able to withstand some of the shocks it has faced in the last 18 months or so.

"The banking system is on strong footing and has long term potential – a feature which has served to attract a substantial amount of FDI in the sector, with established global financial institutions now active participants in the domestic financial sector," it said and added that it has been well-governed and being in private hands under professional management, has witnessed outstanding financial performance during the last few years.

The Report states that with strong regulatory oversight, there has been a significant enhancement of capital and risk-weighted capital adequacy, supported by high provisioning requirements which were tightened in 2007. Stringent loan provisioning requirement has built sufficient reserves against the NPLs' portfolio. In contrast to the liberalized financial system in the west which took its toll in the form of the current global financial crisis, there are stringent regulations and adequate policies in place to help the banking system manage its risks.

It pointed out that aggregate financial soundness indicators have improved since early 2000, and continue to exhibit strong performance. "Tighter provisioning requirements may have reduced profits, but have positioned banks well," it said and added ongoing consolidation and mergers have enabled a number of banks to position themselves better.

"Having observed the experiences of the global economy, the way forward for the financial sector is to maintain both the simplicity and transparency of product structures and a gradual pace of financial liberalization to enable the financial sector in expanding further in a more sound, healthy and efficient manner," the Report said, and added that effective regulation is the preferred route for central banks responsible for safeguarding both monetary and financial stability.

The Report said solvency profile has improved, and given the pressures from the macroeconomic environment, there is an indication of marginal deterioration in asset quality, which banks are well-equipped to handle. Stress tests conducted on June-2008 data indicate that the large banks are relatively robust, with the medium and small-sized banks positioning themselves in niche markets, it added.

Capital adequacy of the banking system is strong, 12.1 percent at end-June 2008, well above the internationally acceptable minimum requirement of 8.0 percent, it said and added core capital constitutes about 80.0 percent of the total capital, and Tier 1 to risk weighted assets ratio of the banking system is at 9.7 percent.

"This strong capital base is accompanied by adequate reserves on the back of stringent provisioning requirements against classified assets – the net NPLs to net loans ratio is reasonably well-contained i.e. at 1.3 percent in June 2008, comparable to international best standards," the Report pointed out. Profitability of the banking system continues to be impressive, largely emanating from the persistent growth in high-yield earning assets and expanded business volumes. Before-tax Return On Assets of the banking system remains strong at 2.3 percent in June 2008. The strengths built up over the years are now coming in handy in managing the recent financial strains.

The Report mentioned that the demand for credit from both the government and the private sector resulted in liquidity strains faced by some individual banks, which also emanated from the combined impact of their weak deposit mobilization and low interest rates offered on deposits. The Government's and public sector organizations' excessive borrowings from the banking system posed another challenge for the banking system. Notwithstanding, the liquidity strains were temporary and the inter-bank market is now functioning normally.

"Albeit going forward, the banking sector faces a significant challenge in maintaining its deposit base and in attracting new deposits, given the three rounds of increase in the rates of return on NSS instruments in the first few months of FY09. This will in a way force them to enhance the quality and returns on their liability products, and strengthen competition," it pointed out.

The Report noted that the liquidity position of banks also had an impact on the Non-Banking Finance Companies (NBFCs), whose main source of funding continues to be credit lines from banks. "A broader assessment of financial stability indicates that the financial sector is too bank-centric, and the outreach and growth of the Non-Bank Finance Companies and the Insurance sector have languished in recent years," it said and added NBFCs face direct competition from banks and are not likely to grow significantly until their funding sources and costs are streamlined. At the same time, growth in the insurance sector is weak, and private pension funds have only recently started to gather some pace. The insurance sector is unlikely to grow unless it gets an infusion of innovation and efficiency. The interest from banks to associate themselves with insurance companies and develop new products for cross-selling may also revitalize the sector. Private pension funds have an enormous potential as indicated by the growth of such funds in other emerging markets, where they have become important and in some cases, principal institutional investors and the main providers of long-term funds.

The Report asserted that an excessive dependence on the banking system to meet the financing needs of the economy, as well as other participants of the financial sector, is quite stark in comparison with other emerging economies, where in general, the growth in other components of the financial sector, such as capital markets, complements and supplements the financing capacity of the banking sector.

While financial markets (money market and foreign exchange market) remained resilient to the developments in the macroeconomic environment and functioned well in maintaining financial stability, the imposition of the floor of 9,144 points on the KSE-100 index in August 2008 has adversely impacted investor sentiments by effectively blocking the exit mechanism generally taken for granted in a market based system. Incidentally, there is no known precedent of placing a floor on a market index, albeit temporary suspension of trading in equity market has been implemented in some cases as an extreme measure, the Report added. The Report gives a detailed assessment of the channels of transmission of the second-round impact of the ongoing global financial crisis on the domestic economy and financial sector. The Report points out that despite several achievements of the financial sector in recent years, financial depth and penetration in Pakistan continues to be low, and SBP's financial inclusion strategy as well as the recently launched strategic plan for the Islamic Banking Industry, are both aimed at extending the net of financial services.

The detailed Report can be accessed at SBP's website www.sbp.org.pk