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Pakistan's Financial Sector demonstrates strong resilience: SBP Report

Pakistan's Financial Sector has shown strong resilience to a challenging macroeconomic environment and global developments, says State Bank's Financial Stability Review 2008-09, which was released today.

According to the Report, the size of the country's financial sector, which includes Banks, Non-Bank Financial Institutions (NBFIs), Microfinance banks, Central Depository of National Savings (CDNS), the Insurance sector, and financial markets, in terms of assets, has increased to Rs 8.2 trillion by end-June 2009 from Rs. 7.1 trillion at end December 2007. The report summarizes the developments over 2008 and the first of half of 2009.

The Report says that the stability of the financial system is largely derived from the predominant position of the banking sector, as other components of the financial system continue to grow at a more gradual pace. As opposed to the speculative tilt in conducting the business of banking in western economies, the underlying operating model of the banking sector in Pakistan fulfills the basic requirements of the function of financial intermediation: loans and advances are funded by a large and growing base of deposits, with virtually negligible reliance on borrowing, or the short-term wholesale market for financing assets.

The Report noted that the growth in deposits did slowdown to 9.4 percent in CY08 after growing successively at an average rate of 18.1 percent for the last 5 years, despite the increase of 17.2 percent (in USD terms) in home remittances; a reflection of both the slowdown in the economy, preference for hard currency due to the prevalent environment of uncertainty, and competition from the National Savings Schemes (NSS) offering a higher rate of return than bank deposits.

"These developments even overshadowed the potentially positive impact of introducing the minimum rate of return of 5.0 percent on all PLS savings deposits by the SBP, w.e.f. June CY08," it said and added a visible increase in the currency to deposit ratio and a slowdown in the money multiplier during H2-CY08 also highlights the challenging operating environment of the banking sector. Notwithstanding, deposits growth has picked up pace in H1-CY09, growing by 8.2 percent in H1-CY09 alone. But the impending transfer of government deposits from banks to a single treasury account maintained by the State Bank of Pakistan can potentially have a significant impact on those banks which have a large reliance on these deposits, it said.

The Report said that banks' exposure to the government increased tremendously during CY08, with particular concentration in the power sector due to the issue of circular debt and unprecedented increase in lending to Public Sector Enterprises (PSEs) and commodity finance in general. It said heightened concerns on credit risk surfaced in Q1-CY08, and became pervasive as the year progressed as non-performing loans (NPLs) rose 68.4 percent in CY08 to Rs. 359.3 billion by the end of the year – the biggest increase in a single year since CY97.

"While aggressive credit expansion in the last few years played its role in this visible deterioration of asset quality, the widespread rise in NPLs is seen to be a direct consequence of macroeconomic instability, and largely a *cyclical* rather than *structural* factor," it said and added that this assertion is supported by the slowdown in the growth of incremental NPLs in the first half of CY09 to Rs. 397.9 billion, as the process of economic recovery picks up pace.

The Report noted that encouragingly banks' ability to absorb unexpected losses is on a strong footing. Implementation of the minimum capital requirements in a phased manner continues to strengthen the capital base and the aggregate risk-weighted capital adequacy of the banking sector as of end-CY08 was maintained at the CY07 level of 12.3 percent against the minimum requirement of 9.0 percent, despite the inclusion of the capital charge for operational risk under Basel II requirements. "This is also due to the *anti-cyclical* policy support extended by SBP in response to the difficult operating environment, as reflected in the rationalization of the MCR requirements, with a subsequent enhanced concession in the FSV rules in October CY09," it said.

The Report pointed out that while Pakistan's financial sector was not directly impacted by the events in the global financial markets, various developments over the period of assessment did alter the risk profile and outlook of the financial sector. These developments include: (i) banks faced a temporary liquidity strain in Q4-2008 which translated into solvency problems for some of the weak small banks, (ii) the liquidity stress brought forth NBFIs' dependence on the banking sector more visibly as their credit lines from banks dried up, (iii) rising NPLs, monetary tightening and structural impediments in the economy hampered the flow of credit to the private sector, (iv) deposits growth slowed down, (v) banks' exposure to the public sector increased substantially, and (v) the equity market's capitalization declined by around 63 percent (from its peak level) by end-CY08 while the exchange rate depreciated by over 20.0 percent against the USD.

Referring to other components of the financial sector, SBP's Report said that the dormant element of funding risk in case of Non-Bank Financial Institutions (NBFIs) emerged as a strong threat to their commercial viability in CY08: NBFIs are largely dependent on banks to fund their assets, and in wake of the liquidity strains faced by the banking sector in Q4-CY08, these credit lines dried up to the extent that the viability of their ongoing operations came under threat. "Notably, NBFIs have long lost their niche in the face of competition from the banking sector, and the leasing companies, investment finance companies, modarabas, venture capital companies seriously need to rethink their business model if they are to remain commercially viable," it said.

Similarly, it pointed out that insurance sector continues on its sluggish pace of growth and gradually increasing penetration of insurance services. The insurance industry has enjoyed robust growth in the last few years, driven by favorable economic conditions, expansion of the financial sector as a whole, privatization of large state-owned entities and foreign investments. But factors such as the emergence of macroeconomic instability since late 2007, turmoil in global financial markets and dislocation of the domestic equity market along with the deteriorating security situation has posed substantial challenges to the performance of the insurance sector in CY08, it added.

The Report asserted that an efficient financial system is one which is diversified, and in which all components function in meeting the financing needs of the economy. "Not only does Pakistan's economy continue to have an undue reliance on the banking sector, the emergence of the government as the major user of bank credit has led to the crowding out of the private sector even as the economy is headed towards a gradual recovery," it added.

The detailed Report is available at State Bank's website www.sbp.org.pk

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