Shamshad Akhtar: Pakistan – financial stability

Address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Institute of Bankers Pakistan (IBP) Convocation, Karachi, 23 February 2008.

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1. Recent and recurrent episodes of financial crisis have magnified the significance of financial stability and its dimensions. Every crisis – be it economic, currency, banking or, more recently, liquidity – has resulted in huge financial and banking losses and adverse economic consequences that transcend beyond national boundaries. Learning from the crisis, globally, there has been incremental understanding and build up of knowledge of what disrupts and promotes financial stability. New approaches and methodologies have evolved to assess different dimensions of the risks facing different segments of financial markets and their implications.

I. Financial stability: approach and dimension

2. Mishkin in 1991[1] defined financial stability to ensure and promote, in a lasting way and without major disruptions, an efficient allocation of savings to investment opportunities. Generally, maintenance of financial stability depends on effective financial regulation, which aims to provide right incentives for prudential conduct and risk behavior by financial institutions. Primary objective of financial stability policies and assessment should be to provide early warning signals for crisis prevention as distinct from crisis mitigation. Stability of financial system benefits and promotes (i) smooth and efficient financial intermediation processes that allocate savings to profitable investment opportunities; (ii) balanced development of different segments of financial system; and (iii) proper transmission of monetary policy, whose effective conduct and implementation in turn facilitates price stability.

3. Price stability and financial stability tend to mutually reinforce each other in the long run. High inflation creates financial instability since it generates misperceptions and creates problems in predicting real returns. It can also worsen the asymmetry of information available to lenders and borrowers. A business cycle boom accompanied with high inflation is traditionally considered as the typical environment in which real over-investment and asset price bubbles blossom. Excess liquidity provided by the central bank is one of the main factors responsible for the development of inappropriately lax lending standards. Credit growth, which is excessive in view of realistic return expectations, is often the foundation for financial instability. Hence, monetary policy focused on price stability plays an important role in ensuring stable financial markets.

4. Keeping in view these considerations, most countries have developed elaborate frameworks designed to measure, monitor and safeguard financial stability. It is prudent to assess macroeconomic and financial sector vulnerabilities and to judge the implications of these two so that appropriate corrective actions and policies may be put into place to prevent a crisis. A number of advanced countries have adopted sophisticated models to conduct macroeconomic and financial sector surveillance. However, other developing countries, given the data limitations and size of financial sector, have adopted simpler frameworks for assessment of financial stability.

5. In assessing macroeconomic vulnerabilities it is standard to examine the sustainability of the fiscal and external accounts – any drift in these two principal modules of the economy creates monetary complications and can generate instability in both domestic and foreign

[1] Mishkin, F. (1991): "*Anatomy of financial crisis,*" NBER Working Paper, No. 3934.

exchange markets. Depending on the intensity of disruptions, there may be implications for the financial sector, often resulting in repricing of assets and affecting the growth of private sector including banking business.

6. To comprehensively assess the financial sector vulnerabilities, there is a need to assess the risks associated with (a) financial institutions relying on a range of financial soundness indicators that help assess credit, liquidity, market, exchange rate, operational and reputational risks etc.; (b) financial markets that may face counterparty risks, contagion or asset price misalignments; and (c) financial infrastructure risks ranging from legal and regulatory risks to the clearance, payments and settlement system.

7. While assessing the key risks and vulnerabilities in the economic and financial system, it is critical to adopt analytical approaches to:

(i) identify, assess and measure the source of risks and track the channels through which they may propagate and ultimately affect the financial system;

(ii) developing an understanding of financial stability transmission mechanism; and

(iii) aggregate the risks and properly stress test the impact of potential shocks on different institutions and markets.

II. Pakistan Financial Stability Review

8. State Bank of Pakistan (SBP), the central bank and primary regulator of financial sector, is responsible for conducting financial stability review given its dual mandate of monetary policy and financial regulation and supervision. SBP has a hand on the pulse of economy and as such is able to decipher monetary transmission mechanism and its impact on the economy and the financial sector. At the same time, vigilance on banking sector helps SBP to understand the financial transmission mechanism which assists in the formulation of overall policy stance for both monetary and banking sector.

9. SBP has been conducting financial stability analysis for the last 5 years or so. However, the framework for financial stability is still evolving. Starting in 2004, SBP conducted an annual Financial Sector Assessment Program dovetailed with quarterly and annual Banking Surveillance Reports. Integrating these reports, in 2007, SBP launched its first comprehensive Financial Stability Review (FSR) that offers a rich assessment of risks and vulnerabilities of financial sector and macroeconomic challenges.

10. Among other components, the main component of FSR is the assessment of banking sector as it constitutes the largest segment of financial system. Banking sector has managed to grow substantially and its stability can be assessed in a number of ways:

(i) **Solvency of banking system** is safeguarded if the banks' capital offers necessary cushion to absorb unexpected losses. Rising profitability coupled with SBP's policy to strengthen the capital of banks has contributed to rise in the risk based capital adequacy of banking system to 13.6% by September 2007 (relative to 8.8% in 2001). Quality of capital has also improved (with the rise in risk weighted assets to Tier 1 capital) and the share of risk based capital now constitutes close to 80% of core capital.

(ii) **Profitability**: Performance of banks has been good converting the commercial banks' losses, registered until early 2000, to positive: return on assets is now 2% and return on equity 20%. Although, net interest margins have increased from 59% in CY03 to 70.5% in September 2007 and cost to income ratio, an important ratio to measure operating efficiency, has improved from 62.4% to 42.3% from CY01 to September 2007, there is substantial scope to enhance efficiency in financial intermediation process. Structural change in ownership structure, with private sector now holding almost 79% of total banking assets, has augured well to enhance profitability of banking sector while ensuring professionalism in the management of banks. Growing foreign ownership and acquisitions have paved way for strengthening the capital base of banks and is helping to enhance competition. In addition, in line with the empirical evidence in other countries, it is expected that entry and growth of foreign banks will contribute to higher average loan growth, better risk management practices, greater provisioning and loan loss absorption capacity.

(iii) **Asset quality** has benefited from loan restructuring and write offs, stronger regulations, prudent lending and growth in advances. Non-performing loans (NPLs) to gross loans fell from 17% in CY03 to 7.7% by September 2007 and net NPLs from 7% to 2.3% over this period. Concurrently, provisions to NPLs ratio improved from 64% to 72%. Bank's capacity to absorb losses has grown as net NPLs to capital ratio declined from over 150.5% in CY01 to merely 11.4% in September 2007. Furthermore growth and sector diversification of loan portfolio has helped to reduce the risk of overexposure.

(iv) **Market risk** has different dimensions as banks are engaged in a variety of businesses that expose them to interest rate, foreign exchange and equity market risks etc. The principal market risk facing banks is interest rate risk. The duration of assets and liabilities offers an accurate indicator of interest rate risk. With banks primarily raising short term deposits and lending for longer maturity the asset-liability mismatches are significant, though banks are being encouraged to raise long tenor deposits through exemption of cash reserve requirements.

(v) **Liquidity risk**: Liquidity management is a key banking function and it helps banks withstand shocks and losses. Liquidity risk, as measured by liquid assets to total assets and other indicators, has remained stable over the last 5 years albeit a modest decline recently along with decline in liquid asset to deposit ratio while advance to deposit ratio rose modestly.

11. While these indicators allow us to gauge the soundness on selective basis, the Financial Soundness Index (FSI) indicator offers a more holistic measure. FSI is calculated as an aggregate index assigning 0.25 weights to four key financial soundness indicators including capital adequacy, asset quality, profitability and liquidity. This index was negative for a number of years but since CY02 it has been positive and has consistently improved.

12. Another major aspect of effective surveillance is checking the resilience of the banking system to various shocks through stress testing exercise. SBP performs stress testing through a set of exceptional, but plausible, assumptions using simple sensitivity analysis. The shocks cover different risk factors namely interest rate, forced sale value of collateral, NPLs, stock prices and foreign exchange rate in addition to liquidity, credit and market shocks. The stress testing exercise allows SBP to gauge the possible adverse impact on the banking system and provides basis for taking future regulatory measures. In principle, fortifying capital base has lent greater resilience to the banking system against the adverse shocks. As of September 2007, capital of all banks can fairly absorb the impact of a shock of 10% in increase in total NPLs. None of the groups would experience a fall in its CAR to below 8%. In consumer finance category, however, a rise in NPL-to-loan ratio to 10% (which is at 4.4% as of 30 Sep 2007) of total consumer loans can have adverse impact on some banks. Individually, four banks holding a share of 11% in the assets of the banking system would experience a decline in their CAR to below 8% under this sensitivity test. The impact of interest rate, exchange rate and equity price shocks can also be well absorbed by the healthy capital base of banks.

III. Key policy drivers of financial stability

13. Financial stability in Pakistan has benefited from structural transformation of banking sector and wide ranging policy initiatives of the central bank. In particular, Pakistan's prudential regulatory regime has been crafted to promote and preserve financial sector stability. Regulatory framework encourages

(i) financial sector growth, diversification, and innovation;

(ii) healthy competition and risk taking to ensure a sustainable and aggressive income stream;

(iii) opportunities for enhancing the franchise value of banks;

(iv) prudent behavior and effective risk management to discourage infection of loan portfolio; and

(v) safeguarding social obligations and consumer interests.

14. Promoting sound banking practices, SBP has implemented exhaustive guidelines for corporate governance and on risk management, business continuity plan, internal controls and stress testing. In 2007, SBP has been stringent in overseeing the Management and Board conduct and their conformity to fit and proper criterion. Furthermore, two major sets of new regulations were introduced under which banks were required to induct independent Board members and adopt umbrella risk management guidelines. A survey is currently underway to assess corporate governance practices of banks.

15. Financial stability has been further fostered by the strengthening of banks' system-wide capital base to Rs 372 billion. Process of consolidation has been catalyzed by 30 odd mergers and acquisition (both domestic and foreign-led), moratorium on licensing of conventional banks and rise in minimum capital requirements for banks and DFIs. To streamline capital with risks, banks have initiated implementation of the standardized approach, as prescribed under Basel II regulations. Over the period, this is expected to augment the economies of scale and improve efficiency as competition and innovation grows.

16. Enhanced push from SBP for delivery of development finance will help diversify the credit portfolio and will alter risk profile as there is relatively low correlation of the inherent risk factors among different sectors.

17. Financial stability will further benefit from SBP's operationalization of the Real-Time Gross Settlement System (RTGS) named PRISM (Pakistan Real Time Inter-bank Settlement Mechanism) in June 2008 which will allow shift from traditional paper-based, end-of-the-day settlement system to electronic payment system for large value, low volume inter-bank fund transfers and settlements.

18. Money market stability has improved with SBP's efforts to develop an effective market determined yield curve for government securities which sets the stage for development of the corporate debt market. Moreover, derivatives market, which is an important pillar for effective risk management, though still in its infancy, has taken off. Presently there are five banks which have been given the status of Authorized Derivative Dealers by SBP. The derivatives market is being regulated under SBP's Financial Derivatives Business Regulation and covers interest rate swaps and forward rate agreements, in Pak Rupee and other currencies (after SBP approval).

IV. Risks to financial stability

19. The financial sector of Pakistan has experienced an extraordinary growth in recent years. Financial assets have grown to $180 billion and are now equivalent to 125% of GDP (compared to 95% of GDP at end-1997) reflecting strong growth in banking sector assets

and stock market capitalization. The substantial growth in financial sector brings with it associated risks. Results for banking sector surveillance, as highlighted above, give comfort that financial risks are well contained though growing macroeconomic imbalances, unless addressed urgently, could threaten the financial stability.

20. A principal risk to financial stability is often country's economic structure and the macroeconomic framework. Country's with high concentration in one or two sectors often face risks to financial sector, if there is an over-exposure of the system to these sectors. Similarly, macroeconomic imbalances introduce economic vulnerabilities which in turn induce inflationary pressures and/or exchange rate volatility. These factors do pose system wide challenge to financial stability.

21. Another risk to Pakistan's financial stability is its overall lack of financial sector diversification. Of particular concern is the size and issues surrounding the nonbank sector. Of the total financial sector assets, insurance companies account for barely 3%, mutual funds 3% (and are largely sponsored by banks) while other non-bank finance companies (NBFCs) are 2% of the system and holders of listed private bonds are less than 1%. Furthermore, NBFCs are fragmented and weakly capitalized. For financial sector stability, it is critical that such institutions be better capitalized and a conducive environment is created for the growth of promising segments (collective investment schemes, including mutual funds), niche markets and products are introduced for leasing companies, modarabas, housing finance and venture capital, and penetration is enhanced in the insurance industry. It is also important to consider that while market capitalization has grown impressively, its role in raising long term risk capital or debt for new industry over the last several years has been limited.

22. There is further scope for enhancing banking sector stability too. Although competition is emerging with the growth of mid-sized banks and foreign acquisitions, five largest banks hold 50.6% of total banking sector assets; though there has been a clear reduction in the level of concentration which was at 63.2% in 2000. While this is a concern, the presence of undercapitalized small banks is likely to pose risks particularly during periods of adverse economic cycles.

23. Another area where there is scope for strengthening financial sector stability is greater credit diversification. Over 50% of the bank credit portfolio is concentrated in corporate sector serving fewer industries. Diversification of bank's loan portfolio to support more retail and infrastructure financing will be critical for the growth of banking sector. SBP needs to develop its capacities to monitor financial position and probability of default of the corporate and household sectors within the stability framework.

24. Cognizant of maturity mismatches, SBP has introduced different cash reserve requirements (CRR) 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 CRR of 8%, time liabilities of more than one year maturity are exempted from CRR.

25. Finally, now predominantly private sector-owned financial sector presents its own challenges. SBP is working towards developing adequate policy framework for consumer protection, development of Financial Safety Nets such as Deposit Insurance and a well-laid out "Lender of Last Resort" procedure to strike a balance between enhancing consumer protection and minimizing moral hazard. At the same time, there is need to encourage efficiency of financial intermediation by reducing banking spreads. SBP is further developing capacities to monitor operational risks associated with weak internal control systems, delays in adoption of information technology solutions and outsourcing of processes by banks.