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Risks to financial stability may elevate further: SBP

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KARACHI: The State Bank of Pakistan (SBP) Friday said that risks to financial stability may further elevate if external account challenges and fiscal imbalances persist and savings stay low.

The State Bank has issued its flagship annual publication Financial Stability Review (FSR) for the calendar year 2017 saying that the first-hand information received from the market participants in January 2018 through SBP Systemic Risk Survey also suggests that political uncertainties and macroeconomic vulnerabilities such as deterioration in balance of payments and exchange rate dynamics pose a risk to the stability of financial system in the next six months.

The FSR presents performance and risk assessment of various components of the financial sector including banking, non-banking financial institutions, financial markets, exchange companies, non-financial corporate- and financial market infrastructure. It also discusses the possible implications of the assessed risks for the overall stability of the financial sector.

“In the short-term, risks to domestic financial stability may elevate further if external account challenges remain, fiscal imbalances persist, and savings in the economy especially, deposit growth stay low,” the SBP warned. Equity market volatility, within reasonable bounds, is essential to restore investor confidence, it added.

According to the SBP, the projected path of financial vulnerability index does not show any major deviations in CY18. Nevertheless, the uncertainties surrounding the projections reflect rising odds of upside risk.

Moreover, the Monetary Policy Committee of the SBP, acknowledging the emerging near-term risks to the macroeconomic stability, has increased the policy rate by 50bps to 6.50 percent in May 2018.

This rise has implications for the banking sector, in the short term, through mark-to-market revaluation of large investment portfolio. Interest income on earning assets, however, could see a significant rise, the FSR said.

The review suggests that in the medium-term, risks to the financial system may decline in perspective of sustained growth momentum, rising opportunities from CPEC, improving energy availability, and expected increase in exports on the back of improving global demand.

According to review, State Bank, taking a proactive and holistic view of the emerging vulnerabilities, is not only strengthening its own regulatory and supervisory regime but is also collaborating with Securities and Exchange Commission of Pakistan (SECP) to address systemic concerns.

The FSR revealed that financial sector has remained resilient despite tightening of macro-financial conditions during the last year.

The FSR suggests that the level of overall risks to financial stability, as measured by Financial Vulnerability Index, has bottomed out in CY17. Despite tightening of macro-financial conditions, financial institutions have performed fairly well, however, some low to moderate levels risks have emerged.

The consolidated asset base of the financial sector has expanded by 12.8 percent during CY17. Asset to GDP ratio has inched up to 74.7 percent in CY17 from 72.0 percent in CY16 indicating higher degree of financial deepening.

On the global front, the review highlights that the pace of global output growth-aided by rebound in trade and investment, has remained above expectations. The world economy has delivered 3.8 percent growth in 2017 up from 3.2 percent in 2016. However, the review notes that short-term risks to global financial stability after receding in 2017 have risen recently in 2018 due to equity market volatility and trade disputes.

The domestic economy has managed decent growth of 5.37 percent in FY17 and the momentum has carried on in FY18 with estimated growth of 5.79 percent. However, the economy is confronted with significant challenges. The foremost being the pressures developing in the external sector because of widening trade deficit followed by fiscal slippages. Headline inflation has been subdued, though core inflation has remained at an elevated level.

The rising macroeconomic vulnerabilities have translated into short-lived volatility in the financial markets (particularly, foreign exchange and equity markets) and impacted the performance of financial institutions.

The banking sector, a key player in financial intermediation, has performed fairly well and registered an asset expansion of 15.86 percent largely due to robust growth in advances to private sector.

The key thrust in financing demand has come from textile, sugar, cement, and agribusiness sectors. Owing to rise in advances, Non-Performing Loans to Advances ratio at 8.4 percent has touched decade low level and Capital Adequacy Ratio (CAR) at 15.8 percent is well above the minimum regulatory requirement of 11.275 percent.

Encouragingly, under resilience analysis, banks are expected to absorb shocks in domestic and global stressed scenarios in the medium-term. Nevertheless, declining profitability and deceleration in deposit growth are the key concerns.

The review highlights that Islamic Banks (IBs) and Microfinance Banks (MFBs) are gaining maturity with improved performance, expansion in advances, deposits and customer base and growing share in assets of the financial sector. However, IBs continue to face liquidity management challenges due to dearth of Shariah compliant investment instruments, while MFBs may flourish further with enhanced outreach and improvement in financial literacy.

The challenging macro-financial conditions, particularly in H2CY17, have influenced the performance of the Non-Bank Financial Sector as well. Mutual funds have shifted a significant portion towards money market funds in response to volatile equity prices and risk adverse sentiments. However, mutual funds portfolio is still dominated by equities that are exposed to equity price risk. The other non-bank intermediaries like Modarabas and leasing companies have been lagging behind in performance due to structural inefficiencies and insufficient availability of low cost funds.

The limited intermediation role being played by Development Finance Institutions (DFIs) have hindered their growth and adversely impacted their performance during the year. Enabling DFIs to assume their true economic role is a key policy concern. The insurance industry has witnessed healthy rise in gross premiums but it is exposed to concentration risk due to the dominance of a few insurers.

It also faces market risk as adverse movement in interest rates or equity prices may affect its investment income. Exchange Companies (ECs), with steady growth and improving profits during CY17, pose limited systemic risk to the financial system. However, since a few ECs are subsidiaries of banks, the upstream risk, though limited, still exists.

The Financial Market Infrastructures (FMIs) have performed smoothly and efficiently. Pakistan Real-time Interbank Settlement Mechanism (PRISM), a key FMI, has facilitated growing volume and value of wholesale settlement transactions. However, cyber security risks remain a key concern for FMIs, particularly for retail transactions, due to increasing adoption of e-banking channels. Further, rising interconnectedness among the FMIs might lead to contagion risk.

The performance of the non-financial corporate sector has remained upbeat as the estimates suggest broad based steady growth in assets and decent profitability in CY17. The large listed firms are self-sufficient in liquidity with low debt burdens and strong repayment capacity. However, small listed firms are vulnerable in this perspective. Moreover, the textile sector, being one of the

largest borrowers of the banking sector, has relatively high leverage and low repayment capacity.