



PIDE

COVID-19 BLOG

No. 30

Assessing the Fallout from the Coronavirus Pandemic on the Banking Sector of Pakistan

The domestic economy was already undergoing stringent reforms aimed at reducing the twin deficits and lowering the aggregate demand, with the economic growth rate for FY20 expected to be lower than 3 percent, the recent shock due to the COVID-19 outbreak has further adversely affected the business sentiment. Consequently, the SBP had to lower the policy rate by 425 bps to 9 percent in a matter of days and to come up with schemes to boost long-term investments in the country. However, in line with the global economic scenario, these measures are not expected to yield immediate results¹, and much is dependent on the lowering of the number of COVID-19 affected cases and fatalities. With the economy now in a further depressed growth outlook it is imperative to have a careful look at the macro-financial linkages and the transmission of COVID-19 shock on the financial sector in general and the banking sector in particular.

Historically, the banking sector of Pakistan has largely been immune to macroeconomic vulnerabilities during 2000s and despite lower growth rates than the trend, the banking sector has posted huge profits and improved their capital base accordingly. A careful examination of the dis-connect between macro-financial performance would reveal the banks to benefit from fiscal distress being the dominant borrowers to the fiscal authority with virtually no risk on its exposures. Moreover, the supervisory role of the State Bank of Pakistan (SBP) of not letting any idiosyncratic or systemic bank failures take place, because of relaxing risk management and prudential measures, has further enhanced the profits of the banks.

Stress Testing of the Banking Sector of Pakistan ²

While considering the effects of Corona pandemic on the banking sector, several scenarios are expected to emerge that may affect the profitability and solvency of the banks. The most immediate is the expected depletion of loans extended by the banks to individuals and the corporate sector. The gross NPL to loans ratio as of Dec -19 was 8.6 percent and the critical infection ratio; the point where bank capital is fully eroded due to bad loans; was at 38.5 percent. This implies that banks can bear a loss of further Rs 2.6 trillion before their capital base is wiped-out. It is important to note that out of the Rs. 8.9 trillion of total gross loans, the share of government guaranteed public sector loans was 22.8 percent.

While considering the implication of stock market turmoil, the banks are placed in a rather comfortable position as their share in stock market investment has been considerably lower due to prudential regulation restrictions. While the PSX-100 index declined by 19 percent since the emergence of Coronavirus in the country, its impact has been very modest on the banks³. A stress test exercise by the SBP provides two scenarios of depletion in stock market by 41.4

¹ <https://pide.org.pk/blog/a-quick-note-on-sbp-announcement/>

² The stress testing module is taken from SBP. The SBP issued the stress testing result on quarterly basis. Indeed, this stress test DOES NOT incorporate COVID-19 effects. However, it will be useful as a baseline scenario.

³ The KSE 100 touched 27228 on 25th March which showed the 30 percent (that is 39296 on 2nd March 2020) decline. Then the market recovered with the news of lowering policy rate by the SBP.

percent and a severe 50 percent. In both cases, only two smaller sized banks with limited capital base are expected to witness a reduction in the solvency levels.

In addition to the stock market crises, the banking system is also exposed to other risks including the sudden influx of deposit withdrawals or the run on the banks. Due to the Corona shock, it is expected that deposit withdrawals might increase. A stress test of deposit withdrawals of customer deposits by 2%, 5%, 10%, 10% and 10% for five consecutive days respectively before the central bank liquidity injection pose no major issue for any bank.

The Pak Rupee depreciated around 7 percent in the last few days. In addition to this, we are further expecting a pressure on Pak rupee due to capital outflow (hot money), lesser worker remittances and lower export receipts. Therefore, the depreciation of rupee and exchange rate risk may also be a source of concern for the banking sector. However, the stress testing of SBP shows that 30 out of 33 banks remain robust to 30 percent depreciation (that is Pak/USD 207 from Pak/ USD 160) of Pak Rupee.

The banking sector of Pakistan has come a long way from conventional branch banking operations to digital/internet banking services. Banks' ATM coverage has spread across the country and most of the banks have developed internet-based banking services which enable the customers to perform all kinds of transactions without visiting the banking premises. While considering the Corona shock and following the social distancing measures, the usage of ATM and Point of Sales (PoS) transactions are expected to increase. Moreover, it is also expected that internet and mobile banking would also witness higher volumes and larger quantum of transactions. There are 3.4 million internet and 6.4 million mobile banking users in the country⁴. It is expected that the banks would be able to cope with this surge in usage of e-banking and the downtime of ATM would be minimized to prevent loss in services.

Pakistan has largely remained immune from the direct consequences of the global financial crisis of 2007-08 and other prior international financial vulnerabilities⁵. However, being a small economy with limited cross-border banking linkages, it has experienced second round effects and spillovers on its Balance of Payments (BoPs) which has amplified the twin deficits (fiscal and current account) faced by the country and compromised economic growth. Nonetheless, the financial sector in general and the banks in particular have thrived over the years despite these adverse developments.

In case of the COVID-19 shock, the country is expected to have direct consequences on its macroeconomic environment, business sentiments, external sector demand and high cost of health recovery. However, it is expected that the banks would be able to withstand all sorts of plausible shocks including worsening of loan and investment portfolio, depreciation of domestic currency and sudden deposit withdrawals. The banks having a strong capital base serve as a cushion to absorb unexpected losses originating from idiosyncratic and macroeconomic shocks. The banking sector of Pakistan has consistently evolved with strong risk bearing capacity with a gradual buildup in its capital base.

In the worst-case scenario, even if the banking sector face a crisis, the recovery will depend on two factors. First, how long and deep the COVID-19 crisis lasts. Second, what is the response of the SBP and the government. We have seen that the SBP has a number of measures in response to the outbreak⁶. Therefore, it is expected that the banking sector will perform its functions effectively during these testing times.

⁴ September 2019 data as per SBP - <http://www.sbp.org.pk/PS/PDF/PS-Review-Q1FY20.pdf>

⁵ Pakistan is among very few countries that has never faced a banking crisis. It did face the currency crisis in 1971/72 post creation of Bangladesh.

⁶ see for details <http://www.sbp.org.pk/corona.asp>

Annex

Stress Testing Results of the Banking System						
Position based as December 2019						
	Shock Details		Number of Banks with CAR			
			< 0%	0% - 8%	8% - 12.5%	> 12.5%†
	Pre-Shock Position		2	0	1	30
	Credit Shocks	Nature of Shock	< 0%	0% - 8%	8% - 12.5%	> 12.5%
1	10% of performing loans become non-performing, 50% of substandard loans downgrade to doubtful, 50% of doubtful to loss.	Hypothetical††	2	1	5	25
2	Default of top 3 private sector borrowers/Groups (fund based) exposures, including outstanding or limit whichever is higher and investments in borrowers' TFCs, equity etc., as defined under Revised PRs, net of deductions.	Hypothetical	4	1	10	18
3	All NPLs under substandard downgrade to doubtful and all doubtful downgrade to loss.	Hypothetical	2	1	2	28
4	Increase in provisions against NPLs equivalent to 25% of Net NPLs.	Hypothetical	2	1	2	28
5	Increase in NPLs to Loans Ratio (NPLR) equivalent to the historical maximum quarterly increase in NPLs to Loans Ratio of the individual banks.	Historical	2	1	1	29
6	Increase in NPLs to Loans Ratio (NPLR) of Textile Sector of the banks equivalent to the historical maximum quarterly increase in these banks.	Historical	2	0	2	29
7	Increase in NPLs to Loans Ratio of Textile Sector of the banks equivalent to the historical maximum quarterly increase in these banks.	Historical	2	0	1	30
8	Increase in NPLs to Loans Ratio of Consumer Sector of the banks equivalent to the historical maximum quarterly increase in these banks.	Historical	2	0	1	30
9	Increase in NPLs to Loans Ratio of Agriculture & SME Sector of the banks equivalent to the historical maximum quarterly increase in these banks.	Historical	2	0	2	29
				NPLR	Critical NPLR	Difference
10	Critical Infection Ratio (The ratio of NPLs to Loans where capital would wipe out)	Hypothetical		8.6%	38.5%	29.9%
	Market Shocks		Number of Banks with CAR			
			< 0%	0% - 8%	8% - 12.50%	> 12.50%
1	Parallel upward shift in the yield curve - increase in interest rates by 300 basis points along all the maturities.	Hypothetical	2	1	8	22
2	Upward shift coupled with steepening of the yield curve by increasing the interest rates along 3m, 6m, 1y, 3y, 5y and 10y maturities equivalent to the historical maximum quarterly increase.	Historical	2	1	8	22
3	Downward Shift plus flattening of the yield curve by decreasing the interest rates along 3m, 6m, 1y, 3y, 5y and 10y maturities equivalent to the historical maximum quarterly increase.	Historical	2	1	0	30

4	Impact of Increase in interest rate by 100bps on investment portfolio only	Hypothetical	2	0	3	28
5	Depreciation of Pak Rupee exchange rate by 30%.	Hypothetical	3	0	1	30
6	Depreciation of Pak Rupee exchange rate by 15.9% equivalent to the historical quarterly highest depreciation of rupee against dollar.	Historical	2	0	1	30
7	Appreciation of Pak Rupee exchange rate by 7.0% equivalent to the historical quarterly highest level of appreciation of rupee against dollar .	Historical	2	0	1	30
8	Fall in general equity prices by 41.4% equivalent to maximum decline in the index.	Historical	2	0	4	27
9	Fall in general equity prices by 50%.	Hypothetical	2	0	4	27
	Liquidity Shocks			No. of Banks with no liquidity after		
				3 Days	4 Days	5 Days
1	Withdrawal of customer deposits by 2%, 5%, 10%, 10% and 10% for five consecutive days respectively.	Hypothetical		0	1	2
				1 Day	2 Days	3 Days
2	Withdrawal of Wholesale Deposits and Unsecured Borrowings by 10%, 20%, and 50% for three consecutive days respectively.	Hypothetical		0	1	3
<p>Source: State Bank of Pakistan (December 2019): “Quarterly Compendium: Statistics of the Banking System”</p> <p>Note †: CAR is capital adequacy ratio, also known as capital to risk-weighted assets ratio. It measures a bank's financial strength by using its capital and assets. 12.5 % is required by SBP for each bank.</p> <p>Note ††: Historical means that historical minimum (maximum) level in the case of Pakistan. Hypothetical implies a hypothetical scenario in the case of Pakistan.</p>						

By: Abdul Jalil, PIDE.

Pakistan Institute of Development Economics

Web: www.pide.org.pk, Twitter: @PIDEpk, Facebook: PIDEIslamabad