

Ishrat Husain: Banking sector reforms in Pakistan

Article by Mr Ishrat Husain, Governor of the State Bank of Pakistan, reproduced from Blue Chip - The Business People's Magazine, January 2005.

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Why did we need reforms in the banking sector in the first place? Why is it so important to have healthy and buoyant banks? What is the exact role of State Bank of Pakistan and how does it go about performing this role? Where does the Government come in this picture? How do these reforms serve the interests of a common citizen as a consumer, depositor, and businessman? These and a host of other questions arise in the minds of a layman who is not so familiar with all the jargon and specialized terminology of finances.

We start with the simplest proposition: Financial Sector Development and Economic Development are inter-related. No economy can grow and improve the living standards of its population in the absence of a well functioning and efficient financial sector. Banks in Pakistan account for 95 percent of the financial sector and hence good health of banks is directly related to economic growth and development of Pakistan.

What was wrong with the Pakistani banking system that such massive reforms had to be undertaken?

Banks in Pakistan have been catering basically to the needs of the Government organizations, subsidizing the fiscal deficit, serving a few large corporations and engaging in trade financing. There was no lending to small and medium enterprises, to the housing sector or to the agricultural sector, which create most of the growth and employment in Pakistan. Most important, the financial system suffered from political interference in lending decisions and also in the appointment of managers. The middle class which is the backbone of any economy was not given due attention by the banking sector. There were legitimate reasons for such an errant behaviour.

First, the government's fiscal deficit was so high that most of the deposits the banks used to get, were loaned to the government and government corporations. This was safe lending which fetched good returns and the banks made good profit out of it. Naturally, there was little incentive for them to do anything else except lend to the Government which was both risk free and highly remunerative.

Secondly, the government owned most of the banks. In the government banks the staff worked like typical government employees, coming to office at 9:00 a.m., checking files; having nothing important to do and leaving at 5.00 p.m. without doing much work. These banks suffered from a high bureaucratic approach, overstaffing, unprofitable branches and poor customer service. Administrative costs were high reducing profits of depositors.

Thirdly, recovery rate was so low that almost 25% of the loans were stuck up as a large number of loans to the private sector borrowers were not given on the merit of the proposal but on political considerations. These influential borrowers hardly repaid their loans.

Fourth, banking industry faced a high tax rate of 58 percent while the rest of the corporate sector paid only 35 percent. This high punitive rate along with the burden of stuck loans and inefficiency of the staff was passed on to the customers in form of high lending rates and low deposit rates. The banking industry was not attractive for new entrants who could foster competition and improve efficiency.

Because of these factors, i.e. high administrative costs, burden of stuck-up loans and excessive tax rates, the average interest rate for lending was about 21% per annum. The middle class borrowers could not afford to get credit on such high interest rates and pay it back.

Banking sector reforms were thus needed badly to address these and other constraints so that the banks could play their due role in the economic development of the country. Although, there is no room for complacency and a lot still needs to be done, even the worst critics of this government do concede that if there is one sector which has undergone basic transformation that is the banking sector. **The IMF and the World Bank who are not always very generous or effusive in their praise had this to say about the Banking sector in Pakistan after completing a comprehensive and thorough review in early 2004.**

Quote: "far reaching reforms have resulted in a more efficient and competitive financial system. In particular, the pre-dominantly state-owned banking

system has been transformed into one that is predominantly under the control of the private sector. The legislative framework and the State Bank of Pakistan's supervisory capacity have been improved substantially. As a result, the financial sector is sounder and exhibits an increased resilience to shocks". Unquote.

What was the role of the State Bank of Pakistan in these reforms and how did it go about performing this role? The State Bank of Pakistan (SBP) has four major functions to perform under the law:

- ensuring soundness of the financial sector.
- maintaining price stability with growth.
- prudent management of the exchange rate.
- strengthening of the payment system.

It was felt and agreed between the Government and the State Bank of Pakistan that major deep rooted reforms had to be undertaken as cosmetic changes have not achieved anything tangible. As a regulator and supervisor as well as adviser to the Government, the SBP carried out diagnostic studies, prioritized the constraints facing the banking sector, designed the reform strategy and action plan, sought the assistance of the Government of Pakistan and international financial institutions, monitored the progress and made policy, regulatory and institutional changes to facilitate the process.

Where does the Government come in the picture and what did it do? The Musharraf Government made some critical policy decisions, i.e. they will not keep the banks under Government ownership and control but privatize them. Politically tough problems such as reducing the labour force and closing down redundant and unprofitable branches were dealt with boldly. The Government injected Rs. 30.7 billion to offset the losses incurred by these nationalized commercial banks and recapitalize them. Professional bankers were appointed as Chief Executives and persons from private sector enjoying reputation of competence and integrity on the Board of Directors.

I must say that the Nawaz Sharif Government in 1997 had initiated some of the reform measures by appointing Chief Executives, Boards of Directors on non political, nonpartisan basis for the first time. That Government had also injected fresh equity to strengthen the capital base of the nationalized commercial banks. Both Sartaj Aziz Sahib and Ishaq Dar Sahib were very much committed to put these banks on sound footing. They did away with the undue interference of labour unions in decision making process of the banks, abolished the Pakistan Banking Council and gave autonomy to the State Bank of Pakistan.

The point I would like to highlight in this context is that continuity of reforms and sound policies that transcend political partisanship and survive political regime changes are good for the country and also for these political parties.

What were the major reforms that had been implemented during the last seven years? I would not go into the details of each one of them, but summarize some of the salient features:

(i) ***Privatization of NCBs:***

All the nationalized commercial banks, except one, have been privatized. As a consequence their domination of the banking sector has been reduced from almost 100 percent in 1991 to about 20 percent by June 2004. Even in the case of National Bank of Pakistan 23.5 percent shares have been floated through Stock Market mainly aimed at small retail investors.

(ii) ***Corporate governance:***

Strong corporate governance is absolutely essential if the banks have to operate in a transparent manner and protect the depositors' interests. The SBP has taken several measures in the last four years to put in place and enforce good governance practices to improve internal controls and bring about a change in the organizational culture.

(iii) ***Capital strengthening:***

Capital requirements of the banking sector have to be adequate to ensure a strong base, ability to compete and withstand unanticipated shocks. The minimum paid-up capital

requirements of the banks have been raised from Rs. 500 million to Rs. 1 billion and have again been raised to Rs. 2 billion (by December 31, 2005). This has already resulted in mergers and consolidation of many financial institutions and weeding out of several weaker banks from the financial system.

(iv) ***Improving asset quality:***

The stock of gross non-performing loans (NPLs) that amounted to Rs. 252 billion and accounted for 22 percent of the advances of the banking system and DFIs has been reduced to Rs. 225 billion i.e. 14 percent of advances. More than two-thirds of these loans are fully provided for and net NPLs to net advances ratio has come down to as low as 5 percent for the commercial banks. The positive development is that the quality of new loans disbursed since 1997 has improved and recovery rate is 95 percent.

(v) ***Liberalization of foreign exchange regime:***

Pakistan has further liberalized its foreign exchange regime and set up foreign exchange companies to meet the demands of Pakistani citizens. Pakistani Corporate sector companies have also been allowed to acquire equity abroad. Foreign registered investors can bring in and take back their capital, profits, dividends, remittances, royalties, etc. freely without any restrictions.

(vi) ***Consumer financing:***

By removing restrictions imposed on nationalized commercial banks for consumer financing, the State Bank of Pakistan has given a big boost to consumer financing. Middle class employees can now afford to purchase cars, TVs, air7 conditioners, VCRs, etc. on installment basis. This, in turn, has given a large stimulus to the domestic manufacturing of these products.

(vii) ***Mortgage financing:***

A number of incentives have been provided to encourage mortgage financing by the banks. The upper limit has been raised from Rs. 5 million to Rs. 10 million. Tax deduction on interest payments on mortgage have been allowed up to a ceiling of Rs. 1 million. The new recovery law is aimed at expediting repossession of property by the banks. The banks have been allowed to raise long term funds through rated and listed debt instruments like TFCs to match their long term mortgage assets with their liabilities.

(viii) ***Legal reforms:***

Legal difficulties and time delays in recovery of defaulted loans have been removed through a new ordinance i.e. The Financial Institutions (Recovery of Finances) Ordinance, 2001. The new recovery laws ensures the right of foreclosure and sale of mortgaged property with or without intervention of court and automatic transfer of case to execution proceeding. A Banking Laws Reforms Commission is reviewing, revising and consolidating the banking laws and drafting new laws such as bankruptcy law.

(ix) ***Prudential regulations:***

The prudential regulations in force were mainly aimed at corporate and business financing. The SBP in consultation with the Pakistan Banking Association and other stakeholders has developed a new set of regulations which cater to the specific separate needs of corporate, consumer and SME financing. The new prudential regulations will enable the banks to expand their scope of lending and customer outreach.

(x) ***Micro financing:***

To provide widespread access to small borrowers particularly in the rural areas the licensing and regulatory environment for Micro Credit and Rural financial institutions have been

relaxed and unlike the commercial banks these can be set up at district, provincial and national levels with varying capital requirements. There is less stringency and more facilitative thrust embedded in the prudential regulations designed for this type of institutions. Khushali Bank and the First Microfinance Bank in the private sector have already started working under this new regulatory environment. Khushali Bank has already reached a customer base of 125,000 mainly in poorer districts of the country and its recovery rate is above 95 percent.

(xi) ***SME financing:***

The access of small and medium entrepreneurs to credit has been a major constraint to expansion of their business and up gradation of their technology. A Small and Medium Enterprise (SME) Bank has been established to provide leadership in developing new products such as program loans, new credit appraisal and documentation techniques, and nurturing new skills in SME lending which can then be replicated and transferred to other banks in the country. Program lending is the most appropriate method to assist the SME financing needs. The new prudential regulations for SMEs do not require collateral but asset conversion cycle and cash flow generation as the basis for loan approval. The State Bank is also contemplating to develop capacity building among a select group of banks for SME lending. This will revitalize the lending to SMEs particularly export oriented ones.

(xii) ***Taxation:***

The Government has already reduced the corporate tax rate on banks from 58 percent to 41 percent during the last four years and it is envisaged that the rate will be reduced gradually and brought at par with the corporate tax rate of 35 percent in the next two years. This will, in turn, help in reducing the spread between the deposit rate and lending rate and benefit financial savers.

(xiii) ***Agriculture credit:***

A complete revamping of Agriculture Credit Scheme has been done recently with the help of commercial banks. The scope of the Scheme which was limited to production loans for inputs has been broadened to the whole value chain of agriculture sector. The broadening of the scope as well the removal of other restrictions have enabled the commercial banks to substantially increase their lending for agriculture by a multiple of four times compared to FY 1999-00 thus mainstreaming agriculture lending as part of their corporate business. Unlike the previous years when they were prepared to pay penalties for under performance they have achieved consistently rising higher targets every year. The private commercial banks have also agreed to step in and increase their lending to agriculture.

(xiv) ***Islamic banking:***

Pakistan has introduced Islamic banking system to operate in parallel with the conventional banking providing a choice to the consumers. A large number of Pakistanis have remained withdrawn from commercial banking because of their strong belief against riba-based banking. These individuals and firms - mainly middle and low class - will have the opportunity to invest in trade and businesses by availing of loans from Islamic banks and thus expand economic activity and employment. A full-fledged Islamic bank has already opened the doors for business and several banks have branches exclusively dedicated to Islamic banking products and services.

The State Bank of Pakistan has set up a full-fledged Islamic Banking Department and a Shariah Advisory Board to help it in the promotion of Islamic banking in the country.

(xv) ***E-banking:***

There is a big surge among the banks including NCBs to upgrade their technology and on-line banking services. During the last three years there has been a large expansion in the ATMs and at present about 700 ATMs are working throughout the country. The decision

mandating the banks to join one of either two ATM switches available in the country has provided a further boost. Progress in creating automated or on-line branches of banks has been quite significant so far and it is expected that by 2005 almost all the bank branches will be on-line or automated. Utility bills payment and remittances would be handled through ATMs, kiosks or personal computers reducing both time and cost.

(xvi) **Human resources:**

The banks have recently embarked on merit-based recruitment to build up their human resource base - an area which has been neglected so far. The private banks have taken lead in this respect by holding competitive examinations, interviews and selecting the most qualified candidates. The era of appointment on the basis of sifarish and nepotism has almost come to an end as the private owners want to attract and retain the best available talent which can maximize their profits. This new generation of bankers will usher in a culture of professionalism and rigour in the banking industry and produce bankers of stature who will provide leadership in the future.

(xvii) **Credit rating:**

To facilitate the depositors to make informed judgments about placing their savings with the banks, it has been made mandatory for all banks to get themselves evaluated by credit rating agencies. These ratings are then disclosed to the general public by the SBP and also disseminated to the Chambers of Commerce and Trade bodies. Such public disclosure will allow the depositors to choose between various banks. For example, those who wish to get higher return may opt for banks with B or C rating. But those who want to play safe may decide to stick with only AAA or AA rated banks.

(xviii) **Supervision and regulatory capacity:**

The banking supervision and regulatory capacity of the Central Bank has been strengthened. Merit-based recruitment, competency-enhancing training, performance-linked promotion, technology-driven process, induction of skilled human resources and greater emphasis on values such as integrity, trust, team work have brought about a structural transformation in the character of the institution. The responsibility for supervision of non-bank finance companies has been separated and transferred to Securities Exchange Commission. The SBP itself has been divided into two parts - one looking after central banking and the other after retail banking for the government.

(xix) **Payment systems:**

Finally, the country's payment system infrastructure is being strengthened to provide convenience in transfer of payments to the customers. The Real-Time Gross Settlement (RTGS) system will process large value and critical transactions on real time while electronic clearing systems will be established in all cities.

These reforms will go a long way in further strengthening the Banking sector but a vigilant supervisory regime by the State Bank will help steer the future direction.

Outcomes:

What have been the results of the above reforms?

We have been working for the last five years to decrease the lending rates to the extent that middle and low-income professionals, who have no other source than their monthly income, may get a home or a car on installments from the banks. If he/she is a small entrepreneur he/she can get loans from SME. Agriculture, the largest sector of economy, which the commercial banks had neglected, has now begun to receive large allocations. The commercial banks are giving more agriculture loans than the ZTBL. If this trend persists, the rural households will be able to intensify the use of modern inputs and raise their productivity and income.

Credit cards, debit cards, personal loans and consumer durable loans are catching up fast. Refrigerators, air conditioners, VCRs, Televisions are now available on credit. The consumers are forced to save when a specific amount is cut from their salary every month to pay the installment. Mortgage financing is one way in which wealth is created. For example, you bought an apartment for Rs. 100,000 and paid Rs. 20,000 as equity and borrowed Rs. 80,000 from the bank. Next year, let us say that the value of the same apartment rises to Rs. 120,000/-. Your loan is still Rs. 80,000, but your own equity has now doubled from Rs. 20,000 to Rs. 40,000. In this way, growth of the middle class wealth takes place through judicious use of bank credit. As the lending rates have come down drastically from 21% to 5% the banks find it profitable to extend the customer base for mortgage and auto loans, agriculture credit, small business and consumers. For the first time in the history of Pakistan, the middle class is beginning to benefit from the banking system. Before these reforms only 400,000 farmers used to get loans from the Agriculture Development Bank, but this year, more than one million farmers have been granted loans by the banking system.

For the poor, who don't have anything to mortgage, we have established microfinance banks where no collateral is required. They can get up to Rs. 20-25 thousand in micro loans. Many people have availed this opportunity, some bought a cow, some bought a milch buffalo or opened a small shop and female borrowers bought sewing machines. They have started income-generating activities and recovery is no problem from the micro-finance banks. Approximately, 125,000 poor people have been given loans in the last two years.

The customer base of the banks has more than doubled during the last few years and covers almost 2 million households in agriculture, SMEs, Microfinance, Credit Cards, consumer loans, mortgage and auto loans, etc.

Another initiative taken by the State Bank of Pakistan was to revive sick units which were lying closed due to unsustainable debt burden. Now these sick industries can be revived through a well designed and transparent scheme. If the loanees pay 75% of the forced sale value to the bank, then these units would be handed over back to the owners. They can run the units and create employment opportunities. If it's an export industry, it will increase exports. This scheme is for all and sundry, across the board and round about 51,000 borrowers will be benefiting from it. The banks will be able to clean up their balance sheets by transforming these stuck loans into paying loans.

Pakistan is one of the few developing countries where the public sector banks went to the private hands in a very short span of time. The government only owns the National Bank, while 80% of the bank assets are in the private sector. And there is tough competition among the banks as in the private sector everything is performance-based. Unlike the public sector or the Government, any employee not producing results is fired because he affects profit of the organization. The bankers these days go out of their cozy offices to market their financial products and build up customer base. The seller market has changed into a buyer market. The customer may choose the bank with best products and services. There was a time - only a few years back - people used to go to the banks and the staff treated them shabbily, was generally uncooperative and unfriendly. Now, they are after the customers.

Cynics say that banking reforms are also promoting consumerism but when you give loan to a consumer, he goes and buys a car. But loan is given to a person who can demonstrate that he has sufficient disposable income to repay the monthly installments after taking care of his family needs. Before 1999 only 30 thousand cars were produced but in the last fiscal 100,000 cars were being produced. 70% of the parts and components for these cars are manufactured in Pakistan which is creating employment. Those who are producing the auto parts have made an investment of millions of rupees and generated new job opportunities. As they have attained economies of scale, Pakistani auto parts are being exported to Dubai and other countries. The whole industry is benefiting from it. Very limited numbers of air-conditioners were manufactured here but now they are produced in hundreds of thousands, similarly several hundred thousands of refrigerators and television sets are manufactured locally. If a company produces such products, they make huge investments in industry, people are employed and incomes are generated. This is not consumerism; rather we are stimulating demand in the economy by giving purchasing power to the people who can afford to pay them not in one shot but in installments spread over several years. If domestically manufactured goods are bought it's boosting the industrial growth. How have we achieved 17% industrial growth during the last fiscal year? The private sector is doing all this because they see a rising demand for their goods. For the first time in the history of Pakistan, the private sector received bank credit worth more than Rs. 325 billion. They used this money to invest in the industry and expand their capacity. This is a complete cycle - banks provide credit to consumers who purchase goods with this money, the

manufacturers respond to this higher demand by investing in new capacity and employing more people. As the new employees receive income they also add to the demand for these goods.

Similarly, the housing industry where steel, cement, paint, timber wood, electric gadgets, etc. are used is creating many more jobs in this sector. Unless there is credit available, except the millionaire/billionaire, the common man doesn't have enough money to build a house for himself. Credit increases his purchasing power. Home is a basic need. He will cut his monthly expenses but pay installments to the bank to keep his house. It will change his thinking. This is a kind of motivation for him. Everybody wants to have a home and a car. The banking sector is catering to such needs all over the world.

One of the adverse effects of lower interest rates in the country has been erosion of rates of returns on bank deposits. Small depositors who keep their savings in the banks have been badly hurt as they hardly get a decent return these days. The Government, therefore, had to come up with some scheme to safeguard the most vulnerable groups of our society whose only source of livelihood is their savings. To compensate the senior citizens, pensioners and widows we have launched "Behbood Scheme" through which they get 10.25% per annum. These returns are not affordable by the Government as they have reduced their fiscal deficit and do not need this money. Moreover, people used to misuse the saving schemes. They were in the habit of buying national saving certificates and then getting loans against those certificates and again buying more saving certificates.

As interest rates move up in the economy, it will be the depositors who will get the benefit while the borrowers will have to pay a higher price. This is the normal cycle through which market-based economies work. If we have chosen to live with this type of economy, we have to bear its costs along with its benefits. But it is our duty to protect the poor and vulnerable groups of the society. Here the Behbood saving schemes, Bait-ul-Mal, Zakat, Microfinance loans and Poverty Alleviation Funds come handy.

It can be seen from the above description and analysis that in the banking system the interests of depositors and borrowers are quite different. What we have been able to ensure is that competition reduces inefficiencies in the system and the gains are passed on to both the depositors and the borrowers. But, beyond this, there will always remain a tension between depositors who want higher returns on their savings and the borrowers who want lower interest rate on their loans.

To sum up, banking sector reforms have brought in competition within the system, improved internal efficiency, reduced the lending rates significantly and broadened access to the middle class. While these results are encouraging, a lot more needs to be done and, therefore, we have spelled out the agenda for the second generation reforms in the financial sector covering the period 2005-2010.