Shamshad Akhtar: Pakistan's financial services sector – a future perspective

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Pakistan Society Dinner, London, 21 June 2006.

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Poised to continue on its high-growth trajectory, Pakistan has now joined the league of emerging economies. The economic turnaround owes its origin to two principal factors: (i) persistent political and macroeconomic stability which has helped restore investor confidence and attracted domestic and foreign capital; and (ii) the ongoing financial sector development and transformation which has helped meet the growing financing requirements of the productive sectors, while generating consumption demand that turned out to be the main driver of economic growth.

Consistent with trends observed in growing Asia, structural changes in financial markets have been remarkable and significant. First, a word on Pakistan's financial sector's scope and scale:

- Financial assets grew by 70% over the past five years and by end-CY05 reached Rs 5.1 trillion, equivalent to 80% of GDP.
- Banking sector grew at a faster pace relative to non-bank sectors and currently accounts for 71% of the financial industry assets.
- Market capitalization of the stock exchange has grown steadily and recently peaked at 44% of GDP relative to 10.3 percent in June FY00.

Second, a word on the qualitative change and improvements in the financial sector. The liberalization and deregulation of the financial sector has helped transfer the banking sector's majority ownership to the private sector. This has helped to reorient the sector, which is continuously changing and restructuring itself in the wake of enhanced domestic and external competition as Pakistan's economy is rapidly integrating itself with global and regional markets. There has been exceptional growth in the profitability and efficiency of the financial services industry. This, among others, has induced a degree of institutional diversification as evident from: (i) the growth of equity markets that, given their high returns, has attracted foreign portfolio flows; and (ii) proliferation of a wide array of non-bank financial institutions which provide a range of financial services such as leasing, investment banking and fund management, and offer Islamic instruments such as modarabas and musharikas.

The changing characteristics and complexion of the financial sector, its dynamism and growing strength has catalyzed economic transformation. In FY05, real GDP growth rose to 8.6% supported by double digit growth in large-scale industry which has met domestic requirements and has generated an exportable surplus which facilitated almost doubling of the exports to $16.5 billion in FY06 relative to $7-8 billion in the preceding decade.

Normally real sector development precedes the development of the financial sector, but strong credit growth in the wake of a low interest rate environment in the last few years helped Pakistan stimulate economic activity. Consistent and stable economic policies enhanced business confidence. In the absence of alternative sources of funding, businesses relied heavily on banks to finance their needs. Growth in advances coupled with gradually rising interest rates has provided a unique opportunity for banks to generate unprecedented profits and redeployment of these funds in the banking and economic system has helped strengthen banks' balance sheets and continue to meet the growing economic requirements, respectively.

After having achieved high economic growth, the key question posed to the Pakistani economic-policy makers is how sustainable is this high economic growth path? Some even contest that the economy is showing signs of overheating. This debate is triggered by few emerging trends which are typically observed when economies are set to achieve new heights of growth. Economic sustainability is being questioned on the grounds that:

(i) Pakistan's growth has been primarily driven by growth in real consumption expenditure – this is partly true but is also a manifestation of rising per capita income that in FY06 is around $850, and higher remittances inflows that have now reached close to $4.1 billion.

(ii) After a consistent reduction in macroeconomic imbalances over FY00-04, the fiscal and external current account deficits have been above the targeted levels for FY06 and are likely to remain in that range in FY07. Most notable is the concern regarding trade deficit which is around $8.2 billion in FY06.[1] Around 45% of the increase in trade deficit for July-May FY06 over the comparable period in the preceding year is on account of the rise in import bill for crude oil and petroleum products, 39% due to higher imports of machinery, 11% because of iron and steel and 14.3% for food and fertilizers.

(iii) Government is offering a renewed and aggressive fiscal stimulus in FY07, but as is well known, Pakistan has no choice but to accelerate social and infrastructure development and offer relief to certain segments of population and businesses to sustain its economic achievements. Infrastructure sector programs while ambitious are absolutely needed to meet the growing demands in the economy as capacities are being enhanced, new industries and sectors are being opened up and development of industrial parks and additional EPZs are in the offing etc.

(iv) After a span of price stability, Pakistan continues to face inflationary pressures that emerged in late 2004 as a by-product of an accommodative monetary policy. Thus far effective monetary management and administrative measures to ease product supplies have controlled inflation which is now well within single digits. With demand pressures expected to grow, SBP will continue to pursue monetary tightening but there is need to strike an appropriate balance between promoting economic growth and price stability.

Over the medium term, Pakistan is well positioned to deal with these emerging trends effectively. While consumption demand would remain high, there are clear indications that investment has picked up – though perhaps not fully captured by national accounts statistics. Rising investment demand is confirmed by: **First**, the rise in gross fixed capital formation over the last two years by 29.6% in nominal terms and by about 9.8% in real terms. This has raised investment levels to Rs 1.42 trillion, equivalent to 20% of GDP and is likely to result in a reversal of the declining trend observed in the preceding years. Private investment accounts for two thirds of the gross fixed capital formation. **Second**, the rise in imports which, excluding crude and POL products, grew by 33%. **Third**, the rise in private sector credit which, while decelerating, still grew by 23% in FY06 despite rising interest rates. **Fourth**, foreign direct investment flows, excluding privatization proceeds, also contributed to the rise in investments. **Finally**, high corporate profits have largely been reinvested in industry and there is a high degree of self financing taking place.

Furthermore, the Government is confident that all spade work undertaken in the last few years will now pay off as the approved or lined up industrial and infrastructure investments take off. The Medium Term Development (MTDF) anticipates a rise in the investment/GDP ratio of 20.7% of GDP by FY10. Early indications are that both the domestic and foreign investors are upbeat about the future prospects and there are some investment commitments lined up from the Gulf states. During its economic transition, Pakistan will have to develop the capacities to tolerate and finance the required level of trade deficit as fresh investments will bring in additional import demand. Over this period, leveraging non-debt foreign flows will be critical to finance and sustain the external current account deficit.

Sustainability of investment trends would, among others, depend on Pakistan's success in improving the business climate by removing investment constraints, continuity in financial reforms coupled with strong vigilance of credit growth, and success in curbing inflationary pressures and tendencies within manageable levels.

The latest Financial Sector Assessment for Pakistan and the Banking Sector Review,[2] which will be released by July 2006, together lend comfort that:

(i) Banking sector profitability, at over $1 billion, is at an all time high and is generated by the enhanced business volume, the rising share of high-yield assets and widening spreads, on the back of the lagged impact of rising interest rates on deposits. Non-core activities also made valuable contribution. Resultantly, the return on assets (after tax) increased to 1.9% from 1.2% in CY04; easily surpassing the relevant international benchmark. The rapid

[1] Provisional figure, Statistics Department, State Bank of Pakistan.

[2] Annual publications of State Bank of Pakistan

growth in profits also resulted in considerably higher return on equity (after tax), which improved to 25.8% from 20.3% in CY04.

(ii) Falling NPLs to loans and net NPLs to net loans ratios improved to 8 percent and 2.1 percent respectively.

(iii) With strong profits, declining overhang of NPLs and fresh capital injections, the solvency position of the banking system strengthened further. Capital adequacy ratio (CAR) increased to 11.3% from 10.5% in CY04. The core capital to risk weighted assets (RWAs) ratio also improved to 8.3% from 7.6% in CY04. Both these ratios comfortably satisfy the generally acceptable benchmarks for wellcapitalized banks.[3]

(iv) Despite losing some momentum, the overall performance of the corporate sector, which is the major user of banks' funds, remained satisfactory.

(v) The exposure of banks to the households increased at a fast pace carrying it to more than 12% of total outstanding private sector credit. The low default rate remained the prominent feature of lending to households.

While the banking system has grown significantly in strength, rapid expansion in loans during the past few years in the midst of high inflation and a rising interest rate environment could pose a risk, if the debt burden on banks' borrowers exceed its limits and potentially erode their repayment capacity. So far the exposure and default rates on advances to the consumer, SME and agriculture sector have been manageable but potential losses in view of high credit risk cannot be ruled out. In a stark contrast to past practices, the risk management systems within banks have improved significantly. The greater disclosure requirements, strengthened corporate governance structures and the enhanced capacity of SBP's Credit Information Bureau, which will allow access to the credit reports of all borrowers, irrespective of the loan amount, all contribute as risk mitigants. Nevertheless, banks' classification strategies of their liquid assets portfolio contributed to increasing the liquidity constraints. Loans to deposits ratio, an important liquidity indicator, also increased to 70.2% from 65.9% in CY04. Market risk, dominated mainly by interest rate risk, also depicted increasing concerns. While the upward movement of interest rates started to erode the value of banks' investment portfolio, especially the proportion held in longer-term securities, investments in capital markets garnered precious capital gains due to the rise in the stock market index. The absence of any fresh issue of long-term paper gave rise to heightened uncertainty regarding the future movement of interest rates, and market displayed greater interest in short-term paper leading to a significant rise in the banks' holding of MTBs.

Despite these positive results, Pakistan can ill-afford to be complacent. With an average credit growth of 30% over the last three years, and the rapid diversification of banks' loan portfolios, there is need for vigilance in the future. Recognizing this, Pakistan is embarking on the next phase of financial sector reforms. Broadly, this would involve reforms that would focus on:

(i) Further consolidation and restructuring of the banking sector;

(ii) Strengthened risk management

(iii) Developing capacities to cater to unmet requirements of special segments of the economy and catering to diverse needs;

(iv) Diversification of the financial sector by further development of the equity and debt markets which, while fairly vibrant, need to play a more significant role in meeting the country's financing requirements.

(v) Promoting financial product innovation

Furthering consolidation and restructuring of the banking sector

Following the privatization of banks, today almost two-thirds of the banking sector consists of local private banks and 9 percent is owned by foreign banks; consequently the share of the public sector

[3] For a well-capitalized bank the capital adequacy ratio should be above 10%, tier 1 to capital to RWA ratio and capital to total assets ratios should be above 5%.

banks has been scaled down to around 20 percent, from 50 percent in CY00. The net effect of the liberal licensing policy and consolidation is that today Pakistan has 39 banks (down from 46 in 1997). Excluding the five large banks, of which the largest bank is government owned, there are around 20 banks among the remaining 35 banks, which together hold a mere 9 percent share in the banking system. While large banks are improving their performance and converging on bottom-line performance indicators under increased competition, small banks are gradually losing ground because of the lack of scale and operational efficiency. Enhanced competition and the need to substantially grow the lending portfolio to remain commercially viable would eventually pose problems of existence for small banks. Recognizing the system risk, SBP has stiffened its licensing policy and regulatory capital requirements and has increased the paid up capital requirements for banks to $100 million.[4]

Positioning themselves accordingly, a few banks have injected fresh capital or amalgamated with other financial institutions to meet these requirements. A wave of mergers and amalgamation has become a business reality in Pakistan and over the last five years, 21 financial institutions have been merged / acquired. This has involved a buy-in of foreign banks by the local banks, merger of smaller banks and DFIs, merger of investment banks with commercial banks and so on and so forth. In order to eventually have a stronger banking system, Pakistan is striving for further consolidation of the banking sector and it is with this in mind that the SBP has approved in principle additional five strategic mergers:

1. Standard Chartered Bank (SCB) is acquiring Union Bank which had sometime back acquired Bank of America and Emirates International Bank. Following this SCB will emerge as a local subsidiary
2. Merger of Rupali Bank Pakistan operations with and into Arif Habib Rupali Bank
3. Merger of Atlas Investment Bank with and into Atlas Bank Limited after its acquisition of Dawood Bank Ltd.
4. Merger of Habib Bank AG Zurich Pakistan operations with and into Metropolitan Bank
5. Merger of PICIC and PICIC Commercial Bank

Going forward, SBP's strategy is to allow new entrants by way of strategic partnerships with licensed banks and to encourage additional mergers and acquisitions. This will help evolve a stronger and robust banking system to meet the challenges of the increasingly complicated financial environment. The competitive environment might also force financial institutions to specialize in offering certain types of services based on their respective expertise and market niches.

Government shareholding is still significant in about 11 financial institutions including 4 larger banks, few joint ventures, and DFIs. Barring joint ventures, the Government is in the process of offloading its shareholding in larger banks through the stock market. Aside from restructuring and selling of the Industrial Development Bank (IDBP), SBP is working with specialized financial institutions and the provincial government to also reduce their shareholding in provincial banks.

Developing capacities to meet requirements of the underserved markets

SBP has been quite proactive in developing the prudential regulatory framework for the SME and microfinance sectors. Even though access to credit has improved, there are still outstanding issues of inequitable distribution of credit to the sectors and segments which remain underserved. With rapid economic growth in the country, there are plenty of opportunities available for these sectors to grow, the key issue is to provide an enabling policy environment, improve delivery and outreach of banking services to far flung area, and resolve collateral issues.

In order to improve the access of financial services to these sectors, the State Bank is in the process of setting up a Development Finance division dedicated to serve as an interface with the industry and improve access of credit to various districts and provinces. SBP has also been instrumental in the amendment of the legal framework for microfinance. These amendments are quite far reaching, are in line with the stakeholders' demands and hold the promise of providing the desired level of flexibility

[4] Under the regulations, Banks were required to increase their capital base to Rs2.0 billion by end-CY05, and further to Rs6.0 billion in a phased manner by end-CY09.

both at the regulatory cum supervisory level, while easing constraints of the industry. Microfinance Institutions will now be able to tailor their products to meet the needs of their customers as they move along the prosperity continuum. Going forward, development finance is a high priority area for the central bank.

Strengthening risk management

SBP has instituted an all-embracing framework viz. the Institutional Risk Assessment Framework (IRAF) to further strengthen the existing supervisory mechanism and to mitigate the variety of risks banks are exposed to. The framework envisages a collaborative and seamless supervisory focus amongst various supervisory departments within SBP to ensure cohesive and proactive monitoring of risks within banks and DFIs. The framework, being highly technology driven, provides for the timely flow of information and enables SBP to institute more efficient and effective banking supervision and continuous monitoring both on the part of SBP and the financial institution themselves, integrating off-site surveillance, on-site examination and current market information.

Further, considering the importance of a forward looking approach to risk management, SBP has instituted a framework of stress testing. The framework is based on single factor sensitivity and regression based analysis. Under the single factor sensitivity analysis, exposures of all banks towards five major risks i.e. interest rate risk, credit risk, real estate price risk, equity price risk and exchange rate risk is assessed after subjecting the underlying risk factors to unusual but plausible shocks. These exercises have helped considerably to assess overall risk exposures as well as structural vulnerabilities in banks that could trigger potential externalities and market failures. Besides, in order to inculcate sound risk management practices among the banks and DFIs and to make the stress testing exercise more effective, consistent and focused, SBP has issued guidelines on stress testing. These guidelines contain a framework for regular stress testing, the technique and scope of stress testing along with methodologies and calibration of shocks.

Encouraging greater depth and breadth in equity markets

Pakistan's Stock market has been the best performing market in the region. The Karachi Stock Exchange (KSE) share index – that stood at 1,507 points at the end of the year 2000 – reached record levels by 17 April 2006 at 12,274 points with market capitalization being close to $57 billion, or equivalent to 44% of GDP. In recent weeks, the stock market has experienced substantial volatility and has declined to under 10,000 points. In a vein similar to global and regional exchanges, there are different interpretations and conflicting stories regarding the current volatility in equity markets. Aside from rising global interest rates and uncertainties regarding US economic data, the fall in share prices in the regional markets is being attributed by some to "overdue correction" and by others to rising domestic inflationary pressures or other macroeconomic concerns. In case of Pakistan, there is no one explanation for the oscillation in share prices which after a decline seem to be re-bounding – with almost 1,174 points being added on one day in one go. Besides the standard pre-budget euphoria and reaction to a modest increase in the turnover tax on shares and the perceptions relating to the removal of capital gains tax scheduled to be phased out by 2007, there is a view that this volatility is a manifestation of structural weakness in the front line regulator i.e. the stock exchange, overleveraging of the market, and margin calls which triggered heavy selling, uneasiness with delays in the settlement of the continuous funding system (CFS) which is expected to be modified and eventually be replaced by margin financing to do away fully with *badla* – a form of short selling – tightening of some regulations, introduction of universal identification number for brokers etc. SECP has launched a probe of short and blank selling and has proposed measures to boost investor confidence by tightening the risk management practices at the stock exchanges, addressing issues of netting of open market positions across three markets, mark to market profit/loss, etc.

Barring these aberrations, the stock market has been exceptionally buoyant benefiting from the (i) increased investor confidence in economic policies and high corporate profitability, (ii) increased supply of scrips augmented by privatization of large government owned companies such as the recent additions to the market of issues of the Pakistan Telecommunication Corporation (PTC), Muslim Commercial Bank (MCB), and the large issue of a power project, namely the Hub Power Company (HUBCO), which has been actively traded (iii) renewed interest of a large number of buyers of shares, (iv) bright prospect of reaping dividends and capital gains, (v) foreign portfolio investments and (vi) continuous efforts to strengthen the legal and regulatory framework of the ,securities markets.

The events in equity markets not only provide an opportunity for self correction of overvaluation but also will help strengthen the governance of the exchanges. The stock market is expected to further receive a boost from the continued implementation of the privatization program, issuance of GDRs by OGDC – a large utility company – and as the banking sector offloads more of their shareholding to markets, and companies initiate IPOs to meet their financing requirements.

To restore investor confidence, the regulator is encouraging systematically the strengthening of the governance of exchanges by restructuring of Boards and appointment of independent management, encouraging the demutualization of exchanges, while strengthening risk management systems that have involved the introduction of T+3 settlement and circuit breaker limits, proper capital adequacy for brokers etc. Investor confidence will be further enhanced as the Code of Corporate Governance has been incorporated into the listing regulations of stock exchanges, there is enhanced vigilance to check undisclosed trading and front running, and effective enforcement mechanisms are implemented. Efforts are underway to achieve market development through the introduction of stock futures, over-the-counter market and online access for Internet trading and over the period phasing out of badla with CFS and eventually margin financing to provide funding to leveraged investors. Pakistan has set up its first fully automated National Commodity Exchange which plans to introduce trading in derivatives, mainly futures contracts in commodities starting with gold contracts and later to expand to agro-commodity contracts such as cotton, rice, and wheat. Riding on the strength of the stock market boom and in response to the rising demand for investment avenues among retail investors, mutual funds in Pakistan have more than tripled in the last few years. The industry's combined net asset value stands at Rs125 billion as of end-June FY05.

In parallel, there is need to launch pension and insurance reforms which would eventually help impart long term liquidity to equity markets. As a beginning, the Government is encouraging the Voluntary Pension Schemes and allowing Asset Management Companies and Life Insurance Companies, meeting the fit and proper criteria, to be licensed to act as Pension Fund Managers. Life insurance companies would be authorized to offer Annuity Plans at the retirement age of the participants. For insurance businesses, stringent solvency standards have been introduced and minimum capital requirements have been enhanced. Insurance companies have also been directed to obtain reinsurance treaties from the international "A" class re-insurers. Takaful rules have been issued to allow for Islamic insurance products.

Promoting product innovation

In Pakistan, though derivatives have been a relatively new concept until recently, the derivative volume has increased manifold amidst the changing market and regulatory environment. In response to the evolving market dynamics and in order to develop an Over the Counter (OTC) financial derivatives market in the country, SBP issued Financial Derivatives Business Regulations in November 2004. Prior to this, banks were allowed to undertake the business of financial derivatives after getting specific approvals from SBP. However, with the issuance of these guidelines, the banks/ DFIs, besides meeting the eligibility criteria specified therein, also obtain Authorized Derivatives Dealer (ADD) or Non Market Maker Institution (NMI) status from SBP; have been allowed to undertake derivatives business. The grant of such status is based on the capacity of the applicant to undertake derivatives transactions based on both onsite and offsite analysis. At present, three banks have been granted the status of Authorized Derivatives Dealer. The regulations allow three types of transactions viz. Interest Rate Swaps (IRS), Forward Rate Agreements (FRAs) and FX options.

During the last one year, derivative transactions have grown substantially owing to the growing interest of the market players. Resultantly, the derivatives players in OTC derivatives market reported outstanding derivatives contracts with a notional value of Rs 115.5 billion as of March FY06, a measure that has grown manifold compared to Rs14.5 billion in March FY05. Most of these derivative transactions were under the IRS category. So far, foreign banks have been quite active in carrying out derivative transactions as the major chunk of these transactions lies with such banks. As for the FX options, around Rs 18 billion have been booked with major currency being the Euro against the US Dollar. Most of the IRS have been undertaken by the foreign banks with both their corporate and financial sector clients. Since FRAs are essentially short term in nature, outstanding FRAs stand as nil. Whilst the banks can undertake derivative transactions both for hedging and market making, most of such transactions were assumed for hedging purposes up till now. However, with greater sophistication of the market, the transactions for the latter are also expected to grow in future.