Shamshad Akhtar: Pakistan banking sector – the need for second tier of reforms

Address by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Pakistan Banking Association, London, 12 November 2006.

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Introduction

1. Banking sector of Pakistan has been transformed within a short period of 5 years (CY2000-05) from a sluggish and government-dominated sector to a much more agile, competitive and profitable industry. Speed and sequencing of banking sector transformation and its role in promoting economic growth is now a leading story of a sector success. Within Pakistan it offers a story of what effective leadership of regulator and change management and corporate governance can achieve and offer. Outside Pakistan it is serving to offer rich lessons in what difference governance of regulator can make and how bank restructuring and privatization can change the landscape of the industry. At this session of UK's Pakistan Banking Association I propose to share with you few key elements of this success story. I would however be amiss if I did not share with you the profitability and gains in banking industry and its role in promoting economic growth.

2. The banking industry in Pakistan will continue to enjoy these trends and has promising prospects. However, sustainability of banking sector performance is dependent on continued macroeconomic stability, stronger vigilance on the sector to ensure effective compliance of industry with the prudential regulatory and supervisory framework, and banking sector's maturity to reorient their business models to enhance their penetration ratio and address the asset: liability mismatches. At Pakistan to ensure macroeconomic stability coupled with effective risk management and mitigation will be critical to Pakistan's future and a precondition for sustainability of banking sector reforms.

3. The astounding growth of banking sector has stimulated and leveraged growth across the board. Major reforms in the banking sector have resulted in a more resilient and efficient financial system that is better placed to absorb significant macroeconomic shocks. Confidence in banking sector performance and prospects remains strong and scope for expansion and diversification remains phenomenal. This is supported by a combination of factors:

4. Banking sector liberalization and restructuring was well sequenced and well designed. In early 2000, financial sector reforms received strong impetus from high degree of political commitment as well as macroeconomic stability, both a prerequisite for smooth and effective implementation of financial sector reforms. The pace and sequence of bank restructuring was possible as the Government created fiscal space for absorbing the costs of the nonperforming and legacy loans. In parallel the financial deepening process triggered by financial liberalization reinforced and was supported by the rising economic growth and activity.

5. Financial liberalization process in Pakistan has been remarkable. It not only resulted in privatization of large public sector banks but the process of privatization was effectively conducted offering new management in most cases relatively cleaner bank where the key issues of NPL resolution and rationalization of work force were dealt with upfront or ongoing flexibility is awarded through special schemes to deal with the outstanding issues. Augmenting the private sector involvement, the entry requirements for new private banks were relaxed but made more stringent - both in terms of capital requirements and fit and proper criteria for both management and Board of Directors.

6. Accompanying financial liberalization process was a strong effort on the part of central bank to bring the prudential regulatory and supervisory framework for banks at par with the BIS standards. Pakistan is fully/largely compliance with the 28 of the 30 Basel Core Principles for effective Banking Supervision and the remaining 2 principles relate to consolidated supervision, and are under consideration for future compliance.

7. Growth in Banking Sector and its profitability is unprecedented. Banking assets rose three-fold over the last 5 years and industry size is reaching Rs4 trillion. The banking sector's assets to GDP ratio grew from 47.2% in CY00 to 55.6% in CY05 since the growth in banking assets outpaced the nominal GDP; these trends are in sharp contrast from the declining trend in banks' assets to GDP ratio during the second half of the 1990s. Supported by privatization and consolidation, assets of the

banking sector have shifted from public to private sector and there is a decline in asset concentration within the banking sector. This changing structure had far-reaching implications for the banking sector profitability.

8. Return on banking assets before taxes have grown to 2.6% (1.8% after tax) relative to 0.2% in CY00 and return on equity has been 25.4%. Improvement in profitability has been supported by high economic activity but it is important to recognize that sustained economic growth, rather than sporadic improvement in real GDP, helps the financial institutions to earn higher profits. In quantitative terms, one percent rise in the real GDP growth tends to improve the profitability by 113 basis points. In addition, low interest rates and inflation for most of the period in the last four years also supported the financial sector profitability, as one percentage point increase in real interest rates and inflation tends to reduce the ROA by 27 basis points in each case. Pakistan's economy to a higher growth trajectory during the last four years contributed significantly towards the improved profitability of the financial sector.

As per the latest study conducted by the World Bank, Pakistan has been ranked second in performance and efficiency indicators (India being the first) among the South Asian countries.

9. Bank's profitability has also been driven by changes in assets and liability management; key trends in this area have involved:

(i) rise in share of earning assets to 82% indicating a rise of 7% over CY00 but much more relative to pre-reform period;

(ii) rising focus on business income has helped raise advances/total asset ratio from 43.8% in CY03 to 54.4%;

(iii) while corporate loans remain an important share of lending, the rise in share of SME, consumer finance and agriculture which typically carry higher charge than corporate loans;

(iv) deposit as a % of liabilities rose by almost 10% since CY00 and reached 84% in CY05 consequently borrowing to liability ratio declined and banks have access to cheaper deposit funds as a large proportion of deposits were either non-interest or low interest bearing short term deposits, while the share of fixed-term deposits of six-month and above has witnessed a substantial decline. The average cost of resource mobilization for banks (deposits plus borrowings) has fallen from 6.6% in CY00 to 2.5% in CY05; and

(v) Operating expenses to income declines from 106% in CY98 to 91% in CY00 and to further 51.2% in CY05 and total expense to income is in the range of 65%.

Privatization has significantly contributed in improving profitability of privatized banks, though it has not reduced but enhanced the intermediation spread.

10. Improvements in financial health of banking sector continue. On the wake of this reforms process overall financial health of the banking system improved well and further strengthened since year 2000. Capital adequacy ratio of the banking system now stands at 11.9 percent from 10.9 percent in year 1999. Loan infection ratio has significantly came down to 2.1 percent closer to the internationally acceptable level, as compared to very high infection ratio (at 15.3 percent) in year 1999. These indicators seem more attractive while looking at the commercial banks perspective only and loan infection ratio for commercial banks stands as low as 1.4 percent in June 2006. Profitability indicators have significantly outpaced the international averages and the ROA after tax of all banks in Pakis tan now stands at 2.1 percent as compared to net losses in year 1999. In terms of their core business activity, the banks are now operating at the capacity significantly higher than was in 90s and the loan to deposit ratio now is around 70 percent.

A recently released study conducted by the World Bank on "Getting Finance in South Asia" also evaluates Pakistan, after India, as having higher capital adequacy, lower non-performing loans and stable liquidity position among the South Asian countries.

11. To tackle the problem of non-performing loans, a multi-track strategy was adopted which included enacting of new laws, creation of institutions to pursue recovery of bad loans, and an incentive package for genuine cases (rescheduling of loans of those borrowers who were unable to pay due to economic constraints). Specifically, a new law under the title "The Financial Institutions

(Recovery of Finance) Ordinance 2001" was promulgated.[1] The new recovery law provided a mechanism for expeditious recovery of stuck up loans, e.g., the law provided a comprehensive procedure for the foreclosure and sale of mortgaged property, without the interventions of a court of law, and automatic transfer of all cases pending in any other courts to banking courts for their early resolution.

12. Furthermore, amendments were made in the Banking Companies Ordinance 1962 (BCO) to; provide legal coverage for expeditious recovery of loans. To deal with the historical portfolio of stuck-up loans of the nationalized commercial banks and DFIs, the Corporate and Industrial Restructuring Corporation (CIRC) and Committee on Revival of Sick Industrial Units (CRSIU) were set up. While NCBs and DFIs were able to clean their balance sheets by transferring a part of their historically stuck up loans to CIRC which would then pursue their recovery independently, CRSIU was set up to valuate the possibilities of restructuring the loans of those industrial units that had became non-operational due to unsustainable debt and were otherwise viable. On the incentive side, while concessions were offered to those borrowers who were keen to regularize themselves, cases of willful defaulters, after due course of law were referred to the National Accountability Bureau (NAB).

13. While political resolve was necessary to tackle the issue of the NPLs, it was equally important to have a dependable infrastructure to provide accurate information on the past credit history of the borrowers. Such information generation entails substantial cost for the lenders, and at times, a lender may opt not to incur this cost, thereby exposing it self to credit risks. The need for setting up a centralized database of the borrower's credit history was realized early in the reform process and the Credit Information Bureau was set up at SBP. Over the years, the scope, coverage and efficiency of this bureau has been enhanced to meet the needs of the growing financial sector.

14. Within South Asia, Pakistan's banking industry fares well relative to all financial indicators too. Stepping back, the disproportionately high growth in advances, while improving the profitability, has raised the risk exposure for financial institutions. However, the simultaneous improvements in capital adequacy and relatively better quality of the fresh loans have mitigated the risk so far.

Sustainability of banking sector reforms requires second tier of reforms

15. To ensure growth, high profitability and improvements in financial health are sustainable, it is critical that Pakistan maintains macroeconomic stability which lends investor confidence. Not only have the first phase of structural reforms launched in 1999 still to be completed and impact of its implementation yet to take firm roots, SBP has recognized the added urgency to take stock of our achievements and to evaluate where gaps still exist and to design the strategy and road map for the next phase of reforms.

Pakistan banking sector is about to enter a long-term secular growth trajectory (Merill Lynch, 2006)

16. Explosion in banking industry has proven that the sector potential is high. The sector is further expected to receive an impetus as Pakistan has a large base of young population (69.5 million - having less than 19 years of age - as per Census of 1998) and the country's per capita income have risen to US $ 526 doubling relative to FY2000 and reaching US $ 847 annually with promising prospects of these levels set to double by 2015. An evaluation of banking sector reforms reveals that preoccupation with the privatization of banking industry and clean up of past nonperforming loans, the reforms executed thus far are partial and incomplete. The diagnosis reveals that while there remain outstanding issues in Pakistan's banking industry resolution of these offer significant opportunity to the banks to exploit the untapped markets.

17. **First**, although the banks have witnessed a substantial rise in profitability and improvement in capital adequacy ratios, the asset: liability management practices discussed above have increased the risk exposure of the banking sector, especially in the wake of monetary tightening since Q4-FY04. Few trends were noteworthy:

(i) The fall in the share of longer-tenor fixed deposits led to an emergence of maturity mismatch in banks' balance sheets. In particular, the incremental advances and investment had longer maturity compared with the incremental bank deposits. SBP encourage banks to attract long

[1] Vide Ordinance No. XL VI of 2001 dated 30 August 2001

term deposits by reducing cash reserve requirements (CRR) for long tenor deposit while raising CRR on shorter tenor deposits. Besides improving the maturity profile of banks' liabilities, this measure was intended to reduce the stickiness of bank deposits. Responsiveness of bank depositor to interest rates is expected to drive down the interest rate spreads.

(ii) Advances to total assets rose due to strong credit growth and impacted banking systems credit risk and liquidity indicators considerably from CY03 onward as reflected by the rise in advances to deposit ratios and decline in liquid assets to total assets ratios. Surge in advances, with a relatively larger exposure towards high-risk cliental (such as agriculture, SME and household sector) also exposed the banking sector to higher credit risk; the increased maturity mismatches, i.e., higher average maturity of assets than liabilities, have raised liquidity risk.

So far the banking sector has effectively coped with the increased risk exposure. While non-performing assets registered a downward trend from FY01 onward; banks witnessed a strong growth in capital, which stemmed from substantial improvement in profitability and increased in minimum-paid capital requirement.

18. As expected, the indicators for productivity and capital adequacy have shown a positive relationship with ROA of financial institutions.2 The latter reflects that a well-capitalized financial sector is able to tap business opportunities more efficiently and have more flexibility in dealing with problems arising from adverse developments in the operating environment of the financial sector. This also supports the ongoing policy of strengthening the capital base of financial institutions through raising paid-up capital requirement.

19. **Second**, banking sector reforms have not penetrated deep down or spread across population and regions. Vast majority of the population does not have access to financial services. Country is characterized by lowest savings rates and access to finance remains weak. Few selected indicators are quite illustrative of the situation: Of the 156 million people, the number of deposit holder as per Statistical Bulletin is 26,321,688 which also include multiple accounts by same persons/entities. For a country with a population of approximately 156 million these numbers are abysmally low since it only accounts for less than 17 percent of total population. Enhancement in deposit mobilization and in particular promoting long term resource mobilization – this will require banks to raise deposit rates to stimulate low savings rate which have been partly hurt by low returns and partly by high propensity to consumption. Equally important are steps being taken by central bank to stretch maturity of deposit by charging lower reserve ratio's for long dated deposits.

20. As per Credit Information Bureau (CIB) records the number of borrowers from the banking system is under five million i.e. 4,781,509 as of end June 2006, which accounts for only 3 percent of the population. Not only is the population underserved but banks are catering to largely urban or semi urban areas and concentrating in similar locations/segments with limited reach to the middle and lower strata of society. Notwithstanding credit to previously underserved markets such as consumer, housing, small- and medium-sized enterprises (SME) and agricultural sectors has expanded markedly and is now being provided by a broad range of financial institutions. Despite this large segments of the economy continue to operate with little formal credit. Credit penetration of banking sector is lowest in Asia pacific: number of borrowers is barely 5 million. Credit/GDP ratio is only 27% of GDP. While rising from under half a percent total consumer loans remains only 3.9% of GDP. Mortgage market currently is only $1 billion. Formal microfinance network which has witnessed significant growth reaches only 770 households with limited coverage to women.

21. In developing a program for access to development finance, SBP is adopting a four-pronged approach:

(i) Encouraging the Government to divest its remaining stake in banks. Plans to privatize Small- and Medium-sized Enterprise Bank (SMEB), Industrial Development Bank of Pakistan (IDBP), House Building Finance Corporation (HBFC), Investment Corporation of Pakistan (ICP), and National Investment Trust (NIT) are on cards.

(ii) Promoting microfinance industry development

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2 In order to avoid the simultaneity problem between equity ratio and profitability, we have included one period lag of EAT as an explanatory variable in the equation.

(iii) Leveraging Islamic finance to extend outreach to unbanked people and regions where Shariah compliance products may offer an incentive and appeal to augmentation of financial services

(iv) Launching efforts to promote new business models and technologies that will broaden access to financial services in a sustainable and cost-efficient manner. This will require some adaptation of relevant regulations.

The progress achieved thus far can be solidified by revising key financial sector legislation, most notably the SBP Act and Banking Companies Act, in accordance with best practice to avoid relapsing into past practices and unwarranted government interference.

22. **Third**, Banking consolidation is critical to enhance bank's economies of scale and cost effectiveness while developing strong and robust banks that can withstand business cycle downturns. Central bank has encouraged the consolidation process by enhancement of minimum capital requirement (MCR) in a phased manner to be raised each year by Rs1 billion from Rs2 billion to Rs6 billion by 2009. As of end of September 2006, all the banks, except four, were meeting the Rs2 billion capital requirement and the average capital held by the banks remains higher than Rs3 billion. The process of banking sector consolidation is ongoing but is yet to fully unfold. While some banks have already complied with new MCR, others are following the timetable and another set is seeking mergers with stronger banks. The mergers and acquisition wave is facilitating the process of consolidation. While some small banks are up for sale as they cannot meet capital requirements or do not see themselves as withstanding competition, others like foreign banks are acquiring banks given the attractiveness of Pakistani banks and their profitability and their desire to expand their outreach. Several mergers have taken place and more are expected in near future. The way the financial sector scenario has emerged over the past few years with number of mergers and acquisitions, it is expected that the process would continue at least for the next 5 years. We would have even fewer banks than today owing to capital requirement of 6 billion rupees by the year 2009. A typical figure could be 25 to 30 banks by end of year 2010. In the near future, we foresee at least three mergers/acquisitions transactions per year. Although number of small banks would reduce but the number of foreign institutions are likely to increase.

23. This is largely because while conventional banks are being consolidated, SBP has been licensing both Islamic and Microfinance Banks. The ultimate aim is to have fewer and well capitalized banks of sound repute having a broad based clientele and geographical reach. It is only the sound, and adequately capitalized banks that can take up the dynamic role required in a developing economy like Pakistan. Consolidation is also critical factor to deal with any effects of the reversal of business cycle. At the moment, the economy is enjoying high growth, and the future outlook is quite buoyant. Sound policy making, however, demands that the institutions are strengthened during the boom period to make them resilient against cycle reversal. The rise in interest rates can become a forbearer of economic contraction or at least limited market correction. As such it is important to pursue policies that encourage creation of reserves on the balance sheets of the banks that will act as a cushion in the time of crisis. The recent step of tightening up of classification criteria of NPLs is very timely.

24. **Fourth**, while banking sector's profitability has improved, there is need to further enhance competitiveness in the industry Currently, there is high sector concentration as the top five banks (out of total 39 banks) hold more than 50 percent of the industry assets, advance and deposits. The wave towards consolidation of banks is expected to enhance competitive pressures – for instance foreign banks are enhancing their outreach by acquisition of some strategic small banks which have a good branch network and few newer, relatively smaller, private banks have spread their reach to most major cities. These banks are now providing clients an option to diversify their business and not exclusively dependent on nationalized and large privatized banks that were the only sub-groups that had nation-wide branch network.

25. **Fifth**, adoption of new Basel II accord brings in a comprehensive risk management system and links economic capital with the risk assessments. Banking industry worldwide today faces several issues and challenges which unless effectively addressed would impact the pace of adoption and implementation of Basel II. In Pakistan the roadmap has already been given, and the standardized approach will commence from January 2008, while parallel run have been started from July 2006. The SBP's strategy is to work very closely with the banking industry to ensure that Basel II implementation is well planned and formulation of a Steering Committee is already underway under the guidance of SBP. However simply upgrading banking sector will be quite impossible to undertake unless the allied/support entities (e.g. credit rating agencies, IT systems etc) are also developed.

26. There is, however, a need to provide institutional support for those sectors that are complimentary to the banking sector success yet sufficient market mechanism has not taken roots. At the moment market development is limited in Credit Rating Agencies, private sector Credit Information Bureaus, and independent debt/financial advisories etc. The gaps in the rating agencies are of particular concerns for SBP, given the heavy reliance of Standardized approach under Basel II.

Conclusion

27. Central bank is now in midst of evaluating and stock taking of financial sector reforms. While the transformation of financial system is impressive, it is far from complete. Not only is the change more visible in banking and equity markets relative to institutional finance as insurance and pension reforms have lagged and corporate debt market remains small, but the change is more fundamental in the banking relative to even equity markets. Consequently it is no surprise that the banking system assets remain the larger component of financial asset and cater for bulk of financing requirements of the country. The banks also have been engaged in taking advantage of low hanging fruit and have leveraged lack of competition for resources and businesses to the best of their advantage. However, these trends are not sustainable as the economic and business cycles accompanied by changing interest rate environment eventually both global and based on domestic market fundamentals are a reality and call for the banks to be thinking of their long term interests. Banking sector's long term sustainability requires a more fundamental change accompanied by

(i) Greater degree of consolidation to provide a stronger and robust banking system;

(ii) A system that is well diversified and competitive;

(iii) Stronger corporate governance and risk management aligned to principles of Basel II; and

(iv) Financial system which is socially inclusive and facilitates access to financial services. Although finance has help promote economic growth, but its contribution to providing access to finance to poor and disadvantaged region is limited.