Syed Salim Raza: Reflections on financial sector dynamics

Keynote address by Mr Syed Salim Raza, Governor of the State Bank of Pakistan, at the Institute of Bankers, Karachi, 18 June 2009.

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It gives me great pleasure to chair this event organized by the Institute of Bankers and to share some thoughts with senior bankers and the distinguished personalities attending. I wish to congratulate all those who have passed the IBP examination and have qualified for the awards to be distributed today. They deserve much appreciation on their achievement. I am sure the banking industry will utilize their knowledge for the larger benefit of our society and economy.

I would like to take this opportunity to share some views on emerging trends in the financial sector. Even though financial institutions in Pakistan have remained largely insulated from the shocks of the global financial crisis, we cannot ignore the implications of events which started in the summer of 2007 in the global financial system. The crisis brought forth the realization that organizations which are not just too-big-tofail but also too-interconnected-to-fail, are the major source of systemic risk. It reinforced the fact that complete reliance on mathematical model-based risk management systems is insufficient in assessing the wide array of risks faced by the financial sector, some of which need a more qualitative analysis and judgment. Most importantly, it showed how its protracted duration severely impaired the basic function of the financial sector i.e. efficient allocation of resources in the process of financial intermediation. As I will elaborate, the regulatory focus in Pakistan has strived to prevent and mitigate the occurrence of these factors as the financial sector continues to evolve and progress.

The banking sector in Pakistan has undergone a sea change in the last few years. The unprecedented performance in terms of profitability, in building up a resilient capital base as reflected in the aggregate Capital Adequacy Ratio (CAR), implementation of Basel II and stringent provisioning requirements etc. have all contributed in providing a cushion against shocks from both the external and domestic macro-financial environment. Banks in Pakistan have been able to withstand the headwinds from weakening macroeconomic fundamentals since FY07. Now that the economy is poised for a turnaround, the banking sector has an even more emphatic role to play in supporting the real sector by meeting its financing needs.

Admittedly, banks face a challenging environment going forward: first, there is increased credit risk in the industry, a large part of which emanates from the nature of economic cycles. Credit booms inevitably lead to higher NPLs in subsequent years. The loan portfolio of the banking sector registered an annual average growth of over 20.0 percent in recent years (CY02 to CY07). Some correction in the loan portfolio was, therefore, to be expected. Also, the build-up of macroeconomic pressures which eventually led to a slowdown in economic growth in FY09 aggravated the increase in NPLs of the banking system. This is a cyclical process and is expected to stabilize with the improvement in macroeconomic fundamentals. Sensitivity analysis by the SBP suggests that the banking sector is well placed to withstand credit risk shocks of a modest nature. The provisioning coverage ratio of around 70 percent at end March 2009 also shows a prudent and proactive approach towards credit risk management.

Secondly, competition from NSS instruments offering a relatively higher rate of return has put increasing pressure on banks’ deposit generation capacity. Since the beginning of FY09, NSS instruments have seen a net inflow of Rs 206.7 billion, as compared to Rs. 86.6 billion in FY08. On one hand this augurs well in substantiating financial savings and meets the government’s objective of raising funds for deficit financing from non‑bank sources. However it does also imply that banks need to make concrete efforts to ensure sustained deposit growth by tapping the unbanked market, increasing financial penetration and facilitating the process of financial intermediation.

Third, given the associated pressure on profitability levels, small banks faced the challenge of meeting the minimum capital requirements (MCR) specified by the State Bank of Pakistan in 2008. In response to the challenges in the macro-financial environment, we have rationalized the MCR and the time period in which it needs to be implemented, thus providing breathing space to the industry in difficult conditions, fostering competition and a level-playing field in the industry.

Notwithstanding these developments, banks in Pakistan are meeting the financing demands of not just the private sector, but as seen in the recent past, of the public sector enterprises as well. Private sector credit to GDP ratio has declined from 26.2 percent in FY08 to 20.2 percent by April FY09. Such developments reinforce the need for diversification in the available financing options. One of the most illustrative examples of the grave implications of a skewed financial sector is the East Asian crisis, where banks were the predominant provider of finance. Post-crisis reflection on events brought forth the realization of the significance of alternative debt markets and in particular, money and bond markets, as a complementary source of finance. Moreover, the continued integration and deepening of financial markets is a significant issue for policy makers, and particularly for central banks entrusted with the formulation and implementation of monetary policy, since well-integrated and efficient financial markets are crucial in ensuring a smooth transmission of monetary impulses to the economy.

Indeed, banking sector dominance is an impediment to the fundamental principle of market competition; it leads to inefficiencies and therefore to sub‑optimal outcomes in the loan market, which may jeopardize the stability of the financial system. Consider the following:

(i) When the banking sector has to face competition from a well developed local currency bond market, it is forced to improve the efficiency of its operations and develop corporate financial services beyond primary lending. In Pakistan, the banking sector faces very little competition from the corporate debt market. Indeed, extraordinary banking spreads, as witnessed in Pakistan recently, provide some evidence of the lack of strong competition and efficiency in Pakistan's financial markets. So our capacity for corporate finance remains undeveloped.

(ii) The short tenor of bank loans, itself a consequence of the nature of banks' deposits in Pakistan, leads to maturity mismatch issues in the banks' asset and liability portfolios. This essentially means that long-term funding needs are financed by a consistent roll-over of short-term loans and in times of tight liquidity, borrowers may find themselves unable to roll over their maturing obligations. Access to bond markets then serves the purpose of a complimentary, rather than the alternative source of finance, as encapsulated in the much cited example of the essential "spare tyre" that a financial system needs. This is particularly true when a growing economy like Pakistan needs to raise sufficient funds for financing long‑term infrastructure projects.

(iii) When firms can raise their own funds through the issuance of market bonds, they are less dependent on banks and therefore not vulnerable to difficulties that banks might face. This also puts pressure on banks to diversify and widen their portfolio and service range, as they no longer possess captive clients. Consequently, banks can focus more on enterprisers in the economy that typically face credit constraints due to their small size, relatively new stage of development, or simply asymmetrical information. At present, the banks' loan portfolio is highly skewed towards big sized loans. Only 0.5 percent of total bank borrowers with loans size of more than Rs 10.0 million take up 71.7 percent of banks' loan portfolio. Among others, this indicates high concentration risk in the banking sector. Default of any of the three largest fund-based exposures can cause the aggregate CAR to fall below the minimum requirements. These risks can be easily managed in the presence of well developed capital markets.

(iv) One inherent characteristic of bond and securities finance is the provision of better risk-sharing than banks. When securities are spread across a large number of individuals, the risk is more efficiently diversified. Better risk sharing then is an incentive for creditors to commit themselves for longer periods of time, thus facilitating the borrowers in meeting their long-term funding needs. Indeed, all this adds up to the stability of the financial system.

Similar to the trend observed in most Asian countries, the major drivers of financial assets in Pakistan are deposits and government bonds, whereas corporate bond issuances remain a miniscule portion, with the total outstanding (listed) issues at Rs. 66.2 billion (0.5 percent of GDP). Pakistan Investment Bonds (PIBs), introduced in the year 2000, remain the longest tenor sovereign bonds, providing the benchmark yield curve for private issuances, whereas National Savings Schemes (NSS), on the other hand, with tenors up to 10 years, provide risk - free investment options to retail and institutional investors. The funds mobilized through NSS reached Rs. 1.3 trillion by end April-09 (9.9 percent of GDP).

Historically, the key obstacle to the development of the corporate debt market has been the competition for long term investment alternatives from the NSS instruments, which offer zero risk yields higher than returns on corporate bonds. In order to align NSS rates with market-based yields on instruments of similar tenors, the yields on NSS instruments were first reduced, and then pegged to the yields on the government's market-based long term bonds. From March 2000, institutional investors were barred from incremental investment in NSS. These measures helped in developing bond market to some extent as the number of issuance increased subsequently. The corporate sector issued 69 TFCs worth Rs 45.7 billion during FY01 to FY07. Market activity slowed down in the following years due to both overall slowdown in economic activities and the policy-reversal by the government to re-allow institutional investment in NSS. The corporate sector issued only two bonds worth Rs 6.1 billion during FY09.

In view of the above, the following factors could potentially facilitate the development of a debt market in Pakistan.

(i) The **banking sector**, which has a virtual monopoly on providing financing to all sectors of the economy, can play a central role in the development of the debt market. Banks are often among the most important issuers, holders, dealers, advisers, underwriters and guarantors in the market. Given the skewed nature of their balance sheets with maturity mismatch issues, banks can issue long-term bonds for Asset Liability Management (ALM). This is particularly relevant from the perspective of financing long term projects. To further manage their risk profiles in changing interest rate environments, there are now sophisticated risk - management tools such as Interest Rate Swaps (IRS) at their disposal.

(ii) The **central bank** has a crucial role in promoting secondary market trading of debt securities – by improving the effectiveness of monetary policy implementation. Efforts to reduce the volatility of short-term interest rates, while credibly signaling the policy stance, go a long way in increasing investor confidence while promoting the maturity transformation of financial intermediaries' portfolios. Moreover, stable money market rates foster repo activity and anchor the yield curve as trading develops in longer maturities. SBP has focused essentially on improving the transmission of the policy rate, by managing market liquidity and maintaining the O/N repo rates close to the discount rate. This approach has proved to be very effective and SBP will continue to work towards further improving the mechanisms of monetary policy implementation.

(iii) Development of the term structure of interest rates depends on regular issues in the primary market, increased trading activity in the secondary market, and providing ease of entry and exit to both the issuers and the investors. Regular auctions of Pakistan Investment Bonds (PIBs) since May 2006 is a step in this direction.

Developing bond markets and enhancing the capacity of public- and private-sector borrowers to issue long-dated, domestic currency denominated debt securities is high on the country's policy agenda. Among other factors, the presence of the requisite investor base is crucial for the development of both the primary and the secondary markets in debt securities. The regulatory environment should provide the right incentive framework to encourage both individual and institutional investors to invest, and trade in, debt instruments. A wide range of investors, with varying risk preferences, time horizons and trading motives would ensure active trading and liquidity.

Having shared these thoughts, I would like to conclude by saying that SBP stands committed to develop and diversify the financial sector in order to enhance its role in supporting economic growth. Pakistan is standing at a juncture where investment in infrastructure is crucially needed to facilitate the process of economic growth. The very nature of infrastructure projects, where funding is required for long tenors and cash flows only start to materialize after a certain time, is such that options for effective financing will only be possible once there is requisite support from the development of the local currency bond market and the financial sector provides access to a wide range of diversified financing options.