Yaseen Anwar: Role of financial institutions and capital markets in Pakistan's economy

Speech by Mr Yaseen Anwar, Governor of the State Bank of Pakistan, at the PAF Air War College, Karachi, 21 December 2011.

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The Commandant PAF Air War College, Members of the Faculty and the Future Leaders of the Armed Forces

I am delighted to be invited by the PAF Air War College which is one of our premier institutions of the armed forces of Pakistan, to share my views on the Role of Financial Institutions and Capital Markets in the Pakistan Economy.

The importance of Financial Institutions (FIs) cannot be overemphasized. FIs perform the vital function of intermediation between providers of investable funds (depositors, securities holders etc) and the users of such funds (namely businesses). No economy can progress unless its financial sector facilitates its business activity consistently, and in the case of a developing country like Pakistan, these FIs act as a necessary catalyst for economic growth as well.

The State Bank of Pakistan, as the central bank of a developing country, has played two very critical roles with respect to the financial sector. Firstly it ensures soundness of banks and DFIs through prudential oversight with a view to maintain financial stability; secondly it pursues a developmental objective under which it facilitates financial markets developments and enhancement of access to finance. Over the years much has been accomplished, yet a lot more is yet to be achieved.

The banking system, which constitutes 88 percent share of the total financial sector, is comprised of 34 commercial banks and 4 specialized banks. The share of non-bank financial institutions is approximately 12 percent, and includes leasing companies, Mudarabas, insurance companies, investment banks, housing finance companies, venture capital companies, and mutual funds. The Banking sector of an economy is generally the most significant player and performs three primary functions which include the facilitation of the payment system, mobilization of savings, and allocation of loanable funds. By virtue of its pivotal role, the banking sector can exert its positive influence on various other segments of the economy.

During the course of my speech, I would be giving you a historical perspective of the development of financial sector in Pakistan, followed by a discussion of challenges and opportunities of present scenario. Finally, I would like to share with you our priorities related to the banking sector for the future to come.

Historical perspective

The current structure of the financial sector in Pakistan is the result of several policy shifts and developments. The eras of financial sector developments in Pakistan can broadly be segregated into 1947–70, 1971–90 and 1991 to date period. Prior to 1971, the primary focus was on developing commercial banks in the private sector and creating development finance institutions backed by the government. The private sector development, however, almost clogged during the period 1971–1990, owing to the nationalization policy of the government. During this period, the banking sector came under the government's control. Since 1990s, more liberal and market-based reforms have been followed.

Period of 1947 to 1970

At the time of independence in 1947 the banks services were adversely affected and by June 30, 1948, the number of branches of scheduled banks came down to only 81 in the territories now comprising Pakistan. However, commercial banking made tremendous progress and achieved phenomenal growth since independence as by December 31, 1973 i.e., before nationalization, there were 14 scheduled Pakistani commercial banks with 3,323 branches all over Pakistan and 74 branches in foreign countries. Development Finance Institutions (DFIs) played a significant role in the early industrial development of Pakistan from the sixties up to about the mid eighties. These DFIs were major channels for routing development funds to the private manufacturing sector and achieving socio-economic objectives such as encouragement of new entrepreneurs, setting up of industries in less developed areas and wider diffusion of industrial ownership. However in the 1980s and 1990s many DFIs ran into problems stemming basically from poor management, excessive bad loans, withdrawal of incentives or resource constraints, and considerable losses to the point of their financial ruin. They were also unable to compete with the increasingly nimble banking sector of the 1990s which was able to capture substantial investment banking business.

Period of 1971 to 1990

As you may be aware, all 14 Pakistani commercial banks were nationalized and merged into 5 banks from January 01, 1974, and the financial landscape of the country changed significantly. One of the rationales given for nationalization was the fact that private banks were likely to neglect small borrowers and other priority areas, and it was thought that with nationalization, the government could direct credit to desired sectors. Consequently, various steps were taken, which included commencement of subsidized credit schemes, introduction of a complex system of credit ceilings, and the imposition of controls on interest rates.

The experiment of nationalization, however failed to give the desired results, as political interference in lending decision and also in the appointment of the boards and chief executives marred the operations of these banks. The efficiency of the banks was affected severely, and by the end of 1980s, the banking sector in Pakistan had become unsuitable for adequately meeting the growing financial needs of the country.

Period of 1991 to date

Realizing the inherent weaknesses in Pakistan's financial system, a broad based program of reforms was framed for the financial sector in the early 1990s. The reform agenda included, among others, financial liberalization and deregulation measures which were: privatization of NCBs, removal of restrictions on opening - up of private banks, phasing out of subsidized and mandatory credit schemes, removal of caps on deposit and lending rates of banks, abolishment of the system of credit ceiling, and switching towards a market based approach of credit distribution, etc. These measures were implemented over time with gradual improvement that continues today.

The State Bank of Pakistan played a pioneering role in these reforms, and has championed the developments in the financial sector. A brief summary of some of the major steps taken under these reforms are as follows:

For privatization of nationalized commercial banks, the Government injected Rs. 30.7 billion to offset the losses incurred by these banks and recapitalized them. Professional bankers were appointed as Chief Executives and persons from the private sector enjoying a reputation of competence and integrity were nominated on the Board of Directors and ultimately the banks were privatized.

Besides the privatization, fresh licenses were also issued to private sector sponsors to set up new commercial banks. These new banks provided the necessary competitive stimulus in the system, and have contributed to the enhancement of banking services in Pakistan. Resultantly the overall share of private sector owned commercial banks in the banking sector assets increased from almost negligible in 1991 to about 80 percent by June 2004.

The legal and regulatory framework was strengthened significantly, and State Bank powers under the Banking Companies Ordinance were enhanced in order to make it an effective regulator. Here I would like to emphasis that strengthening of the framework is a dynamic process, and as recently as in April 2011, the amendments in the BCO were carried out which further reinforced SBP's role as regulator of the banking sector.

The prudential regulations and various guidelines issued by SBP provided the essential impetus for prudent operations of the banks and DFIs. Under the regulatory framework, corporate governance, and risk management standards have improved significantly across the industry. These regulations also aim to enhance the quality of oversight of the Board of Directors of banks, mainly by (a) ensuring that only reputable and competent persons sit on these boards and (b) requiring that the members fulfill their responsibilities towards policy making for their respective banks.

Foreign direct investment in the banking sector was made more viable; and since liberalization, large numbers of reputable foreign shareholders have invested in locally incorporated Pakistani banks. At the same time several foreign banks have opted to operate in Pakistan in branch mode as well. One of the most recent positive development is the entry of largest Chinese bank ICBC in Pakistan that started operations earlier this year.

Since capital of a bank provides the buffer against unexpected losses, it is essential for any bank to have adequate capital to survive the ups and downs of a business cycle and to bear exogenous shocks successfully. The Capitalization of the banks has been enhanced steadily over the years. The minimum paid up capital (net of losses) was set at Rs.1 billion in 2003, increased to Rs2.0 billion by 2005, Rs6.0 billion by 2009, and Rs.10 billion to be achieved by 2013.

In addition to Minimum Capital Requirement (MCR), SBP also adopted internationally accepted solvency standard of Basel I in 1997; and the revised standard of Basel II has been enforced since 2008. Under this regime, banks have to maintain a Capital Adequacy ratio of 10%. The ratio is calculated keeping in view the risk profile of a bank's assets, with an ultimate objective to ensure that banks carrying higher risk assets should be required to hold more capital.

Over the years the monitoring of banks and DFIs has also improved. The on-site inspection and off-site surveillance has increased the level of supervision of SBP. Electronic information gathering has made oversight timely and consequently more effective. The SBP also undertook massive capacity building during the late 1990s and early 2000s to upgrade the level of expertise of its officers. Merit-based recruitment, competency-enhancing training, performance-linked promotion, and induction of skilled human resources are now regular feature of SBP's corporate strategy.

The IMF and World Bank in their banking sector assessment of 2004 state 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.

Present day scenario

Before I discuss the present day challenges and opportunities, let me first identify the key performance figures of the current banking sector. Total assets of our banks amount to Rs7.7 trillion as of end June 2011. The deposits stand at Rs6.0 trillion, while Advances and

Investments of the sector are Rs3.8 trillion and Rs2.6 trillion respectively. In spite of the economic slowdown, the pretax profit of the banking sector for year 2010 was Rs105 billion and for the first six month of 2011 it was Rs77 billion. The banks stand at a healthy Capital Adequacy Ratio (CAR) of over 14 percent and have shown a steady increase in capital even in absolute terms, and equity of the banks is now Rs722 billion (June 2011). While the picture appears quite stable, the key challenge comes from the word I used just now "economic slowdown". We have witnessed the impact of an economic slowdown through rising credit risk in the banks. The gross non-performing loans which were low in 2007 (7.6%) are now at 15.3% as of June 2011. Thanks to our conservative provisioning regime, the net NPLs are still at a reasonable level at 5.5%, but we are aware that unless an economic turnaround is achieved within a reasonable time, the impact of high credit risk can cause serious problems, at least for some banks.

Since FY07, banks in Pakistan have been able to withstand the headwinds from weakening macroeconomic fundamentals. While they have remained largely insulated from the first round of shocks from the global financial crisis, we cannot ignore the adverse trends that have risen since then.

The Global Financial Crisis (GFC) has continued despite the recovery efforts of advanced economies and has morphed from a financial crisis to a sovereign credit crisis with serious political implications. The crisis brought forth the realization that organizations which are not just too-big-to-fail 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 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. 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 silver lining from the GFC is the fact that the emerging markets are gaining more focus. The contribution of BRIC and other emerging economies in world economic growth is on the rise. The relatively less sophistication of their financial markets has been a blessing in disguise, as they did not face the brunt of the GFC and the growth continued at an even faster pace. It will be unfortunate if Pakistan is unable to take advantage of this shift in the growth paradigm. We are facing several domestic issues that limit our ability to fully attain our potential. Our financial institutions and businesses must become more competitive and innovative, regulators like SBP and SECP must actively facilitate financial markets, and the Government should step up its function of providing infrastructure for growth, most crucially to meet the Energy demand of productive sectors.

As is true in most cases, the challenges provide opportunities as well. As banking regulator, the big challenge arises from a two-pronged dilemma. We want our banks to be sound, profitable and efficient users of their funds, yet we also want them to increase financial service penetration into unbanked segments of the economy. Interestingly this challenge is the biggest stimulus for technological innovation.

There is a huge surge among the banks to upgrade their technology and on-line banking services. The ATM network has been expanding and on June 2011 there were approximately 5200 ATMs operating throughout the country. Progress in creating automated or on-line branches of banks has been significant so far and it is expected that 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. The country's payment system infrastructure has been strengthened to provide convenience in transfer of payments to the customers.

The concept of branchless banking has opened a new avenue for efficient channeling of funds. It has the potential of changing lives of those people who are still unbanked and without any financial services and opened new vistas for the entrepreneurs and households of those areas; particularly with the increasing ease of mobile phone usages, it is a preferred channel of choice for those customers for transfer of funds.

Keeping in view its importance, the State Bank took the lead and introduced Branchless Banking Regulations in 2008. These were the first of its kind regulatory initiative and since then other jurisdictions have replicated them for development of the branchless banking. Since 2008, Branchless Banking has expanded steadily with increased participation of stronger as well as new players. At present, the agent network under the umbrella of branchless banking exceeds 20,000 that facilitate around 53 million transactions amounting to Rs196 billion (Sep-11).

Notwithstanding this progress, overall financial penetration in Pakistan remains quite low. The number of borrowers of 3.8 million constituted only 2.3% of the population on December 2010. Recognizing the overwhelming size and intensity of financial exclusion in Pakistan, SBP is pursuing the second generation reforms for the financial services industry and has placed high priority on developing and implementing an effective strategy for financial inclusion.

Enabling regulatory environment has been provided for lending to SME, Agricultural and microfinance; thus banks and financial institutions are encouraged and enabled to expand their scope of lending and customer outreach. Licensing and prudential norms for micro finance institutions have been designed with particular emphasis on facilitating growth of these institutions and expanding their outreach to the poor and vulnerable segments of the population. In 2010 & 11 Consecutively, Pakistan has been ranked First in a sample of 55 countries in the category of "overall regulatory framework and practices for Microfinance" by The Economist Intelligence Unit (EIU) of The Economist Magazine.

The customer base of MFBs (Microfinance banks) has crossed 700,000 whereas that of MFIs has exceeded 1,300,000 in June 2011. At present 8 MFBs are operating in Pakistan, with total assets of Rs21.4 billion. Moreover, SBP is engaged in collaborative efforts with civil society institutions, especially involving large NGOs and RSPs in providing complementary services, such as social intermediation and capacity building. The regulatory regime adopted by SBP for the microfinance sector is that of a facilitator, guide and problem solver. We do not prescribe for Micro Finance Banks the same onerous regulations that prevail for other financial institutions. We have a Consultative Group drawn from the representatives of stakeholders, who guide us in the development of our regulations and prudential norms.

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. There exists strong evidence that SME expansion boosts employment more than Large Firm growth because SMEs are more labor intensive. We realize the fundamental importance of the SME sector in the economic development of the country. While SME prudential regulations have been in place for years, we are in the process of reviewing and revising the same to make them more conducive for this sector. The economic slowdown has hit them particularly hard. The advances to SME sector declined from Rs.383 billion in Dec 2008 to Rs.292.5 billion in June 2011. The loan infection ratio of SME sector has also risen and is around 16.8 percent. Clearly we need to come up with sound solutions for revival of this sector. In March 2010, SBP came up with the Credit Guarantee scheme for small and rural enterprises with the assistance of GOP and donor agencies that aims to motivate the banks to lend to borrowers, who otherwise would not have access to credit under normal circumstances. Several other initiatives are also underway.

Pakistan introduced the Islamic banking system in 2003 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 now have the opportunity to invest in trade and businesses by availing of loans from Islamic banks and thus expand economic activity and employment. The total Islamic banking assets stand at Rs.560 billion (June 2011) which is 7.3% of total assets of the banking sector. More importantly, this sector has shown more accelerated growth as compared to other segments. Deposits grew by 15.9 percent while the overall deposit growth was 9.4 percent (June 2011 data). We are very optimistic about the prospects of IB system.

Now I would like to touch upon the role and importance of Capital markets that mainly consists of Stock (equity) and Debt markets. The capital market provides an avenue for raising long-term financing needs of businesses through equity and long term debt by attracting investors with a long term investment horizon. Both the banks as well as capital markets are vital in ensuring the desired level of liquidity in the system, facilitating efficient price discovery and allocation of credit and diversifying risks in the economy. However at present the level of development varies considerably in each market. While banks take the lion's share of the overall financial sector as dominant players in money and foreign exchange markets, the capital market has yet to develop and still requires nurturing to reach its true potential. Even within capital market, the corporate debt market is truly at nascent stage.

While equity markets typically tend to develop earlier than the debt markets in most developing countries, Pakistan's economy and financial sector are now at a stage where they can support and benefit from a vibrant and efficient debt market. The size of Private debt, or Term Finance Certificates (TFCs) in Pakistan, remained around Rs. 74 billion (0.5% of GDP) which is paltry compared to the outstanding domestic government debt of PKR 4.64 trillion (31.4% of GDP). There is clearly underexploited capacity available to support economic growth.

Banks continue to be the main provider of debt in the system. In the absence of an active capital markets, the commercial entities fail to procure long term debt financing, and rely on short and medium term loans from banks. Consequently banks carry sizable maturity mismatches on their balance sheets as they fund their advances through short term deposits. Since banks tend to lend to only larger borrowers, their portfolio is highly skewed towards large sized loan.

In recent years, with rising NPLs, and increased borrowing by the government, the growth in private sector credit has become stagnant. Banks are trying to limit their credit risk and it has become more challenging to raise private debt for a business. While some credit uptake may take place in the future, it is unlikely that banks will be keen to finance new long term projects anytime soon. There is a need for coordinated efforts and support of the Government as well as of regulators (SBP & SECP) and banks for the development of a fixed income market that is necessary to diversify the financial sector which in turn would enhance its role in supporting economic growth.

Future priorities for the banking sector

The future is obviously not isolated from the progress made so far. We have unambiguously designated our future path that includes three main priorities (a) to make our banking sector more resilient against exogenous shocks through our macro (systemic) and micro prudential framework, (b) actively encourage technological solutions for financial access and an efficient payment system, and (c) address the development needs of the financial markets and broaden the array of product and services as well as outreach.

We would like to see our banks operating at world class standards and synergistically reinforcing the real economy. We are actively working at a pace to achieve this goal, and despite the current economic challenges, we are confident that we will succeed.