Yaseen Anwar: Developing non-bank financial models while addressing the risks of shadow banking

Address by Mr Yaseen Anwar, Governor of the State Bank of Pakistan, at the SECP (Securities and Exchange Commission of Pakistan) Conference on "Non-bank financial institutions", Karachi, 4 March 2013.

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Mr. Muhammad Ali, Chairman, SECP,

Distinguished Speakers,

Ladies and Gentlemen – Good Afternoon!

I would like to thank the SECP for inviting me to join you and address this very timely conference on Non-Bank Financial Institutions (NBFIs). I congratulate the organizers for holding this pertinent event which has gained special prominence in the aftermath of the global financial crisis. I sincerely hope that today's session will give further impetus to our efforts in promoting NBFIs as an alternative source of funding for businesses and also as a separate class of assets for investors in the country, adding to the financial sector's diversity, stability and viability in the long-run.

Globally, NBFIs have gained a prominent position and role in the financial sector and economy. However, the role of this sector has recently been scrutinized for its contribution to financial sector fragility during the recent global financial crises. Therefore, at the November 2010 G20 Seoul Summit, while reviewing the new capital standards for banks (Basel III), the G20 Leaders identified some remaining issues of financial sector regulation that warranted attention. They highlighted "strengthening regulation and supervision of shadow banking" as one of these issues and requested the Financial Stability Board (FSB), in collaboration with other international standard setting bodies, develop recommendations to strengthen the oversight and regulation of the "shadow banking system".

The "shadow banking system" is defined as "the system of credit intermediation that involves entities and activities outside the regular banking system" in other words intermediation through non-banks. The term started to be used widely at the onset of the recent financial crisis. The emergence of the term reflected recognition of the increased importance of entities and activities structured outside the regular banking system that perform bank-like functions.[1]

The financial sector in Pakistan comprises of Commercial Banks, Development Finance Institutions (DFIs), Microfinance Banks (MFBs), Non-banking Finance Companies (NBFCs) (leasing companies, Investment Banks, Discount Houses, Housing Finance Companies, Venture Capital Companies, Mutual Funds), Modarabas, Stock Exchange and Insurance Companies. Under the prevailing legislative structure the supervisory responsibilities in case of Banks, Development Finance Institutions (DFIs), and Microfinance Banks (MFBs) falls within legal ambit of State Bank of Pakistan while the rest of the financial institutions are monitored by other authorities such as Securities and Exchange Commission and Controller of Insurance.

In Pakistan, while the overall assets of the financial sector have increased from Rs. 5.202 trillion in 2005 to Rs. 11.107 trillion in 2011, the share of the financial sector in terms of GDP is very low at 57.4 percent. In 2011, Banks held 74 percent of the financial assets while the share of NBFIs was only 4.7 percent of the total financial sector assets which was around 7.6 percent in 2005. The low financial sector to GDP ratio and NBFIs

[1] Shadow Banking: Scoping the Issues: A Background Note of the Financial Stability Board, 2011.

declining share in financial sector assets clearly underscores the need for financial sector development and diversification of financial sector assets to attract investors with different return expectations and risk appetite and channelize financial resources for the economic development of the country. Therefore, today's conference is very important and we should use this opportunity to understand the key bottlenecks in the way of financial sector development and also come up with concrete measures to address these shortcomings in a sustainable manner.

Alan Greenspan identified the role of NBFIs in strengthening an economy, as they provide "multiple alternatives to transform an economy's savings into capital investment [which] act as backup facilities should the primary form of intermediation fail".[2] On the other hand, the NBFIs offer an alternative to typical commercial banking saving-investment products. However, in Pakistan, NBFIs other than Investment banks and leasing companies which offer saving and investment products on a relatively small spectrum need to develop appropriate and affordable products to increase its market share. The key negative outcome of this is that there remains limited access to funding resources and relatively higher risk avenues to earn spreads.

Here I would like to briefly touch on the major constraints that the NBFI sector in Pakistan is beset with:

First, although there has been an increasing effort by NBFIs to broaden the range of their business activities and product base, thereby diversifying their revenue streams, the sector is yet to make a breakthrough in this regard.

Second, the sector is fragmented and each NBFI is trying to create its niche market in pursuit of establishing a sustainable revenue stream. In this regard, most companies are concentrating on financial advisory and other fee-based income segments. Unfortunately, the sector is yet to capitalize on the huge opportunities offered by previously relatively untapped areas like SMEs, Consumer, and Agriculture segments to enhance avenues for fund deployment.

Third, the sector needs to develop and diversify sources of funding for sustainable growth. This would require a shift from the traditional sources such as commercial banks credit lines etc for on lending to clients. The NBFIs need to develop capital market instruments to pool funds from a diverse set of investors to ensure certainty to the source and cost of funding.

Fourth, we need to strengthen the oversight and regulation of NBFIs to reduce the risks emanating from "shadow banking". As observed by FSB, the objective of this exercise should be to ensure that shadow banking is subject to appropriate oversight and regulation to address bank-like risks to financial stability emerging outside the regular banking system while not inhibiting sustainable non-bank financing models that do not pose such risks.[3] The measures articulated today adhere those very regulatory issues going forward.

In conclusion, I would like to say that the financial system in Pakistan is yet to grow to its full potential and play a more meaningful role in the economic development of the country. Therefore, we definitely need to add to its diversification and depth. NBFIs can play a meaningful role in this pursuit. In light of the global financial crises, we are better informed about the various risks that the NBFIs/Shadow Banking carries with it. As regulators we need to remain vigilant to ensure that those risks are mitigated without inhibiting sustainable non-banking financing models.

Thank you.

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[2] FRB: Speech, Greenspan – Do efficient financial markets mitigate crises? – October 19, 1999

[3] FSB Consultative Document: Strengthening Oversight and Regulation of Shadow Banking – An Integrated Overview of Policy Recommendations, 2012.