Keynote Address: Mr. Jameel Ahmad, Deputy Governor, State Bank of Pakistan

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H.E. Dr. Indrajit Coomaraswamy, Governor Central Bank of Sri Lanka;

Mr. Senarath Bandara, President of the Association of Professional Bankers (APB) – Sri Lanka;

Distinguished Members of the APB's Executive Council;

Esteemed Speakers, Dignitaries and Guests;

Ladies and Gentlemen,

Good Evening and Ayubowan!

It is indeed a great pleasure for me to be here today to address the 29th Annual Convention of the Association of Professional Bankers (APB) of Sri Lanka. I have always enjoyed visiting this beautiful country and am a great admirer of the friendly relationship that both our countries enjoy.

Pakistan and Sri Lanka are time tested friends and share cordial bilateral relations which date back to as early as 1948. We have stood together and have shared strong cooperation with each other during difficult times. Pakistanis are also grateful to the people and government of Sri Lanka for the visit of their cricket team to Pakistan last month which is a major step towards the revival of international cricket in our country. Pakistan and Sri Lanka also share excellent economic cooperation. Pakistan is the second largest trading partner of Sri Lanka in South Asia while Sri Lanka was the first country to sign a Free Trade Agreement with Pakistan, which became operational in 2005. I have no doubt in my mind that the bilateral trade between the two countries which is approximately USD 330 million today, has the potential to increase to more than USD 1 billion.

I would also like to commend the role of Central Bank of Sri Lanka in fostering financial stability in the country and achieving decent economic growth. Central Banks of both our countries also regularly collaborate on SAARCFINANCE which provides an excellent platform for exchanging ideas and lessons learned among central banks of SAARC member countries. I hope that the experiences especially in today's rapidly evolving banking and financial sector can further be shared as these are interesting times for Central Banks around the world.

Before sharing my thoughts on the main topic, I would like to felicitate the Association of Professional Bankers of Sri Lanka for regularly organizing annual conventions on topics that are in sync with today's changing realities and contribute to the debate on pertinent financial sector risks and challenges. The theme for this year's Convention i.e. "**Changing Dynamics: Bank of the Future**" is of particular interest to banking professionals and policy makers given the fundamental shifts taking place in the financial sector and the wider economy. I am confident that the discussions held during the event will result in generation of innovative ideas for banks and provide important insights on the challenges being faced by the banking sector today and in days ahead.

Ladies and Gentlemen; in my speech, I would therefore reflect on the prevailing course of banking and the emerging challenges that are reshaping the banks' business models along with developments in the supervisory approach of regulators. But more importantly, I would like to talk about the challenges that banks and their regulators face due to technological advancements. I will also briefly discuss the measures taken by State Bank of Pakistan (SBP) to keep up with the changing dynamics and in the end will make a few suggestions that can help prepare the banking industry to adjust to the new paradigms.

I will discuss the future of banks and banking by focusing on two themes: The first one relates to the Global Financial Crisis of 2007-8 which was perhaps the most significant event in recent financial history that presented challenges relating to financial stability to regulatory authorities around the globe. The second theme that I would like to discuss today is the impact of technology on banks and their customers. As you all will appreciate, the bank customer of today, equipped with sophisticated gadgets and devices is demanding state of the art financial services from the comfort of their homes. Neither do they want to visit a branch, nor do they want to fill up long forms in order to open an account. Is this a threat for the banks or an opportunity to transform? I believe the latter is true which I will explain afterwards in my speech.

But let me begin by talking about the Global Financial Crisis and its impact. The decade preceding this crisis saw remarkable expansion in international banking. As a result, heightened cross border lending coupled with sizeable presence of international banks across the globe, and particularly in developing countries, manifested an increasingly integrated world of banking and finance. The financial crisis actually forced regulatory attention towards ensuring financial stability by beefing up capital and liquidity buffers, more stringent regulations, and introduction of macro prudential policy toolkit. There is no doubt, that the coordinated efforts made by the multilateral bodies and regulators have facilitated to better internalize systemic risk and strengthen the overall international financial system.

Ladies and Gentlemen; while the post crisis regulatory response has resulted in a more robust financial system, it has also increased the complexity of regulatory framework. To give you an idea of the complexity of regulations, I will briefly describe some significant financial regulatory reforms which have been designated as priority areas for implementation:

- Number one: creation of a quick and effective resolution regime with no tolerance for using tax payers' money to bailout failing banks;
- Two: application of stringent AML/CFT regulations to prevent the use of banking channels for illicit transactions.
- Three, Implementation and adoption of policy framework on Global Systemically Important Financial Institutions and Domestic Systemically Important Banks as the prevailing regulatory regime and policies may not be sufficient to address the "negative externalities" that large financial firms create.
- And finally, full and timely implementation of Basel III to ensure a sound and properly functioning banking system that is able to support economic recovery and growth on a sustainable basis.

Therefore, an important challenge and one of the top priorities of banking sector, is to adapt to the complex regulatory landscape while maintaining profitability. And let me tell you, this is a big challenge as not only the number of regulatory changes that banks need to comply with has more than tripled since the last decade but the scope and complexity of these regulations have expanded from multiple perspectives.

I will now briefly discuss some of the consequences of the financial crisis and measures I just described.

- First, while the focus of these measures was to repair banks' balance sheets and improve financial stability, they also led to contraction of the cross border lending activities.
- Second, you may all agree that since the Financial Crisis, a partial reversal in international banking continues as multinational banks from the developed world have scaled back their offshore operations.
- Third, we have seen that the post crisis profitability of banks has declined as a result of deleveraging in international banks, a sharp slowdown in revenues due to lower demand for credit, high cost of compliance, and various other policy measures adopted by central banks like the sustained lowering of interest rates.

Ladies and Gentlemen; before we discuss how banks can address these challenges let me switch to a second theme which is about the technological and digital revolution that may be threatening the very existence of banks today. Traditionally, the banking industry has been an early adopter of technology; they have embraced technology to automate and consolidate their core banking operations and offer services like the credit cards. 1970's saw the emergence of SWIFT, enabling rapid and secure cross-border financial messaging thus speeding up trade and remittance transfers across countries. During the decade of 1980's and 90's services like the ATMs and Point of Sale terminals started becoming ubiquitous and central banks implemented large value payment systems like the Real Time Gross Settlement Systems. But, I think that the banks of our time have mostly been unable to keep up with the rapid technological evolution of the post dotcom bubble with regard to innovative product offerings and enhanced customer experience.

Let me briefly describe some of the technological trends that our banks are facing today:

First is the rise of internet, Social Media and mobile devices. On one hand social media allows banks to reach their customers directly in ways that were not imagined before to offer them a variety of services like faster payments and instant credits while on the other, negative perceptions about banks and their services can also spread like wildfire. I therefore will not be surprised if Social Media becomes one of the most important sources of systemic risk going forward. But banks can also use these technologies to strengthen their core functions like collateral monitoring and investment and lending decisions to manage their risks better. At the same time, banks can collect and analyze data about the spending behaviours and other related transactions of their customers to proactively respond to their growing needs.

Second, there have been tremendous enhancements in tele-density and mobile broadband coverage while simultaneously the cost of not only these services but of end user mobile devices has also rapidly decreased. Customers can therefore afford smart cell phones, watches and other all-time connected gadgets and by using those can access their bank accounts, avail financial services and advice, and make payments anytime from anywhere. Most importantly, they can decide to switch their service providers as easily as their mobile phone SIMs.

Third, Fintech companies who are small start-ups are using technology to challenge banks in providing innovative financial services like digital nano credit, crowd funding, peer to peer lending, online payments and financial advisory services with enhanced customer experience and in a more cost effective manner. On the other hand, large tech companies like Apple and Facebook are using their network power to make inroads in the domain of financial services thus threatening the very existence of banks themselves. Regulatory technology companies known as Regtech are offering low cost solutions to regulatory authorities for compliance purposes. In all likelihood, we would like to see the formation of partnerships of banks and these non-bank entities for lowered costs and superior customer experience in the financial industry.

Fourth is the rise of what is called cloud computing or cloud hosting. These cloud based arrangements can offer extremely cost effective fully managed solutions including hardware and software as a service. Businesses now don't have to worry about high cost of managing their IT or managing the associated risks rather they can simply outsource them to these cloud based digital platforms. These platforms are now offering the concept of "Banking as a Service" or "Digital Banking" which usually runs on infrastructure provided by a licensed entity and offers services using an ecosystem of Fintech start-ups. These platforms have the potential to drive down cost of providing banking services, especially for smaller banks, and open new opportunities of product innovation and service delivery.

Fifth, advancements in artificial intelligence, machine learning and big data analytics are set to transform the financial industry in many ways especially in areas of intelligent customer relationship management systems, fraud detection and prevention, e-commerce and detection of AML/CFT issues.

Sixth, many of the financial services customers around the world do not want to go to a brick and mortar branch to open a bank account or even conduct financial transactions; they would like to be identified, authorized and served digitally. So regulators and government authorities are now focusing on instituting Digital on-boarding programs using National Identity Databases.

Finally, I would like to talk about the emergence of Block Chain technology that enables customers and financial institutions to be directly connected to each other without the need of trusted third parties to perform intermediation functions like settlement and reconciliation. This would mean that, for example, a security trade may settle bilaterally in almost real time without the need of a depository function; or smart contracts would eliminate the need of escrow arrangements in cross border transactions. While virtual crypto currencies like Bitcoin that run on Block Chain technology are being frequently mentioned for their, mostly, upward price fluctuations it is unlikely that they will gain systemic importance as a means of payment. However, Central Banks can experiment with the Block Chain technology and consider issuing digital currency of their own. Block Chain also has the potential to change the landscape of cross border remittances, trade finance, payments and settlements and identity management, etc. I am therefore not surprised to see the interest of many large international banks that are experimenting with Block Chain technology these days and would like to see banks of our region do the same.

While combination of all these aspects will likely drive down costs for the banks and help them improve their service delivery and product innovation capabilities and offer enhanced experience to the customer, we must be aware that technology has its unintended consequences. These unintended consequences will primarily be related to consumer protection, data privacy and money laundering which are easier to camouflage using sophisticated technology.

I must also mention that banks are facing aggravated challenges relating to cyber security. During the last decade or so, hackers and cyber terrorist have gained much superior capabilities of espionage and afflicting damage and are now targeting the financial industry. The theft of electronic identity through hacking could wipe off bank accounts of customers causing not only financial but reputational losses especially to larger banks and their regulators. The proactive detection and response to these cyber threats requires not only specialized security infrastructure within the organization but also enhanced mutual cooperation and information sharing among the banks.

Ladies and Gentlemen; Since I have discussed various challenges that the banking industry is facing and certain worrying developments that are threatening its performance, let me briefly share with you what we at the

State Bank of Pakistan (SBP) have done so far and plan to do in the future to transform our banking sector.

In Pakistan, the banking sector constitutes around 74 percent of the country's financial sector with an asset base equivalent to almost 55 percent of the country's GDP. As such, the stability and buoyancy of the banking system is of critical importance. Over the years, continuous improvements in prudential regulations in line with international best practices and capital strengthening measures have significantly improved the resilience of the banking system of Pakistan. The Capital Adequacy of the banking system at 15.6 percent is well above the local and international benchmarks.

Like elsewhere in the world, SBP has set strengthening the financial stability regime as one of its key priorities under its Vision 2020. SBP is also working on adopting Risk Based Supervision (RBS) in order to advance its current supervisory regime and improve its supervisory efficiency. We are also looking towards a sustainable financially inclusive system which can spur socio-economic development in the country. Recognizing the gaps leading to financial exclusion, we have already developed National Financial Inclusion Strategy (NFIS) 2020 which lays down sound foundations for promoting financial inclusion and identifies the gaps leading to persistent financial exclusion. Our strategic approach to tackle financial exclusion is focused at creating a proportionate policy and regulatory framework that addresses sector-specific risks and strategies regarding infrastructure development and policy interventions - both on the supply and demand side for development finance sector like Microfinance, SMEs, Consumer Finance, Agriculture, Islamic Banking.

I am also happy to share with you that Pakistan has one of the most sophisticated National Identity Systems which is run by a government entity called National Database & Registration Authority or NADRA. NADRA has gained international recognition for its success in providing biometric-enabled identity solutions to all the citizens of Pakistan. The government of Pakistan undertook a massive initiative to biometrically verify all SIMs issued in Pakistan and around 130 million SIMs were re-verified using NADRA's database. State Bank of Pakistan also capitalized this opportunity by requiring banks to use the NADRA database for digital on-boarding of customers, especially the unbanked population, and mitigating the risks relating to Money Laundering and Terrorist Financing. This is a great example of how technology can be used for not only customer facilitation but for compliance purposes also.

Due to rapid technological progress, the global financial and payment landscape is transforming very rapidly. SBP has long recognized the importance of technology and has been facilitating banks and financial industry to reap the benefits of digitization. To keep pace with technological transformation and mitigate the associated risks, SBP has issued various guidelines encompassing frameworks for Enterprise Technology Governance and Risk Management, Payment Systems' Designation, Security of Internet Banking, prevention against cyber-attack, Risk Management in Outsourcing Arrangements by Financial Institutions, etc.

I am pleased to share that last year SBP facilitated the issuance of our domestic payment scheme called the PayPak. The encouraging aspect of PayPak is that it has been issued by a private entity that is owned by 11 private banks thus ensuring full blessing and participation of the private sector in this payment scheme. Moreover, SBP is developing a National Payment System Strategy to modernize the clearing and settlement infrastructure for reducing cost, improving efficiency, enhancing security, and strengthening its regulatory and supervisory oversight.

SBP is also playing a very important role of facilitator and catalyst and our doors are open to innovation and innovative ideas. SBP is also facilitating the entrance of non-banks particularly in payments arena and has issued Rules for Payment System Operators and Service Providers. We have seen encouraging response to these regulations and now a variety of non-bank, digitally enabled businesses have entered or are preparing to enter the Pakistani market with innovative and customer centric products. SBP also engages with the Fintechs in the country on regular basis to understand their business models and facilitate them if required.

Ladies and Gentlemen; keeping in view the discussed challenges and opportunities, banks need to devise certain strategies that can help them grow and stay on course. I must say that banks are essentially required to acknowledge that times have changed and in order to stay competitive they must embrace technology and forge new partnerships to re-invent their business models. I will go to the extent of saying that the upcoming age may become the age of less or even non-intermediation where role of intermediary institutions like banks and their regulators could become limited if they don’t embrace these changes pragmatically.

Now I will present few suggestions which can help to proactively address the challenges of the future:

- First, with regards to the global financial regulatory reforms, we need to be proactive and consider adopting them at an early stage. However, any implementation needs to be proportional to the complexity of the financial institutions and the system. While implementing the standards and regulations relating to AML and CFT we must be pragmatic in our approach so that growth of banking industry or their customers is not hampered.
- Second, authorities are now increasingly focusing on improving the situation of financial inclusion in their respective jurisdictions. Banks and other players of the financial industry need to come forward and help in this regard. Without compromising on the basic regulatory requirements, technology-enabled, risk based approach for assessing client risk and customer on-boarding may be adopted.
- Third, Central Banks and other regulatory authorities must work towards creating a strong, robust and ubiquitous payments system with focus on developing an enabling legal and regulatory environment that is commensurate with the new technological environment. Some of the areas to be covered may include, but should not remain limited to cloud computing, data privacy and protection, cybercrime and formalizing the role of non-banks including critical service providers in the area of technology services.
- Fourth, it is important that we place special focus on formalizing the role of non-banks which include fintechs, Payment Service Providers and especially Critical Service Providers like technology and telecom

providers because the dependence of financial entities on these players is becoming critical and their failure may threaten the overall financial stability. Regulators must especially be wary of issues relating to consumer protection, data privacy and money laundering arising due to new and complex partnerships and data sharing arrangements between banks, fintechs and IT service providers.

- Fifth, banks and the financial industry are facing threats from cyber terrorists which now have far superior capabilities, and probably a good knowledge of the internal vulnerabilities. In order to mitigate this risk, banks will have to pool-up their resources and share their experiences with each other on regular basis and devise strategies and programs to counter the threats they face as an industry.
- Sixth, if the industry concludes that block chain enabled services and their providers will gain more prominence going forward then it is important to take proactive measures to contain their influence. For example, smart contracts and their legal enforceability in a court of law, role of crypto currencies, cross border trade and payments and customer identity management are some of the areas that I think will be important to be looked into.
- Last but not the least, continuous capacity building of bankers and their regulators is the key for growing and thriving in a digital future. Empowering finance professionals with requisite skills will be necessary in wake of increasing complexity of global standards and transformation taking place in financial industry. Financial industry has to adopt collaborative approach for enhancing professional capacity of their human capital through local and international solutions to keep pace with the changing financial land scape. Central Banks must acquire and

enhance the capacity and skill set of their staff especially in areas of algorithmic based system audits, system integrity & security audit and data analytics based regulatory compliance skills.

While the challenges are huge, I have full confidence in the skills and abilities of banking community in our two countries. I am sure that you will adapt to the changing realities of times ahead, take these challenges as opportunities and deliver the best of best to citizens of your great country.

Ladies and Gentlemen; In the end, I would like to once again thank the Central Bank of Sri Lanka and the Association of Professional Bankers – Sri Lanka for inviting me to deliver the Keynote Address for this year's Annual Convention.

Thank you for your attention!