

THE NEWS

Policies for digital banking: Part - I

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The State Bank of Pakistan has recently granted five licences for Starting digital banks that would provide the whole range of banking services through digital platforms or electronic channels from the comfort of homes and offices without making trips to brick-and-mortar branches of the banks.

Two types of banks – digital retail banks and digital full banks – have been allowed both in the conventional as well as Islamic variants. The minimum capital requirement for digital banks is much lower than those for banks that are operating branches. A diverse range of applicants including domestic commercial banks, microfinance banks, electronic money institutions and Fintech players both from within and outside the country had applied for these licences.

As this is a path-breaking step, it is necessary to lay down the objectives and public expectations as well as the policies that should guide the future evolution of digital banking. These should be laid down in the larger context of the Digital Pakistan Strategy and financial-sector reform. While digital banking and e-commerce are ingredients of the overall strategy, this article focuses on financial sector reforms. The salient purpose for which the SBP is promoting digital banking is aimed at strengthening financial intermediation in the country in the pursuit of equitable and sustainable development.

Of course, financial-sector performance cannot be isolated from the overall macroeconomic environment. When the environment is stable and the track record in macroeconomic management and governance is favorable, the financial sector will do well. Under the present fragile, fluid and uncertain environment, it would be unfair to expect that banks and other financial sector institutions will do well.

The first-generation reforms that started in the 1990s but got an accelerated momentum in the early 2000s centered on liberalization of the financial system, privatization of nationalized commercial banks, autonomy and capacity building of the central bank, decontrol of the pricing of financial products, abolition of directed credit ceilings and reliance on market mechanism to allocate credit.

Recovery of non-performing loans was stepped up through a Corporate and Industrial Restructuring Corporation (CIRC) which helped in the revival of sick units at the same time. A code of corporate governance was enacted and enforced through a four-tier structure. Appointments of the chairpersons and CEOs were made on a set of fit and proper criteria. A number of banks were either asked to wind up business or merge, and delinquent boards suspended or dismissed creating a deterrent effect against malpractice. Minimum paid capital requirements were doubled, and capital adequacy was related to risk weighted assets.

Continuous off-site monitoring of the banks/DFIs ensured that they operated in a safe and sound manner and complied with the parameters acceptable under the Risk Management Framework. Timely and effective enforcement actions were taken against those found in contravention. Disclosure of financial conditions was aligned with international financial accounting standards. External auditors were prequalified and divided in two categories to audit the banks according to their paid-up capital. Credit ratings by independent certified agencies were made mandatory for the banks and publicly disclosed.

As a result of these first-generation banking reforms, assets under the control of private banks increased from 20 per cent to 80 per cent. Lending rates dropped to single digits while non-performing loans fell drastically. Instead of subsidies from the exchequer, the banks became profitable and have since then contributed substantial amounts as taxes (Last year the amount paid as taxes was Rs200 billion). Customer service standards improved, quality human resources were inducted and technology started to seep into the operations. Financial Soundness Indicators surged upwards.

Despite these successes and achievements, a number of issues and problems have surfaced that needed to be resolved. The outreach of newly privatized banks duly recapitalized and earning profits remained limited to corporates, big name and high net worth individuals, trade financing and fee-based activities. They did not make any efforts to extend credit to underserved sectors such as SMEs, small and medium farmers, low-cost housing, personal and consumer finance although prudential regulations were amended to enable the banks to lend to these sectors. Their network in underdeveloped areas remained confined to deposit mobilization rather than lending.

To address these shortcomings and broaden access, the SBP embarked upon a further round of reforms. Two new modes of banking institutions were introduced. To cater to those who shunned banking as a matter of faith, an opportunity was given to choose Islamic banking which offered Shariah compliant products.

The other set of institutions was the microfinance banks where micro-enterprises and self-employed individuals could get unsecured credit. Women entrepreneurs were the principal target of MFBs. To meet the requirements of project finance, joint venture DFI companies were established with foreign companies. An upsurge was noticed in the early years in broadening access, but the momentum slowed down once the government became the dominant borrower and the results twenty years later are disappointing.

As of now, the size of the banking system is small relative to the economy and to its peers, and most of the assets are invested in government securities. The share of SMEs in private sector credit has dwindled to 7.0 per cent from 17 per cent. Agriculture credit has remained stagnant in relation to demand. The number of accounts in the banking system is still quite low compared to our neighboring countries. In comparison to its peers, Pakistan lags in terms of financial market development, financial access, depth of financial institutions, credit to the private sector, insurance penetration, and development of capital markets.

Private sector credit as percent of GDP is only 15 per cent while it is 55 per cent in India and 39 per cent in Bangladesh. Firms and individuals have very

limited financing avenues available to cater to their savings and investment needs. Pakistan's stock market has only 250,000 retail investors compared to 12 million in Dhaka and 69 million in Mumbai.

No doubt the above outcomes arising from the dismal performance of the formal financial services industry can to a large extent be attributed to recurring macroeconomic imbalances, frequent balance of payments crisis in addition to the government's dominant role as a borrower in the banking system but the role of the banks cannot remain unscathed. The latest data shows that only 21 per cent of the adult population has a bank account compared to 78 per cent in India and 53 per cent in Bangladesh.

As a consequence of the low deposit-to-GDP ratio, Pakistan's national savings rate has never exceeded 15 per cent and that is largely due to the savings of workers abroad. The domestic savings rate has not exceeded a single digit. Under these circumstances, the investment ratio has remained constrained and continuous borrowing from external creditors has filled the investment-savings gap, leaving the country in a state of heavy and rising indebtedness.

External debt servicing bites away a huge chunk – 85 per cent – of export earnings. Debt servicing is preempting 60 per cent of the federal government budget. Unless the financial markets are able to mobilize savings and the government curtails its fiscal deficit, our dependence on external borrowers will continue to rise.

The vision and firm belief in the importance of e-banking was spelled out as far back as February 2001 in my address to the Institute of Bankers: "We have to consider e-banking not only as a technological issue but also as a viable business proposition as the number of internet users in the country is growing exponentially. The State Bank and the government can act as facilitators and problem solvers but the banks themselves will have to gear themselves sooner than later to reap benefits for e-commerce. They have to enforce deadlines to move to this mode of transactions."

To be continued...