BANKING SECTOR:

DEVELOPMENTS, CHALLENGES AND OPPORTUNITIES

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Pakistan's banking sector like many other developing countries had been faced with several problems and difficulties such as:

(1) Most of the financial assets and deposits were owned by nationalized commercial banks (NCBs) which suffered from a highly bureaucratic approach, overstaffing, unprofitable branches and poor customer service.

(2) NCBs along with specialized banks such as ADBP, IDBP and Development financial institutions such as NDFC had a high ratio of non-performing loans.

(3) Banking industry faced a high tax rate, which affected its profitability and attractiveness for new entrants.

(4) There was a proliferation of banks and some of them were undercapitalized, poorly managed with a scanty distribution network.

(5) Agriculture, small and medium enterprises, Housing sectors were underserved and the middle class and low income group had limited access to bank credit.

(6) Banks had typically focused on trade and corporate financing with a narrow range of products and had not diversified into consumer and mortgage financing for which there is an ample unsatisfied demand.

(7) Poor quality of human resources, weak internal controls, non-merit based recruitments, high administrative costs and undue interference of unions in decisions making process affected the performance of public sector financial institutions adversely.

BANKING SECTOR REFORMS

Banking sector reforms were aimed at addressing these and other constraints. Although there is no room for complacency and a lot needs to be done it is fair to say that substantial progress has been made to improve the health and soundness of the banking sector in recent years. There are still few weak and vulnerable institutions but overall the banking sector in Pakistan is much stronger today compared to five years ago or in comparison to other countries in the region. What are the factors responsible for this improvement? A large number of reforms have either been undertaken or under way.

(i) **Privatization of NCBs**

The nationalized commercial banks are being privatized and their domination of the banking sector is likely to be reduced from almost 100 percent in 1991 to about 20

Keynote address at IBC Gulf Conference – Investing in Pakistan at Islamabad on December 9, 2003 percent by December 2003. The shares of Muslim Commercial Bank are all in the private sector. United Bank has been sold to a consortium of private investors. Privatization of Habib Bank Ltd., is under way and is scheduled to be completed by end December, 2003. 23.5 percent of shares of National Bank have been floated through Stock Market mainly aimed at small retail investors. The NCBs have been restructured and professional management inducted which works under the supervision of independent Boards of Directors drawn from the private sector.

(ii) **Corporate governance.**

Strong corporate governance is absolutely essential if the banks have to operate in a transparent manner and protect the depositors' interests. The SBP has taken several measures in the last four years to put in place good governance practices to improve internal controls and bring about a change in the organizational culture. The salient features of this structure are:

a. Banking license of one of the commercial banks which was found in violation of the prudential regulations and norms was cancelled for the first time in the history of Pakistan after following the due process. This decision was upheld by Peshawar High Court.
b. Ownership and management were changed at two private commercial banks, one of which had committed breach through unauthorized transfer of funds from the bank to associated companies.
c. A number of cases of willful bank defaulters were referred to National Accountability Bureau (NAB) for taking legal actions and recovering the amounts due.
d. The appointments of Board members, Chief Executive Officers and key Executives of all banks have to be screened so that they meet the fit and proper test prescribed by the SBP.
e. Family representation on the Board of Directors of the banks where they hold majority ownership has been limited to 25 percent of the total membership of the Board.
f. To avoid possible conflict of interest and use of insider information the Directors, executives and traders working in Brokerage companies will no longer serve on the Boards of Directors of the banks.
g. External auditors are evaluated annually and classified in various categories based on their performance and other prescribed criteria. Two large audit firms were debarred from auditing the banks and only after showing improvement in their performance placed in a category lower than they originally belonged to.
h. A detailed set of guidelines for the Board of Directors to effectively oversee the management of the banks and develop policies has been issued. A training course on Corporate Governance was organized for the members of the Boards of banks and their Chief Executives.
i. The disclosure requirements for banks have been strengthened and now they are required to prepare their annual financial statements in accordance with the International Accounting Standards. They are also required to publish quarterly and half-yearly accounts to provide information to their stakeholders for taking well informed decisions.
j. In order to institutionalize the decision making process and to provide guidance to staff, the banks are required to formulate and implement well-defined policies in credit, investment, recovery of write-offs, human resources, audit and compliance, risk management, etc.

k. To provide guidance to banks in identifying, measuring, monitoring and controlling various risks and to make them proactive, a detailed set of guidelines on risk management has been issued.

(iii) **Capital Strengthening.**

Capital requirements of the banking sector have to be adequate in relation to the risk weighted assets and conform to the Basle Accord. To further strengthen their competitive ability, both domestically and internationally and to encourage the economies of scale, the minimum paid-up capital requirements of the banks have been raised. The banks were required to increase their paid-up capital from Rs 500 million to Rs 1 billion by 1st January 2003 failing which they will no longer be allowed to carry out full banking activities as scheduled banks. This has resulted in mergers and consolidation of many financial institutions and weeding out of several weaker banks from the financial system.

(iv) **Improving Asset quality.**

The stock of non-performing loans (NPLs) has been tackled in several ways. The gross NPLs amount to Rs 252 billion and account for 22 percent of the advances of the banking system and DFIs. However, there has been aggressive provisioning carried out during the last three years. More than 60 percent of the NPLs are fully provided for and net NPLs to net advances ratio has thus declined to less than 10 percent. Efforts are being made to further reduce this ratio through the active involvement of Corporate & Industrial Restructuring Corporation (CIRC) and the Committee on Revival of Sick Units (CRSU). The settlement reached between loss category loan holders and banks under State Bank circular No.29 will further reduce the volume of NPLs and allow the sick industrial units to revive while at the same time enable the banks to clean up their balance sheets. The positive development is that the quality of new loans disbursed since 1997 has improved and recovery rate is 95 percent.

(v) **Liberalization of foreign exchange regime.**

Pakistan has further liberalized its foreign exchange regime and ensured partial Capital account Convertibility by allowing foreign exchange companies to operate and Pakistani Corporate sector to acquire equity abroad.

(vi) **Consumer Financing**

The State Bank has removed restrictions imposed on nationalized commercial banks for consumer financing. The positive experience of auto financing gives a lot of hope that the middle class of this country will be able to access consumer durables through banks. This will at the same time boost the manufacturing of TVs, air-conditioners, VCRs, washing and drying machines, deep freezers etc. in the country. Credit and Debit Cards are also gaining popularity and the numbers of card holders have doubled during the last two years.

(vii) **Mortgage Financing**

A number of incentives have been provided to encourage mortgage financing by the banks. The upper limit has been raised from Rs 5 million to Rs 10 million. Tax deduction on interest payments on mortgage have been allowed up to a ceiling of Rs.500,000. The new recovery law is also aimed at expediting repossession of property by the banks. The banks have been allowed to raise long term funds through rated and listed debt instruments like TFCs to match their long term mortgage assets with their liabilities.

(viii) **Legal Reforms.**

Legal difficulties and time delays in recovery of defaulted loans have been removed through a new ordinance i.e. The Financial Institutions (Recovery of Finances) Ordinance, 2001. The new recovery laws ensures expeditious recovery of stuck up loans by the right of foreclosure and sale of mortgaged property with or without intervention of court and automatic transfer of case to execution proceeding. A Banking Laws Reforms Commission is reviewing, revising and consolidating the banking laws and drafting new laws such as bankruptcy law.

(ix) **Prudential Regulations**

The prudential regulations in force were mainly aimed at corporate and business financing. The SBP in consultation with the Pakistan Banking Association and other stakeholders has developed a new set of regulations which cater to the specific separate needs of corporate, consumer and SME financing. The new prudential regulations will enable the banks to expand their scope of lending and customer outreach.

(x) **Microfinancing**

To provide widespread access to small borrowers particularly in the rural areas the licensing and regulatory environment for Micro Credit and Rural financial institutions have been relaxed and unlike the commercial banks these can be set up at district, provincial and national levels with varying capital requirements. There is less stringency and more facilitative thrust embedded in the prudential regulations designed for this type of institutions. Khushali Bank and the First Microfinance Bank in the private sector have already started working under this new regulatory environment. Khushali Bank has already reached a customer base of 125,000 mainly in poorer districts of the country and its recovery rate is above 95 percent.

(xi) **SME Financing**.

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. A Small and Medium Enterprise (SME) Bank has been established to provide leadership in developing new products such as program loans, new credit appraisal and documentation techniques, and nurturing new skills in SME lending which can then be replicated and transferred to other banks in the country. Program lending, for example, can help upgradation of power looms to shuttleless looms in Faisalabad area and contribute to the achievement of goal set under Textile Vision 2005. The new Prudential regulations for SMEs do not require collateral but asset conversion cycle and cash flow generation as the basis for loan approval. The State Bank is also contemplating to develop capacity building among a select group of banks for SME lending. This will revitalize the lending to SMEs particularly export oriented ones.

(xii) **Taxation**

The corporate tax rates on banks were exorbitantly high in Pakistan thus adversely affecting their profitability and attractiveness as an avenue for investment and new equity injection. The Government has already reduced the tax rate from 58 percent to 44 percent during the last three years and it is envisaged that the rate will be reduced gradually and brought at par with the corporate tax rate of 35 percent in the next three years. This will in turn help in reducing the spread between the deposit rate and lending rate and benefit financial savers.

(xiii) **Agriculture Credit**

A complete revamping of Agriculture Credit Scheme has been done recently with the help of commercial banks. The scope of the Scheme which was limited to production loans for inputs has been broadened to the whole value chain of agriculture sector. We have, with the grace of Allah, become a surplus country in foodgrains, livestock etc. and thus the needs of agriculture sector have also expanded. The SBP has included financing for silos, godowns, refrigerated vans, agro processing and distribution under the cover of this scheme. This broadening of the scope as well the removal of other restrictions have enabled the commercial banks to increase their lending for agriculture by a multiple of four times compared to FY 1999-00 thus mainstreaming agriculture lending as part of their corporate business. Unlike the previous years when they were prepared to pay penalties for under performance they have set up higher targets for this year. The private commercial banks have also agreed to step in and increase their lending to agriculture.

(xiv) **E-Banking**

The banks are being encouraged to move towards Electronic banking. There is a big surge among the banks including NCBs to upgrade their technology and on-line banking services. During the last three years there is a large expansion in the ATMs has been witnessed and at present about 500 ATMs are now working throughout the country. The decision mandating the banks to join one of either two ATM switches available in the country will provide a further boost. Progress in creating automated or on-line branches of banks has been quite significant so far and it is expected that by 2004 a majority of the bank branches will be on-line or automated. Utility bill**s** payment and remittances would be handled through ATMs, Kiosks or Personal Computers reducing both time and cost. Investment in information technology is being undertaken by the banks to enhance efficiency, reduce transaction costs and promote E-Commerce. It has been estimated that a banking transaction through ATM costs one fourth as much a transaction conducted over the counter in a traditional branch – and the similar transaction over the internet costs a mere **fraction** of the traditional teller costs.

(xv) **Human Resources.**

The banks have recently embarked on merit-based recruitment to build up their human resource base – an area which has been neglected so far. The private banks have taken lead in this respect by holding competitive examinations, interviews and selecting the most qualified candidates. The era of appointment on the basis of sifarish and nepotism has come to an end. This new generation of bankers will usher in a culture of professionalism and rigour in the banking industry and produce bankers of stature who will provide the leadership in the future.

(xvi) **Credit Rating**

To facilitate the depositors to make informed judgments about placing their savings with the banks, it has been made mandatory for all banks to get themselves evaluated by credit rating agencies. These ratings are then disclosed to the general public by the SBP and also disseminated to the Chambers of Commerce and Trade bodies. Such public disclosure will allow the depositors to choose between various banks. For example, those who wish to get higher return may opt for banks with B or C rating. But those who want to play safe may decide to stick with only AAA or AA rated banks.

(xvii) **Supervision and Regulatory Capacity**.

The banking supervision and regulatory capacity of the Central Bank has been strengthened. Merit – based recruitment, competency – enhancing training, performance – linked promotion, technology – driven process, induction of skilled human resources and greater emphasis on values such as integrity, trust, team work have brought about a structural transformation in the character of the institution. The responsibility for supervision of non-bank finance companies has been separated and transferred to Securities Exchange Commission. The SBP itself has been divided into two parts – one looking after central banking and the other after retail banking for the government.

(xviii) **Payment Systems.**

Finally, the country's payment system infrastructure is being strengthened to provide convenience in transfer of payments to the customers. The Real-Time Gross Settlement (RTGS) system will process large value and critical transactions on real time while electronic clearing systems will be established in all cities.

These reforms will go a long way in further strengthening the Banking sector but a vigilant supervisory regime by the State Bank will help steer the future direction.

OUTCOMES:

What have been the results of the above reforms? These can be evaluated through a set of banking soundness indicators. These indicators show the following outcomes:

a) There has been consolidation, liquidation and merger of banks particularly with investment banks and DFIs that has resulted in reduction in number of institutions but fortified the capital base.

b) The share of private sector in banking assets has already declined to 60%. Once HBL is privatized this share will rise to 80 percent.

c) Capital adequacy ratios look much stronger in 2002 compared to five years ago. By the end of CY-02 the overall CAR stands at 8.8 percent which is well above minimum requirement of 8 percent. Commercial banks have much stronger Capital base and then CAR has resin from 6% in FY-97 to 12.6% in FY-02. Thirty two out of 40 banks have ratios in access of 10 percent.

d) Asset quality has improved stemming the flow of non-performing loans. NPLs on all-banks basis have gone down by 7 percent from FY-02 to FY-03. Net NPLs of Commercial banks are down to 7.5%.

e) Not only the lending rates have witnessed historic low of single-digit mark-up but also the spread has squeezed substantially from 700 bases points to 350 bases points.

f) As a result of strong deposit growth and heavy investment in government securities banks are having system-wide abundant liquidity and with robust indicators. The liquid assets to total assets ratio changed from 39.9 percent (CY-01) to 47 percent (CY-02).

g) Credit to private sector has multiplied more than three times to PKR 133.2 billion, in FY03 as compared to PKR 41.7 billion in FY-02.

h) Earnings and profitability have taken remarkable turn upwards. Earning assets to total assets ratio climbed from 77.6 percent (CY-01) to 84.1 percent (CY-02). Part of the profitability has resulted from substantial decline in tax rate (64 percent in FY-95 to 47 percent in FY-2003). The profit after tax of the commercial banks increased to Rs 14.8 billion in 2002 from a loss of Rs 16.2 billion in 1997. Resultantly, the return on assets (ROA) improved to positive 0.8 percent from negative 1.3 percent.

CHALLENGES:

Soundness of financial system requires its constituent institutions to be efficient, having an optimal size and relatively healthy portfolio; and the financial system itself of being the optimal size. These requirements call for persistent and continued efforts for privatization, drastic restructuring of DFIs, a more effective tackling of the problem of bad debts, and the elimination of fragmentation, and ultimate consolidation of financial system.

In state owned banks, we have a history of deteriorating governance and credit discipline, finally eroding their capital, which has largely been compensated through capital injections by SBP. Remaining agenda for ‘Privatization’ needs to be fulfilled as promised. These banks should be sold, as being done currently, through competitive bidding and through listing on Stock Exchanges. This would bring in transparency in the process, fetch a realistic price to the government exchequer and it would help deepen the capital market.

The risk to the banks’ solvency may arise out of banks’ hyper activism in areas like real estate financing (reduction in debt-equity ratio from 60:40 to 80:20 for housing finance has heightened market risk) and equity investment. Although banks’ indirect lending to equity market against their scrips picked up yet remained miniscule in relation to total portfolio. SBP has been monitoring all this very closely.

When the banks are flush with liquidity, it becomes a challenge that they carefully guard themselves against spiraling effect of excess liquidity on their loan to valuation ratio and make rigorous sensitivity analysis before making credit decisions. This will help them to properly evaluate the impact of shocks such as upward swing in interest rate structure on their portfolio as well as individual borrowers’ cash flow projections.

Enhancing efficacy of Supervision. Strengthening of supervisory and regulatory capabilities of governing institutions (SBP and SECP) not only requires enhancement of their own skills but also those of institutions being supervised. This requires installation of good governance, placement of effective legal infrastructure, and clear demarcation of supervisory responsibilities in case of multiplicity of supervisors.

Strengthening of Legal Infrastructure. Although legal and judicial reforms have facilitated financial contract dispute resolution, implementation of court judgments is still ineffective, partly due to remaining weaknesses in the law and its enforcement. The implementation of new foreclosure law is still beset with some teething problems which need to be tackle. Simultaneously, the implementation of court judgment could be facilitated by providing courts with adequate resources to effect loan recovery. A Bankruptcy law is under formulation and needs to be put in place. So is the need to approve the Anti-money laundering law.

Another challenge is restructuring of DFIs. DFIs in Pakistan have failed in reaching the targeted sectors and in achieving sustainability mainly because of large defaults.

Other issues include modernization of Payment System, arresting bad debts, Continuous improvement in Corporate Governance of banks/DFIs, up-gradation of risk management system.

OPPORTUNITIES:

At the national level the biggest opportunity is to integrate into international financial market. Foreign investors in the banking industry are welcome in Pakistan as they bring not only the precious foreign exchange but also the skills and techniques of modern banking system, innovative products and services and networking into global chain.

As the competition in domestic banking system has become fierce and the profit margins on traditional modes of Corporate and trade financing are under pressure the banks are moving into new business areas – Consumer loans, mortgage financing, SME financing and agriculture lending – These New areas require expertise, systems and procedures, controls, technology and risk management technique. The banks have to strike a balance between prudent lending and a rapid build up of risky portfolio. The gradual transition from prudential regulations to a guideline driven framework would require in-house risk management capacity within the banks and further elimination of weaker banks from the system. Derivatives and options provide excellent tools for risk management and the Central bank is encouraging the banks to move in this direction. But creating awareness, educating the counter parties, building up local expertise, introducing proper controls and disclosures standards are some of the pre-requisites that have to be put in place.

Finally, as foreign exchange regime is being gradually liberalized and partial capital account convertibility has been achieved further measures would be undertaken to open up the market for cross-boarder risk products to private wealth managers and well established corporate houses.