SUSTAINABLE GROWTH IN FINANCIAL SECTOR OF PAKISTAN

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It is pertinent to ask whether the reforms brought about in the financial sector of Pakistan will persist generating sustainable growth in the sector or quickly dissipate.

In my view there are at least eight factors that attest to the sustainability of growth in the financial sector. Of course, the sector cannot be divorced from the overall external, domestic and macroeconomic conditions. If there is a breakdown in political stability or macroeconomic situation is under stress, then these factors will not be operative. This analysis assumes stability, continuity of good policies and good governance. What are these factors?

First, capital base of the banks has been strengthened by raising the minimum capital requirements from Rs. 500 million to Rs. 2 billion. This will be raised further in the coming years. In addition, the capital adequacy ratio which reflects the amount of capital to finance the risk weighted assets is now at about 11 percent for the banking industry as an average against the minimum requirement of 8 percent. As the banks mainly use the depositors' money to take risks they should also have their shareholders' money at stake too. This high capital adequacy ensures that the bank management exercise caution and prudence in granting of loans.

Second, the quality of assets of the banking system has improved during the last few years. Gross Non performing loans to Gross advances for the commercial banks have come down from 25 percent to less than 10 percent while the provisions held by the banks against these NPLs cover about 70

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percent of gross NPLs. Consequently, the net NPL to net advances ratio has shown a remarkable decline to 3 percent while is comparable to international standards. The flow of NPLs has dwindled to less than 5 percent that means that 95 percent of the loans in banks' portfolio are being fully serviced on time.

Third, the earnings of the commercial banks have risen not because they have invested in stock market or real estate but because healthy competition and restructuring have resulted in efficiency gains. The spreads between the deposit and lending rates now range between 3.5 to 4.5 percent compared to 7.5 to 8 percent five years ago. The spreads have declined because the drag of NPLs has disappeared, the corporate tax rates on the profits of the banks have been lowered from 58 percent to 41 percent and 35 percent in the next two years and excess labor has been eased out through golden handshake schemes in the three major banks – NPB, HBL and UBL. Cost – Income ratios have therefore fallen from 74 percent to less than 60 percent and administrative costs range between 2.1 to 3.2 percent. The stable earning stream from core banking business allows the banks to build up reserves for facing unforeseen contingencies and strengthens their balance sheets.

Fourth, the accesses to banking services have been broadened to a much wider customer base particularly the middle and lower middle income groups. No country can aspire for sustainable and equitable growth in absence of a strong and healthy middle class. In Pakistan, the banking system was intermediating the savings of millions of depositors primarily to fund the fiscal deficit and the losses of the public sector, to meet the working capital of 200 top named companies and to engage in letters of credit for business and international trade. The number of active borrowers was limited to less than half a million at best. By allowing the banking system to offer new products and services such as agriculture credit, SME financing, mortgage loans, automobile leasing, personal loans etc. a new vista has opened up. Commercial banks that were always hesitant to channel credit to agriculture sector are now the single most source of agriculture financing. This year almost 1 million households will receive about Rs. 100 billion of loans for agriculture. Similarly, the Khushhali Bank, PPAF and other microfinance institutions will reach out to half a million households providing them small unsecured loans ranging between Rs. 5,000 to Rs. 25,000. The beneficiaries of these loans are mainly the landless, the women and other poor classes who never had access to bank financing. Salaried classes have also begun to leverage their incomes by receiving personal loans the installments of which are deducted from their monthly pay checks. At least another half a million families have availed of these loans. This broadening of access not only eases the credit constraint faced by a dynamic segment of the population and transfers purchasing power in their hands but also diversifies the risk for the banks and allows them to earn a decent return on their loan products. This enhanced purchasing power in the hands of a large number of families stimulates aggregate demand in the economy, helps in the expansion of production of manufactured goods and in the higher growth of the economy.

Fifth, with the privatization of nationalized commercial banks the role of the regulatory and supervisory authorities has also changed. A strong regulator is needed to act as a vigilant watchdog on the banks and banking industry as a whole. Prudential regulations and norms and their effective enforcement is one of the potent instruments to perform this function. But ensuring good corporate governance is another way to do so. The SBP has laid down fit and proper criteria for the appointment of the Boards of Directors, Chief Executives and Senior management of the banks. Those who meet this test can hold the office for the prescribed tenure but in case there is deviation and the appointees do not meet the test the SBP advises the banks to replace the individuals concerned by more appropriate persons. In my reckoning 50 percent of the job of the regulator is completed if the right persons are appointed and the corporate governance guidelines are observed in letter and spirit.

Sixth, there have been certain apprehensions expressed about the risks to which the banks have been exposed or will be exposed in the future in light of the rising interest rates. There are two strands of criticism on this count. There are those who believe that there will be more defaults on consumer loans as interest rates go up. It is always true that the default rate will be higher under a rising interest rate scenario compared to low interest rates. But for the last five years the banks have been asked to earmark reserves of 1.5 percent against their secured consumer loans and 3 percent against unsecured loans in their portfolios. This pool of money will enable the banks to deal with in the event they are stuck with higher defaults. At the same time the repossession laws have been strengthened and repossession of automobiles or houses has become much easier for the banks and liquidate their collaterals against which the loans have been given.

A second criticism is that the banks are fuelling the speculative activities such as stock market share trading and real estate purchases. The banks have been restricted by the SBP and their total exposure to shares can not exceed 20 percent of their equity. If we assume, for the sake of argument, that all the banks have collectively used up this maximum limit of exposure their investment of the banking sector in shares would be small – about Rs. 32 billion. This accounts only 1.6 percent of the total assets of the banking system and it can be seen that it does not pose any serious risk to the bank.

As far as real estate is concerned, the banks cannot finance purchase of plots of land and only against housing. The direct lending for mortgage is miniscule but indirectly the banks can be put to risk because of inflated values of property held as collateral. The SBP insists that only the forced sale value and not the market value should be taken into consideration for valuing the collaterals. This will save the banks from downward movement in the market prices of the real estate.

Another risk mitigating measure taken by the SBP is to extend the coverage of all loans – corporate and consumer - in the Credit Information Bureau. This real time on-line information service which is currently limited to the corporate borrowers will enable the banks to appraise the credit worthiness of prospective consumer loanees, determine their aggregate repayment capacity and verify the credit history before approving the loans. Thus, a card holder who already has four to five credit cards and reached his borrowing limit will find it difficult to get a card from another bank.

Seventh, the human resource base of the banking system is being upgraded. Emulating the example set by the SBP in recruitment of new employees through merit based competition, other banks have also started following the same system. I am, therefore, sanguine that the new breed of bankers will be infused with professional skills. We have formed a task force consisting of the HR Managers of all the banks and mandated them to come up with industry wide standards for training, promotion, compensation and benefits, severance and continuing professional education. The banks have to move away from the old paradigm of seniority as the sole criterion for career advancement. In future the promotions should be based on upgradation of skills and demonstration of performance. In a knowledge-based economy and a service-oriented sector, it is absolutely imperative that investment in human skills is given utmost priority.

Eighth, five years ago the technological base of the banking industry was not even at a rudimentary stage. The SBP embarked upon a Technology upgradation project which will be completed this year after five years' serious efforts. The banks have also followed the lead and from almost a scratch we have more than 800 ATMs and almost half of the branches nation-wide are connected on-line. By the end of 2005 it is expected that most branches will have on-line and internet banking facilities. The Real Time Gross Settlement System (RTGS) will allow inter-bank transfer of funds from any place in the country thus increasing the efficiency and providing convenience to the customers.

The cost of transactions will be reduced significantly once the ATM network and on-line banking become firmly entrenched. It is estimated that the average cost of processing a cheque is around Rs. 50 while that of ATM withdrawal is Rs. 15. Thus, the cost savings will result in further efficiency of the banking system and increased volume of business.

Conclusion:

The above analysis shows that the fundamental reforms carried out in the financial sector have brought about significant changes in the structure, processes, regulation, technology and human resource base of Pakistan's banking sector. The reforms have initiated a virtuous cycle of economic growth which is pro-poor. These changes and their future continuation provide the foundation for sustainable growth in the financial sector and the virtuous cycle in economy.