CULTURE, ETHICS AND VALUES IN THE BANKING SYSTEM

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Distinguished Guests, Ladies and Gentlemen,

When I addressed you for the first time on March 25, 2000, we were in a despondent and gloomy mood. The economy was stagnant, external debt payment difficulties were pervasive and the financial soundness indicators of the banking system in Pakistan were quite worrisome. Public sector owned and managed banks dominated the system with its peculiar bureaucratic culture, indifferent service standards, laid back and lethargic business practices and narrow product range. The Government of Pakistan was underwriting the losses of these banks out of its scarce budgetary resources. Average lending rates hovered around 15 to 16 percent, credit growth to private sector was anemic, non-performing loans accounted for almost 25 percent of total loan portfolio and were threat to the capital base (as capital to total assets ratio was low), return on assets and return on equity were negative. Professional management and operational efficiency were by and large missing. Most of the banking assets were channeled to the public sector, large corporates, big name borrowers, and trade finance. Foreign banks were busy making money on foreign currency deposits. In brief, the banking system was dysfunctional and instead of making contribution to the real

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economy it was acting as a drain. We set out in the year 2000 for you and for ourselves – the regulator - the direction, the goal post and the milestones for the journey we were to embark upon together.

Almost six years later, I can proudly say that we have together successfully treaded the path along the direction we had set for ourselves by removing the pebbles, stones and boulders and reached the goal post. We may have tumbled along the way, suffered some bruises but we persevered and never gave up. It would no longer be an exaggeration but a fair statement that the landscape of the banking system in Pakistan has changed dramatically, and there is no better testimony to this fact than the conclusion reached after a comprehensive assessment carried out jointly by the World Bank and the IMF in 2004.

> ***"Pakistan has undertaken major reforms in recent years in the financial sector that have resulted in a sounder and more efficient financial system.***
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> ***Significant financial sector reforms have been implemented during the last decade. These have included a return to market-based monetary and exchange rate policies, a diminishing role of the state in the financial sector through privatization of nationalized commercial banks, improvement in corporate governance, disclosure, and transparency, and the adoption of modern regulatory approach in the oversight of the financial sector.***

The reform efforts are reflected in improving financial soundness indicators, greater resiliency to credit market and liquidity risks and good compliance with international supervisory standards."

The ownership and management structure has shifted from the public sector to the private sector which controls around 80 percent of the assets and deposits. All financial soundness indicators are robust and healthy and can be favourably compared with international benchmarks (Table I). Capital adequacy ratios for 30 out of 39 banks exceed 10 percent with capital to total assets ratio having risen to 7 percent. Gross Non-performing loans (NPLs) of commercial banks have declined to 7.8 percent of the total gross loans while net NPLs are only 2 percent of the total net loans. Between 1997 and 2004 the banking system has advanced new loans of Rs.985 billions but the gross NPLs have increased by only Rs.27 billion i.e. the gross NPL ratio on the flow of loans has been contained at a paltry 2.7% - much below the internationally accepted norms. The average lending rates touched 5 percent and have only risen to 8 percent this year. Despite lowering of deposit rates, the deposits have grown by 78% and the credit to the private sector by 100% during the six-year period. Lending to agriculture sector has accelerated from Rs 38 billion to Rs 130 billion per year. SMEs now receive about 17.5 percent of total private sector credit and consumer financing has seen a phenomenal rise. Credit to manufacturing sector amounted to Rs. 405 billion during this period leading to double digit growth and higher capacity utilization. The banks have improved their profitability and earned 1.4 per cent return on assets and 22.1 percent return on equity – comparable to international standards. Intermediation efficiency has improved as average spread has come down and cost/income ratio has been significantly lowered. Highly educated professionals have been recruited in most of our banks through an open, competitive system and a system of merit based selection and career progression has begun to take shape. Technology upgradation has resulted in expansion of on-line banking, ATMs, Credit Cards, Debit Cards etc.

This is not the occasion for me to dwell on the larger changes in macro economy but I will leave it to you to examine the indicators in Table II and form your own judgment.

These are highly impressive achievements and I wish to congratulate the banking professionals in Pakistan for their efforts in bringing about this turnaround. This does not mean that we should become complacent. The world around us is changing rapidly, the economy is facing new challenges and the banking sector has to keep on adapting itself and improving its capacity and efficiency. You have to extend the outreach to the majority of economically active households and remain vigilant and responsive to the changing environment. The benefits of a sound banking system have to be shared widely across the income groups, regions, sectors and sizes of businesses. I am also unhappy that the depositors haven't received a better deal in the last few years but I hope that this situation is undergoing a reversal.

As I deliver my last annual address at this august gathering I wish to address the bankers on a set of entirely different issues that are very near dear and near to my heart. These have to do with the culture, values and ethics in Pakistan's banking sector.

While the competitive environment in the banking industry has taken a turn for better it has also given some cause for concerns. When you are constantly challenged for bottom line results, for capturing market shares, for attracting new deposits and businesses and when you are dangled with incentives such as performance bonuses, stock options, exceptional merit increases, some of you may feel pressurized to make compromises, cut corners and adopt ethically questionable means. There would be dazzling temptations in front of you, there would be occasions that nobody will be looking over your shoulders and the regulators may fail to detect your lapses and your actions may go unnoticed, there could be lack of oversight by the Boards and the sub-committees and you will escape unscathed under all these circumstances.

But remember that by indulging in unethical practices you will not only betray your own conscience but also violate the self imposed rules of professionalism. You would not be able to look into the mirror honestly without suffering a pang of guilt. You may have earned a huge fortune in the process, acquired material wealth and belongings, proven one-up on the Joneses, attracted envy among your friends and society but at a very heavy cost to your own self respect. Ostentatious life styles of bankers do not get unnoticed or commented upon. Violation of professional ethics is something which you and only you are responsible and accountable and please do not rationalize it by telling yourself that nobody has been hurt. Please do not delude yourself because the most valuable asset you posses is your professional integrity and do not destroy it by indulging in the practices that are contrary to basic ethical standards of the profession. Callous and irresponsible actions by even a few among you will cause damage and bring bad name to the entire banking profession.

As more and more industrial families and big business houses take over the reins of the banks some of them may exert direct or indirect pressures or persuasions on the management to use the bank's deposit base to acquire new businesses or expand existing businesses. Clever schemes will be presented to you under which the prudential regulations will be followed in letter but reciprocal arrangements and linked transactions will be set up whereby the ultimate beneficiary will be the major shareholder. I am quite confident that the SBP inspection teams and market intelligence will eventually track down these arrangements and transactions but it will reflect poorly upon those of you who were wittingly or unwittingly involved in them. It is with great difficulty that we have got the banks privatized but please do not commit such actions that will provide ammunition to the detractors of privatization. They will claim “we told you so” that the private owners will use the banking institutions to enrich themselves, their families and their friends, rather than serve the larger interests of the economy. I wish that moment never arrives in our history but all of us have to work hard to ensure it by upholding highest ethical standards.

I would urge upon the Pakistan Banks Association to develop a code of conduct for all the bankers in the country and have an oversight committee that should enjoy the powers and authority to take to task those who are found guilty of the violations of the Code irrespective of the status, grade or standing. Such credible enforcement mechanism would help in the upgradation of ethical standards across the industry.

Now, I come to the issue of culture. The banking culture in Pakistan is still very much a legacy of the past i.e. ingrained in a negative, can’t be done, come tomorrow, bring the following fifteen documents; way of doing things buttressed by slow, cumbersome, complex, incomprehensible, non-transparent procedures faced by an ordinary unconnected customer. But enter a well-to-do, influential and highly connected individual who can either do some favours or do some harm then all doors are suddenly opened, all the requirements and procedures are either dispensed with or hurriedly contrived, and the work is done to his satisfaction. This highly inequitable, discriminatory attitude on the part of our bankers, if allowed to persist, will retard the broad based growth of the industry. We have to get away from the culture of sifarish, reciprocity, favouritism, nepotism and inculcate a culture of serving the customers equally and honourably without any distinction. We have to apply the KYC regulations with equal fervour, discourage benami loans, or deposits, report suspicious transactions, penalize deceptive pronouncements and practices by sheer force and take criminal action against those found guilty of frauds and forgeries. Marketing and advertising of products should be carried out with full disclosure of all relevant information without suppressing material facts or without any fine print. Long term reputation of banks has to be protected and preserved more jealously than the prospects of immediate financial gains. Transparency, full disclosure, courtesy to the customers and helpful attitude should become integral part of the organizational culture. Continuous learning, skill upgradation and acquisition and mastering of new knowledge and techniques will prove extremely helpful in the professionalization of the banking industry.

The new culture can be nurtured if the leadership acts as the role model, walks the talk, does not exhibit double standards in his conduct, treats all employees in a fair and equitable manner and does not have any favourites. Rules, standards, practices, codes of conducts are applied across the board and postings, transfers, promotions and merit increases for the staff are carried out in a transparent manner. Avenues for redressal of grievances are kept open. Good behaviour is rewarded and bad actions are punished. For bringing cultural change it is essential that responsibility should be accepted squarely and blame game should be stopped. If you don't have the moral courage to tell a loan applicant on his face that he does not meet the appraisal criteria and cannot be granted the loan for the following reasons then the culture in your bank will never change. Don't shift the blame to the Prudential Regulations that the SBP regulations don't permit you to approve the loan although you, as his well-wisher, would very much like to oblige him. This hypocritical behaviour would be exposed sooner or later. So don't spoil the culture of your organization by deluding yourself that you won't be caught one day.

The culture in our banks can change if we faithfully follow the principles of separation of powers between the owners and the management as enshrined in our Corporate Governance Codes and Guidelines. The owners through the Board of Directors have every right to put forth the strategic direction, exercise vigilance and oversight over the affairs of the bank, formulate policies and hold the management accountable for results. But they have to refrain from the temptation of running day-to-day operations of the banks, from interfering in the working of the banks, from second guessing or overruling the decision taken by the management, or approving individual credit decisions or hiring people other than the Chief Executive. If these respective roles can be played in actual practice by both the sides it would lay down a strong healthy environment in which the staff will have clarity, intrigues and game playing will disappear and the bank will be able to attract and retain good people as well as good customers.

Rewards and recognition to the staff and penalties should be closely linked not only to their performance but also to their contribution in bringing the desired cultural change, behaviour modification, attitudinal change, upholding and exhibiting core values and ethical standards.

The next and in my view the most important issue that will safeguard the ethical standards and change the organizational culture has to do with the values we inculcate among our staff. I have already emphasized integrity as the highest value but there are others that need to be promoted and practised. Courage, openness, team work, accountability for results and accepting responsibility for one's action are the other important values that should form the core values of your banking institutions. Integrity – personal, professional and intellectual – should not be allowed to be compromised at any cost. Banking unlike other businesses is based upon Trust. Millions of small depositors have entrusted all their savings in the hands of the bankers. The owners of the banks or major shareholders have limited stakes. At present the equity capital of the banking system is about 7 percent of the balance sheet while 93 percent is derived from the depositors' money. So for each one rupee lost by the shareholder in case of the systemic crisis, the depositors will lose thirteen rupees. Even then they have chosen to entrust this amount in your custody. You are therefore a trustee or "ameen" and the fiduciary and moral duties of a trustee are so well known and obvious that they need not be repeated here. No wonder, I lay so much emphasis on integrity being the highest value to be practised by the banking professionals without any semblance or perception of compromise. All of us should have zero tolerance for those who lack integrity. Those who are found guilty of indulgence in corruption should be removed forthwith. Service excellence should also be the value that needs to be imbibed and practised by all the bankers as you are now charging your customers for various services. They should be fully compensated for these charges in form of excellent service standards.

Good governance has become a buzz word throughout the world today but the imperatives of good governance in the banking industry are more compelling. The standards should be more stringent and strict. The ownership and management of the banking institutions should be passed on only to those who meet these tough standards. We as the regulators may sometimes err just like all human beings in letting slip in people who may not be up to the mark. But the industry itself should be able to resist the entry of such persons and help avoid the mistake and future aggravation. You should not show apathy and indifference by saying to yourself: who am I to raise the red flag and incur unpleasant wrath while the regulator has permitted the person to get in. Remember, a chain is known by its weakest link. If you remain a passive bystander to the weakening of the chain, the chances are that you will witness the breaking of the chain one day.

Cooperation with regulators and self regulation are the means through which the core values I have spelled out above can be harnessed. We as regulator believe we have done away with the culture of fear, suspicion and mistrust, that we have adopted a more collaborative and participative approach, that we do listen to the industry and stakeholders but this does not absolve us from our fundamental task. The task is to safeguard the depositors' interests, avoid recurrence of systemic crisis and keep the financial markets functioning and stable. The first line of defence is the management of the banks, the second is the Board of Directors, the third is the self regulatory body of the banks and the final line is the banking regulator. If the water is allowed to seep in or cross the earlier lines of defence the task of the regulator becomes more difficult and onerous because the intensity becomes fiercer. Thus, if the bank management, Boards of Directors and self regulatory body perform their task well and defend their respective barriers by reporting all infractions, violations, lapses, deviations and slippages to the regulator well in time, the damage can be controlled. Misrepresentation and concealment of material facts from the regulator should attract worst kind of sanctions and penalties including the suspension from the profession. But this will happen only when the values of courage, openness, accountability and responsibility are internalized.

To conclude, the banking system in Pakistan has come a long way from the bad old days of pre-1997 period and has become sound, strong and healthy. But to sustain this path in the future requires that the culture, values and ethics of the banking profession are changed in a fundamental way. I am quite optimistic that, as you have changed the structure, processes, skills mix, incentives in the last six years, you will successfully embark upon this new journey. In 2011, the retiring Governor of the State Bank will be expressing his thanks, satisfaction and commendation to you for completing this journey of a new culture, new set of values and high ethical standards. He will set for you a new direction in which you should begin your next journey for the glory of the banking industry and for the welfare of Pakistani people.

Thank you.

TABLE I

COMPARATIVE INDICATORS OF FINANCIAL SOUNDNESS

OF THE BANKING SYSTEM[1/]

	December, 1999	June, 2005
Capital Adequacy Ratio	10.9	10.9
Capital/Assets	4.8	6.6
Gross NPLs[2]/Total Loans	25.9	10.6
Provisions Held/NPLs	48.6	73.6
Net NPLs/Net Loans	15.3	3.0
Net NPLs/Capital	149.8	24.1
Return on Assets (After Tax)	-0.2	1.4
Return on Equity (After Tax)	-3.9	22.1
Cost/Income	75.8	48.2
Net Interest Income/Gross Income	55.6	71.1
Average Spread	8.16	5.46

1/ Includes Commercial Banks and Specialized Banks.
2/ Non-Performing Loans

TABLE II

CHANGES IN KEY MACROECONOMIC INDICATORS

	October 1999	June 2005	Change in the Indicator
GDP growth rate	4.2%	8.4%	Positive
Inflation	5.7%	9.3%	Negative
Fiscal deficit/GDP	-6.1%	-3.3%	Positive
Current account/GDP	-3.2%	-1.5%	Positive
Domestic Debt/GDP	52.0%	43.4%	Positive
External Debt	$ 37 billion	$ 36 billion	Positive
Remittances	$ 88 million per month	$ 350 million per month	Positive
Exports	$ 7.8 billion	$ 14 billion	Positive
Tax Revenues	Rs. 391 billion	Rs. 590 billion	Positive
Rupee-Dollar Parity	Depreciating	Appreciating	Positive
Foreign Direct Investment	$ 472 million	$ 1.2 billion	Positive
Foreign Exchange Reserves	$ 1.6 billion	$ 12.6 billion	Positive
Poverty Incidence	33%	Data not available	N.A.
Poverty related expenditure	Rs. 133 billion	Rs. 161 billion	Positive
Unemployment	6%	7.4%	Negative

Note: All indicators in Column 1 pertain to 1998-99 or October 1999. All indicators in Column 2 pertain to 2004-05 or June 2005.