# Financial Sector in Pakistan: The Way Forward

Address at the Forty Ninth Annual General Meeting of Institute of Bankers, Pakistan held at Karachi on 25th March 2000.

***Ladies and Gentlemen,***

I thank the Institute of Bankers, Pakistan for providing me this opportunity of sharing some of my thoughts with the bankers and others associated with the financial sector in the country. Before doing so, I wish to congratulate the boys and girls who have earned distinction in the Institute's examinations and have won prizes and awards. While this is an occasion for them to rejoice over their success, they would be well-advised to make a commitment today that in discharging their professional responsibilities in their careers they will work as hard and as honestly as they did in passing these examinations. With the passage of time they are likely to face greater competition as successive generations of financial experts will inevitably be better equipped with continuously improving technology and expanding knowledge and experience. This would make it increasingly difficult for them to make a mark in the profession. However, urge to learn more, hard work and integrity are the strong pillars which can carry any burden any where and meet any challenge. Like every body else people with these qualities may face temporary setbacks but these qualities cannot be substituted. I wish these young bankers best of luck in their professional careers.

The Institute of Bankers, Pakistan has a very impressive record in serving the banking industry in the country in more than one ways. The Institute has been playing a key role in providing different kind of facilities to those in financial sector to improve their professional skills. In addition to providing various facilities for the purpose of examination, the Institute has been holding seminars and training sessions relating to important topics for the benefit of bankers and for the financial sector in general. Through its publications, particularly the quarterly journal, the Institute has done a remarkable job to keep the people in the banking industry updated on a wide range of subjects relating to economics, finance and banking. It is one of the few institutions in the country holding professional examinations without compromising on standards of competence and performance. Relatively low percentage of candidates qualifying these examination has given rise to complaints and grumbling. But I congratulate the management of the Institute, particularly its Secretary Mr. M. M. Malik who have not succumbed to such pressures. This policy of not compromising on standard of excellence has considerably improved both the quality, personnel skills and the standard of banking services. All the same, this tribute should not generate any sense of complacency. With rising expectations about the quality of banking service, the Institute has also to set its goals higher & higher over the years ahead.

Generally on such occasions, Governor, State Bank is expected to give his views on some policy issues. I want to share with you this morning my views on three major issues which are critical to the growth and health of the financial sector and also necessary to prepare ourselves for meeting the challenges of the 21st century as we perceive them today.

First, in the short-term, we in the State Bank as well as the banking and non-banking financial institutions have to shift our managerial attention from an exclusive preoccupation with recovery of defaulted loans to a more multi-dimensional and balanced approach. Under this approach, we have to explore new products, new markets and innovative channels to revive and finance private sector fixed investment and working capital. But at the same time we have to ensure that the quality of these new assets is not compromised in any way, that the recovery of non-performing assets is not slackened and that the efforts at improving the profitability and service standards are maintained. I realize, this is a gigantic task and poses many difficult challenges including some trade-offs but, in my view, this is doable and is the future agenda especially for the big banks in this country. By inducting professional managers of competence and integrity and having people of proven track records in their respective fields in the Boards of Directors we have set the stage for these banks to demonstrate better performance than what was achieved in the past. On our part, the State Bank has assured these banks of our fullest cooperation and support in carrying out their mandate without micro managing their affairs or interfering in their individual commercial decisions or giving them any directive on individual lending proposals. But we will remain vigilant in our watchdog duties to supervise and regulate them in accordance with the highest prudential standards and monitor their compliance and implementation of the agreed performance indicators.

As I have pointed out to many of you present here today, the banks have to diversify their asset base functionally, sectorally, geographically and by size. You have to move away from investing only in Government paper or public sector securities or other risk-free instruments. There is an urgent need to provide the corporate clients in the private sector fixed capital as well as working capital, trade financing, revolving lines of credit and other services for reviving economic activity in the country. You have to develop new consumer products and expand your customer base. You have to move away from concentrating simply on textile, sugar, cement and other saturated industries to finance other new, non-traditional manufacturing and service industries. Within textiles, in addition to value added and exportable products of good quality, balancing, modernization and replacement are needed to improve the productivity of the existing capacity. For export financing, the banks have to develop independent lines of pre-shipment, post-shipment credit and assist the indirect exporters and suppliers involved in the export value chain. There is overbanking in Karachi, Lahore, Islamabad and although other cities do not offer the same attractive living conditions, we have to expand the network in medium size towns, mandi towns, and market towns. China’s industrial success in the last two decades owes a great deal to the Town and Village enterprises which are spread all over the country. The banking industry can make good profits if they extend their network to other emerging centers of economic activity.

We all know that several thousand borrowers in the country have pre-empted more than three-fourths of the banking assets in the country. From a pure risk management view-point this is not such a smart move. The re-payment record of small and medium businesses is much better than that of large borrowers. The present government has committed itself to help expand small and medium enterprises whose potential has not been fully tapped so far. We, in the financial sector, have to align our products, services and outreach to unleash these enterprises and tap their potential. This not only makes good business sense for the banks and non-bank financial institutions but also means increased purchasing power in hands of a large segment of population. This purchasing power will then translate itself into higher demand for goods and services produced in the country. Empirical evidence shows that the pattern of demand exhibited by lower middle classes and small and medium enterprises is less import intensive and more strongly linked to labor intensive domestic economy.

To sum up, the benefits of diversification of asset base across functions, sectors, geographical areas and size outweigh the costs involved in marketing, penetration, new skill acquisition and technology upgradation. I very much hope that the financial institutions will give serious thought to advancing this agenda.

The second issue, I would address is that of Regulation Working with Market Participants. Modern best practices in regulation of capital markets consider 'Self-Regulation Organizations (SROs) of market participants as partners with government in regulating financial markets. We, the regulatory authorities in Pakistan, need to work in collaboration with the boards of stock exchanges and associations of financial institutions. To make this mechanism effective, restructuring and capacity building of these SROs is essential.

Economic theory and international experience all suggest that the Central Bank should encourage such transparent, disclosure-based and market-based regulation that the financial institutions themselves have the incentive to comply with the regulations for their own protection. After all, no Central Bank can have either unlimited resources or such depth of knowledge and information that it can continuously evaluate and enforce compliance in respect of each single institution.

In our case, there has been a lot of criticism that the State Bank did not react promptly in preventing the collapse of Mehran Bank and BEL. I can honestly tell you that even in the best regulated countries in the world there were serious banking failures and such incidents are bound to happen in the future also. All that the regulators can do is put in place systems, procedures and internal controls whereby the management and the supervisory Boards of the Banks discharge their responsibilities in a more prudent and cautious manner. The external auditors have also to play their professional role in verifying the accuracy of the financial statements and reports prepared by the institutions.

This does not imply that we, in the State Bank, should be absolved of our own responsibilities. We carry out periodic inspections at regular intervals of time. It is quite conceivable that in a few instances the information provided during the inspections may be partial, incomplete, tampered with or outright forged. Misreporting of financial information is the worst offence any bank or non-bank institution can commit. But the paradox is that we have to rely on the reports by the management of these institutions to prepare our own evaluation. In some cases, consistency checks or comparison with other benchmarks do provide insights and hunches which can be pursued but it takes time, resources and specialized skills to reach conclusive judgements. Banks have been entrusted by millions of depositors with their hard earned money and the banks thrive and survive in an atmosphere of trust. A regulator who makes undue haste or discloses information without due verification of its antecedents or accuracy or expresses opinions based on incomplete set of facts or does not provide ample opportunity to the erring institution to explain its viewpoint, can soon destroy this trust. Public expectations for mob-lynching the banks and the bankers, therefore, run counter to the imperatives of careful, cool, calm and dispassionate analysis needed to pin the responsibility for default. It is important to make a distinction between those handful of willful defaulters who knowingly and unscrupulously used their connections and influence to borrow huge sums of money from the banking system with no intention of servicing them and those who fell victims to poor business decisions, adverse external circumstances, unanticipated and inconsistent macroeconomic policies, arbitrariness, misuse of discretion and harassment by corrupt government officials, delays in decision making by bankers themselves, red tapism or other unfortunate events. For the latter category of borrowers, restructuring and write offs form normal rules of banking business all over the world. So long as you have no personal axe to grind, no personal agenda to serve, no ulterior motives to follow, it is your professional duty and obligation to carry out this legitimate function without fear of reprisal.

The State Bank of Pakistan is taking a number of critical steps to strengthen its own capacity to supervise and regulate the banks and non-bank financial institutions. We are moving towards a highly specialized human resource base recruited from the finest institutions within and outside the country. We are also strengthening training by engaging the best experts available and are remunerating our specialist staff at competitive market prices. The staff will be supported by up-to-date technological solutions and provided pleasant working environment. By twining with other leading central banks around the world we would continuously improve ourselves to keep up with the international best practices. But once again even this strengthening of State Bank capacity will at best account for 20 per cent of the total effort in ensuring the soundness and health of the financial sector as 80 per cent of the results have to emanate from better management, internal controls and incentive structure within the institutions themselves.

This brings me to the third issue which I wanted to raise with you i.e. consolidation of the financial sector in Pakistan. Financial markets all over the world are becoming integrated as restrictions on movement of capital are relaxed, and technological innovations are facilitating quick information flows and reducing transaction costs. At the same time, this integration has introduced volatility and fluctuations in international financial markets and thus increased the systemic risk to domestic financial institutions. Credit risk has become more difficult to manage as domestic institutions have to face competition by relatively strong cross-border institutions. To participate in this environment and also contribute to economic development, financial institutions need to operate as viable commercial enterprises. Overwhelming pressure on banking industry in future will come from increased competition because of deregulated and liberalized financial structure. Competition leads to both risk and efficiency. Margin of profit is reduced and chances of failure rise. Under such a situation survival of small and weak banks will become difficult. In principle, if a private bank fails, it should be allowed to die. As a matter of fact, government and central bank cannot afford the collapse of banks. Apart from political considerations, 'systemic risk' is a more serious threat associated with bank failures. That is the danger that sudden and unexpected demise of one bank could have domino effect leading to the collapse of other banks or of the system as a whole. It can also have potentially devastating effect on real sectors of the economy.

To avoid failures of small banks and to strengthen their balance sheets, serious consideration would need to be given to enhancing the minimum capital requirements together with necessary amendments in the banking laws for the purpose. The small private banks are too weak either to withstand exogenous shocks, manage risks prudently or capture the market share from the large, established banks. I believe that the present number, functions, human and capital base of the financial institutions are neither conducive to positioning Pakistan in the global financial markets nor helpful for efficient intermediation within Pakistan. At present, we have 25 domestic commercial banks, 20 foreign owned banks, 10 Development Financial Institutions, 16 investment banks, 32 leasing companies, 46 modarbas, 39 mutual funds. The aggregate paid up capital of all these institutions is almost Rs.94 billion or $ 1.8 billion equivalent to 2.8% of GDP. In our neighboring country, the State Bank of India with 28 percent of market share in the banking industry, has announced plans to expand its capital base by an additional $ 2.5 billion – some of which will be raised through international capital markets. To give you a contrast, one of our well capitalized large state owned bank, the National Bank of Pakistan has total capital base of Rs.17 billion or $ 326 million. It is obvious that the financial sector in Pakistan is too much fragmented and we cannot take advantage of the economies of scale. The financial sector requires mergers and restructuring, massive infusion of capital, human resource strengthening and technological upgradation to come up with fewer but stronger institutions. We are reviewing the legal and regulatory framework in place which may have given rise to this fragmentation and to narrow functional isolation. This review, which will take place in active consultation with all the market participants and stakeholders involved, will remove the regulatory impediments. The present dichotomy between SBP and SECP in regulatory functions vis-à-vis the Non-Bank Financial Institutions (NBFIs) has to be resolved. I would, however, very much hope that the market players themselves will pay heed to this call and carry out voluntary and mutually agreeable mergers and consolidations within their respective market segments. Once the review is completed and it appears that the results of the voluntary consolidation do not appear to be satisfactory, I am afraid the regulators will have no other option but to discharge their fiduciary responsibility through appropriate regulations.

The other reason for consolidation and mergers has to do with our future strategy of participating in exports of financial services. Among the positive achievements this country can proudly boast of is the development of a large cadre of professional bankers. Although the events of 1988-98 did cause a setback by politicizing the top bankers in the nationalized banks, we still have an impressive pool which can be harnessed and mobilized to penetrate the market for financial services particularly in the Middle East, Central Asia and Africa. If we are able to make some modest progress in Islamic banking instruments and products, we should be able to find a market niche which will combine the particular product with our banking professional expertise.

To conclude, in my address, I have outlined my tentative thinking on financial sector reforms in the years ahead. All the areas I have talked about need indepth thinking. While we at the State Bank will give further thought to the feasibility, consistency and desirability of these proposals, I expect that my colleagues in the financial sector will help me in sharing these views and thoughts on this strategy. Needless to add that a number of proposals are breaking fresh grounds and would need to be appraised dispassionately and objectively as far as possible.

Thank you,