PAKISTAN'S FINANCIAL SECTOR

A Roadmap for 2005-2010

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The first generation of reforms in the financial sector of Pakistan is about to be completed successfully and we have to lay down the proposals for eliciting wide discussion on the second generation of reforms. The reforms should be implemented in the next five years, although they have to be reviewed continuously to adapt them according to the changing circumstances both domestically and internationally.

The objective of the second-generation reforms is to further deepen the financial sector and integrate it into the global economy. Before we lay down the proposed road map, let me recapitulate briefly as to what we have learnt from our experience so far and what we have accomplished so far.

Lessons Learnt:

First, financial sector functions effectively and efficiently only if the macroeconomic situation is favourable and stable. The need to maintain macroeconomic stability will thus remain imperative for the coming period too.

Second, reforms can be successfully implemented only if there is consultation, involvement and consensus building among all the stakeholders throughout the process. An institutionalized mechanism for this interaction and collaboration has to remain in place.

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Third, there has to be an active champion for conceptualizing, formulating, sequencing, implementing and monitoring reforms. In the absence of such a champion, there is a serious risk of derailment, reversal or abandonment.

Fourth, application of technology, intensive use of human resource competencies and managerial skills are the key tools for achieving results and have to be carefully nurtured and upgraded continuously.

Fifth, the regulators have the responsibility to communicate and explain the rationale, progress and outcomes of their policies and keep the market players fully informed.

Results Accomplished:

(a) Financial markets in Pakistan have been liberalized and have become competitive and relatively efficient but still remain shallow.

(b) The array of financial instruments available for various types of transactions in the market has widened but the evolution of new instruments has to remain on track.

(c) Financial infrastructure has been strengthened but the legal system is still too time consuming and costly for the ordinary market participants.

(d) Regulatory environment has improved and the capacity of regulators to oversee and monitor is much better today but the enforcement and prompt corrective action capabilities need to be further enhanced.

(e) Financial soundness indicators of the system show an upward moving trend in almost all dimensions but there are weaknesses and vulnerabilities that require to be fixed.

(f) Corporate governance rules have been clarified and conform to best international practices but their consistent application and voluntary adoption by the industry remain uneven.

(g) Financial sector is opening up to the middle and lower income groups but the commitment and mindset of the providers are still out of sync with the new realities.

It can be seen from the above catalogue of accomplishments that we have made a lot of progress but, at the same time, challenges ahead of us are quite formidable, the agenda for action is a lot more complex and the need for remaining alert and agile is even more pressing. The industry and regulators cannot afford to become complacent on our achievements but strive to work harder and together to move forward on the road we have set for ourselves.

What needs to be done?

The second generation of reforms should be built on the strengths of the financial system, work on removing the weaknesses and gaps and agree upon the speed, contents and phasing of these reforms. In my humble view, there are at least ten areas in which these reforms will produce promising results.

(a) Broadening Access to Middle and Lower Income Groups:

The banks have learnt that by broadening their client base, adding new products to their portfolio and offering new types of services, they can not only diversify their risks but also earn higher returns. We should continue to move along these lines and aim to reach out to at least three million households in agriculture sector and two million small, medium and micro enterprises in the next five years. The economies of scale and economies of scope make these goals quite feasible but I must also warn that only those who have imagination, agility and capability will be successful while others will fail. Reckless lending or optimistic forecasting that the current low interest rate environment will remain unchanged in times to come, is bound to get your institutions into deep trouble. I would urge you to be enterprising but prudent, strategic but not risk averse and flexible but not too indulgent in reaching out to the small farmers, small firms or individuals with micro-finance or consumer financing needs.

(b) <u>New Liability Products:</u>

The industry has paid adequate attention so far on developing new products on the asset side but neglected the savers and depositors. It is myopic for us to have such one sided approach as it is the savers and depositors who provide the wherewithal for the industry to perform its basic function of intermediation. The banks and non-bank institutions have to come up with innovative solutions tailored to the needs of 28 million depositors and savers of Pakistan. The Government has made the playing field level for you by removing the preferential returns in the National Savings Scheme, which has hurt the scheme holders badly. It is a wake-up time for all of us to begin looking after the interest of this vast majority of small savers and mobilize and utilize their savings in a much better way than we have done so far. Development of new liability products should be on the top of the agenda for the next five years. This is a serious weakness that we cannot afford to live with any more.

(c) <u>Corporate Restructuring</u>:

Financial Sector Reforms in absence of corporate sector restructuring i.e. pruning costs, reducing debt and increasing efficiency will have only short-term beneficial effects. The ratio of total corporate debt to GDP should be lowered, capacity has to be expanded and labour productivity needs to be raised. Firms have to be in better shape and invest in productive activities while new firms have to enter credit markets.

Firms will fail in their businesses for a variety of reasons. Bankruptcy law will provide a mechanism for an orderly settlement of obligations. Bankruptcy separates bad managers from potentially valuable assets, lifts debts from shoulders that cannot support them and preserve value that alternatives such as liquidation might destroy.

(d) <u>Infrastructure Financing:</u>

The traditional mode of financing infrastructure projects only through Public Sector Development Programme has resulted in congestions, shortages and bottlenecks. The experiment with the independent power producer types of arrangements in the private sector has not proved satisfactory from the viewpoint of the consumer. We have, therefore, to find some other ways of fostering private-public partnership in the areas of infrastructure development, and like other countries, the banks and capital markets have to take the lead. You should look at the successful experiences in other emerging markets and adapt them to our conditions. The State Bank of Pakistan (SBP) is prepared to work with you and we plan to hold a conference next year in which we will bring all the stakeholders together to ponder over this issue and come up with some practical course of action.

(e) <u>E-Banking:</u>

It is gratifying to note that a lot of progress has been made in establishing the platform for Electronic banking. With the deregulation of telecommmunication sector in Pakistan, the opportunities for further value added services to underpin banking transactions have multiplied manifold. While small and medium banks can now offer on-line services to their customers, the large banks have to move more expeditiously so that the E-

Banking network can be utilized optimally. Transaction costs will become lower and customer service will improve. A variety of new services can then be offered. Our ATM penetration ratio is still quite low and we should expand ATMs more aggressively while maintaining them in good stead.

(f) Private Equity, Pension and Provident Funds:

There is still a mismatch between the growing appetite of institutional and contractual saving institutions for long term investment vehicles and the demand for long gestation mortgage, infrastructure, real estate and project financing. Private equity and venture capital funds, private pension and provident funds and insurance companies can play an important role in filling in this market segment. I would very much urge those who are always so keen to obtain a traditional banking licence to exploit the vast potential by setting up these new types of funds which are almost non existent in the country but are badly needed. I can assure you, on the part of the SECP and SBP, that we will render all possible assistance to those who wish to move into the fields of private equity funds, venture capital funds, private pension and provident funds, real estate investment trusts and similar other vehicles.

(g) Investment Banking:

The role of investment banking in Pakistan has remained quite murky so far. The spread of universal banking model in the country has led to a certain degree of ambiguity as far as the market niche in which investment banks can operate. In my view, the corporates will always require investment banks to render services such as investment advisory, corporate restructuring, distressed assets acquisition and disposal, mergers and acquisitions, equity and debt financing. The investment banks have to get away from their aspiration to mimic commercial banks and build up their capabilities in the areas, which are begging for help. Commercial banks will never be able to compete with them either on costs or customer satisfaction even if they all profess that they can provide total banking solutions to all the clients needs.

Several investment banks have merged into commercial banks but those who are serious players in this field should re-examine their strategies and direction and build up their human resource capabilities.

(h) Human Resource Development:

I wish to thank all the Chief Executives of banks who have put in place transparent and merit based system of recruitment of entry-level bankers. The next step in this value chain of human resource development is the continuing education, training, testing and progression of in-service employees and identification of future managers of the financial industry. Recently, I had a very productive meeting with the Human Resource Heads of some of your institutions at the IBP and we have agreed that this area needs your personal attention and commitment. We, at the SBP, have gained some experience in this endeavour and we are willing to share that with you. The IBP has been given a much larger mandate, the NIBAF facilities have been opened up to the whole industry and the five large banks have offered to upgrade the quality of their training institutions which can then be available to other banks, leasing companies, etc. I attach a lot of importance to this particular area of work and I will take personal interest in developing a cadre of professional bankers in Pakistan who are of international standards and can move into multinational banks without much difficulty.

(i) Risk Management:

The advent of Basle II regime in a couple of years imposes a sense of urgency on both the regulators as well as the financial industry to put their act together as far as risk management is concerned. I have very little doubt that the foreign banks operating in Pakistan will have any serious problems in making the transition successfully but I remain very much worried about our domestic banks – large, medium and small. Although we all have been talking about Basle II for sometime, our response in preparing ourselves have been at best patchy. The SBP has installed capacity for risk management within the institution and we intend to keep on expanding this capacity but I see that our large banks have not yet woken up to attract the human resource of the right kind, set up the internal rating systems and the supporting technology. We have started the training courses in real earnest and I have asked the IBP to give priority to this area but we need trainable material from the banks. I hope that the Pakistan Banks Association (PBA) will form an internal working group to bring their member institutions to reach minimum standards by certain timelines.

(j) <u>Promotion of Islamic Banking:</u>

I have been very much encouraged by the enthusiastic response to the setting up of Islamic banks and branches in the country. This is an extremely positive development as it brings into the fold of formal financial sector those who have remained outside because of their faith and beliefs. From my interactions, I can tell you that their numbers are in millions and not in hundreds of thousands. That is why we have a highly liberal licencing policy for opening Islamic banks, subsidiaries or branches. But I must caution you that we do not wish to transform this into another façade by moving too quickly and too imprudently. You should have all the ingredients in place – Shariah Advisors and Auditors, credit appraisers and marketing specialists, product development capacity, systems and technology – before you approach the SBP. Merry-go-around a few experienced individuals in this field by offering them attractive compensation packages will soon out price Islamic banking products from the market. This is not in our long-term interest that such kind of reckless actions put the future of Islamic banking in Pakistan at risk.

Ladies and gentlemen, there are many more tasks we have to do but I thought if I had too many items on the platter it would not be possible for us to manage it within the timeframe of the next five years. But, as I said earlier, these are only some proposals and suggestions for your consideration, critical review and scrutiny. You may have some other priorities in mind which may make better sense. Please feel free to articulate them as I do not have any pretensions of having monopoly on wisdom.

My purpose is to initiate discussion, debate and dialogue as to what we ought to be doing together in the next five years. I hope that all of you will come back to me with your feedback and ideas and then we can arrive at a consensual roadmap.

In the end, I wish to thank each one of you for your support, cooperation and assistance to my colleagues at the State Bank of Pakistan and myself. Without your active collaboration we could not have achieved what we have done so far and we look forward to even better relationships in the future to meet these difficult challenges together.