Special Section 2: Regulating Pro-Actively: The Case of Minimum Capital Requirements (MCR)[1]

To strengthen solvency of individual banks, the State Bank of Pakistan (SBP) announced increases in the Minimum Capital Requirements (MCR) for banks and DFIs in September 2008. Banks were required to gradually increase in phases, their minimum paid up capital (net of losses) to Rs 23.0 billion by end-December 2013 (see **Table SS2.1**). The Capital Adequacy Ratio (CAR) was also revised upward from earlier 8 percent to 10 percent. All banks and DFIs were advised to achieve this new level of CAR by end-December 2008. Besides these measures, the SBP also introduced variable CAR for banks and DFIs based on their CAMELS-S Rating assigned by the SBP.

These changes in MCR were followed by two key developments: (1) persisting turmoil in global financial system evolved to full-fledged solvency crises as a number of age-old investment banks collapsed; and (2) domestic economy started signaling visible slowdown from initial months of the FY09. The sharp deterioration in domestic macroeconomic environment forced the government to enter into a Stand-By Arrangements with the IMF by November 2008 to implement a macroeconomic stabilization program. Slowdown in economic activities is visible from the projected GDP growth of 2.0-3.0 percent for the year FY09 as against 5.8 percent for the year FY08.

Table SS2.1: Minimum Capital Requirements

billion Rupees

Dead line	Minimum Paid up Capital (net of losses)	
	Previous*	Revised**
31-12-2008	5.0	5.0
31-12-2009	6.0	6.0
31-12-2010	10.0	7.0
31-12-2011	15.0	8.0
31-12-2012	19.0	9.0
31-12-2013	23.0	10.0

* BSD Circular No. 19 dated September 2008.

** BSD Circular No. 07 dated April 2009.

Although banking sector of Pakistan remained largely immune to the direct impact of adverse developments in global financial system, the indirect impact stemming from trade linkages and difficulties in accessing international financial markets entail negative implications for the overall performance of the banking system. These international developments along with heightened uncertainty in the domestic capital markets on account of 'war on terror' and slowdown in economic activities highlight difficulties in accessing domestic capital markets.

[1] The ownership of this section is with the Research Department.

In such an environment, economic managers have to make an educated judgment on the MCRs. Such judgments are especially relevant in the context of emerging market, such as Pakistan, where financial markets are, and remain, incomplete, and the risk of large corporations exploiting this incompleteness is high. One such judgmental call by the SBP is the revision of the recently announced increase in future Minimum Paid up Capital (free of losses) requirements for banks (see **Table SS2.1**). Specifically, the SBP moved to create: (1) an operating environment where banks can focus on their core business activities; (2) level playing field for all players in the banking sector; and (3) competitive environment by strengthening competition. In this backdrop, we attempt to analyze this decision from all three angles.

Focus on Banking Business

Given the current economic climate, the SBP wants banks to strengthen their business activities so that significant progress made in recent years is consolidated. Specifically, key financial soundness indicators registered significant improvement over the last five years. Slight deterioration in asset quality indicators (NPLs to loan ratio and provisions to NPLs ratio) during CY08 is a reflection of weak economic environment (see **Table SS2.2**). Despite increase in net NPLs to capital ratio during CY08, the banking sector is well positioned to absorb these losses as net NPLs to capital ratio is still 13.6 percent only. Strong capital adequacy along with profitability indicators show, that banking sector is well positioned to withstand losses stemming from of weak economic environment. Improvement in economic indicators in the recent months due to implementation of macroeconomic stabilization with the help of IMF is a welcome development.

Table SS2.2: Financial Soundness Indicators

percent

	CY00	CY01	CY02	CY03	CY04	CY05	CY06	CY07	CY08*
CAR**	9.7	8.8	8.8	8.5	10.5	11.3	12.5	13.2	12.2
Tier 1 Capital to RWA	8.3	7.3	6.2	6.5	7.6	8.3	9.9	10.5	10.2
NPLs to Loan Ratio	23.5	23.4	21.8	17.0	11.6	8.3	6.9	7.2	9.1
Provisions to NPLs	55.0	54.7	60.6	63.9	70.4	76.8	77.9	85.1	74.7
Net NPLs to Capital Ratio	131.3	150.5	85.5	54.4	29.2	14.1	9.7	5.6	13.6
ROA(after tax)	-0.2	-0.5	0.1	1.0	1.2	1.8	2.1	1.5	1.2
ROE (after tax)	-3.5	-12.6	3.2	20.0	20.3	25.0	24.2	15.5	11.3

* Based on Quarterly data for end December 2008.

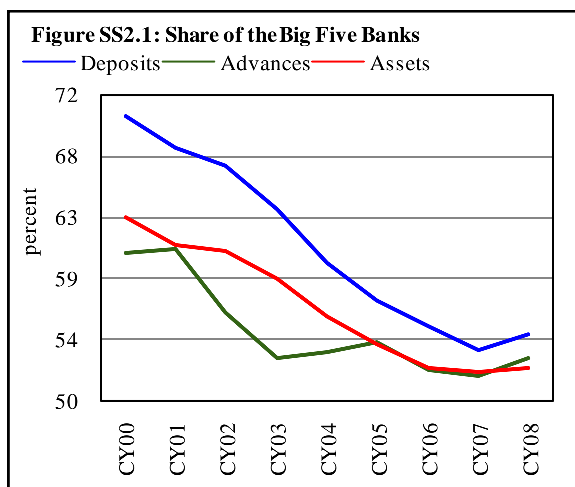
** CAR for CY08 is based on BSEL II framework.

In this backdrop, the regulator has decided to cushion the banking sector achieved progress by revising downwards future MCR-targets so that banks can focus on consolidating their current balance-sheets and worry less about steep rise in future minimum capital requirements. Cyclical increase in NPLs of the banking sector requires close attention of the bank management.

Strengthening Competition in Banking Sector

The SBP has been actively pursuing policies to instill competition in the banking system. Conscious efforts were made to facilitate (1) the emergence of normal size banks (capable to provide meaningful competition to big 5 banks) through mergers and acquisitions; (2) allowing the entry of strong foreign banks; and (3) establishing Islamic Banks parallel to conventional banks are some of the key steps to promote competition and inclusive finance. These initiatives have played an important role in lessening concentration in the banking industry[2] as various measures of concentration have witnessed significant improvement in recent years.

Figure SS2.1: Share of the Big Five Banks



The share of the big five banks in total assets of the banking sector has dropped by 10.8 percentage points since CY00 to 52.4 percent by end CY08 (see **Figure SS2.1**). This loss of market share by these big banks simply reflects the increasing business activities of other banks in the system. The same is also visible from decreasing Herfindahl-Hirschman Index (HHI) and coefficient of variation (see **Table SS2.3**). However, this momentum has somewhat lost its pace since 2005 and the economic downturn of 2008 have further worsened this situation. The decision of downward revision in MCR is likely to bring improvement in the banking competition. Small banks will have an opportunity to create their market niche and provide competition to big banks.

[2] For detail discussion on this issues, please see "Chapter 4: Concentration and Competition in the Banking System" in Financial Stability Review 2007-08.

Table SS2.3: Measures of Concentration

	CY00	CY01	CY02	CY03	CY04	CY05	CY06	CY07	CY08
Herfandahl-Hirschman Index									
Deposits	1,238	1,185	1,130	1,032	946	833	810	785	794
Advances	942	965	852	777	764	772	746	732	742
Assets	1,023	993	973	912	850	762	745	741	736
Coefficient of Variation									
Deposits	2.10	2.05	1.90	1.79	1.63	1.52	1.49	1.45	1.47
Advances	1.77	1.80	1.57	1.47	1.40	1.44	1.40	1.38	1.39
Assets	1.87	1.83	1.72	1.65	1.51	1.42	1.40	1.39	1.39

Source: SBP calculations

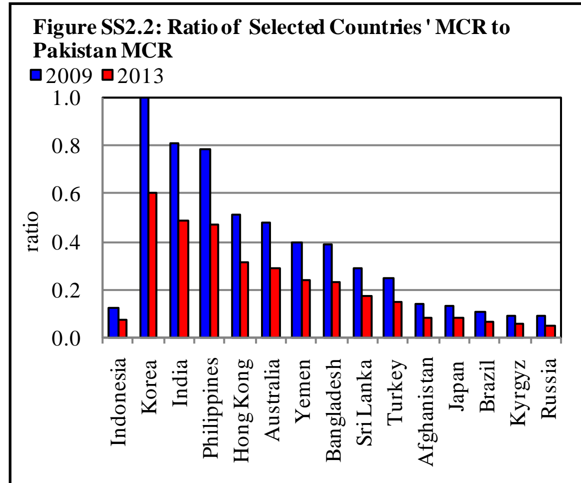
Creating a Level Playing Field

The on-going global financial crises and sharp deterioration in domestic macroeconomic environment during second half of CY08 have significantly changed the incidence of minimum capital requirements for small-medium size banks. Capital accumulation for banks except big five banks has become extremely difficult, especially for small size banks in the wake of losses stemming from cyclical downturn in economic activities, reduced profitability and persisting liquidity strains in international and domestic financial markets. At the same time, capital accumulation needs of the big banks are almost negligible as the net assets of these banks ranges from Rs 22.1 billion to Rs 110.9 billion (end-December 2008 position). It shows that big five banks are well placed to meet current and future MCR targets. In this scenario, the desire and ability of the larger players to acquire smaller ones is high. Anticipating this potential predatory behavior, the SBP has reduced MCR requirements. This decision is expected to reduce excessive burden of capital accumulation for small/medium banks without compromising on capital adequacy of the banks.

The small/medium size banks are in expansion phase as data on number of branches for CY08 indicate that 83.3 percent of new branches were opened by other than big 5 banks. Moreover, the share of the big 5 banks in total no of employees in banking sector has witnessed massive decline of 24.4 percentage points from CY00 to 48.8 percent by end CY08. In other words, the small and medium size banks have attracted larger number of personnel in line with their expanding business activities. The revision is MCR is likely to help small/medium banks to fully bear the fruit by creating level playing field for all players in the banking sector.

Comparing internationally

Finally, the increased minimum capital requirements were likely to put banking sector of Pakistan at disadvantage against the significantly changing regulatory structure of banks around the globe. International comparison of MCR shows that the ratio of selected countries MCR to the MCR for banks in Pakistan is less than one; indicating high capital requirements in Pakistan (see **Figure SS2.2**). The revised MCR are likely to address this problem and provide relatively equal opportunities to domestic banks vis-a-vis other countries. This will further help in mitigating regulatory arbitrage activities in the banking system.



In sum, considering the current economic climate while taking into account the good progress of the banking system over the last seven years, and foreseeing the market behavior during downturns, the SBP's timely decision to reduce minimum capital requirements will help in further expansion in banking activities in Pakistan.