BANKING SECTOR REFORMS [1/]

Current Status and Future Prospects

Pakistan's banking sector has been faced with at least several problems and difficulties. The main problems faced by the sector are:-

(1) Most of the financial assets and deposits are owned by nationalized commercial banks (NCBs) which suffer from a highly bureaucratic approach, overstaffing, unprofitable branches and poor customer service.

(2) NCBs along with specialized banks such as ADBP, IDBP and Development financial institutions such as NDFC have a high ratio of non-performing loans.

(3) Banking industry faces a high tax rate which affects its profitability and attractiveness for new entrants.

(4) There is a proliferation of banks and some of them are undercapitalized, poorly managed with a scanty distribution network.

(5) Agriculture, small and medium enterprises, Housing sectors are underserved and have limited access to credit.

1/ Presidential Address at the Seminar organized by Management Association of Pakistan at Lahore held on August 31, 2002.

(6) Banks have typically focused on trade and corporate financing with a narrow range of products and have not diversified into consumer and mortgage financing for which there is an ample unsatisfied demand.

Despite these problems and difficulties it is fair to say that a lot of progress has been made to improve the health and soundness of the banking sector in recent years. Although a lot more needs to be done and there are few weak and vulnerable institutions the banking sector in Pakistan is much stronger today compared to five years ago or in comparison to other countries in the region. What are the factors responsible for this improvement? A large number of reforms have either been undertaken or under way.

First, the nationalized commercial banks are being privatized and their domination of the banking sector is likely to be reduced from almost 100 percent in 1991 to about 20 percent by December 2002. Muslim Commercial Bank and Allied Bank have already been privatized. The final bidding for United Bank is scheduled for next week. The short list for Habib Bank has been finalized and the plans are for completion of privatization by October 2002. Ten percent of shares of National Bank have been floated through Stock Market and another ten percent will be offered in near future for small retail investors.

Second, strong corporate governance is absolutely essential if the banks have to operate in a transparent manner and protect the depositors' interests. The

SBP has taken several measures in the last two years to put in place good governance practices to improve internal controls and bring about a change in the organizational culture. The salient features of this structure are:

(a) Banking license of one of the commercial banks which was found fulfilling in meeting the prudential rules and norms was cancelled for the first time in the history of Pakistan.

(b) Ownership and management were changed at another commercial bank which had committed breach through unauthorized transfer of funds from the bank to associated companies.

(c) The appointments of Board members and Chief Executive Officers of all banks have to be screened so that they meet the fit and proper test prescribed by the SBP.

(d) Family representation on the Board of Directors of the banks where they hold majority ownership has been limited to 25 percent of the total membership of the Board.

(e) To avoid possible conflict of interest and use of insider information the Directors, executives and traders working in Brokerage companies will no longer serve on the Boards of Directors of the banks.

(f) External auditors are evaluated annually and classified in various categories based on their performance and other prescribed criteria. Two large audit firms were debarred from auditing the banks and only after showing improvement in their performance placed in a category lower than they originally belonged to.

(g) A detailed set of guidelines for the Board of Directors to effectively oversee the management of the banks and develop policies has been issued.

Third, capital requirements of the banking sector are adequate in relation to the risk weighted assets and conform to the Basle accord. To further strengthen their competitive ability, both domestically and internationally and to encourage the economies of scale, the minimum paid-up capital requirements of the banks have been raised. The banks are required to increase their paid-up capital from Rs 500 million to Rs 1 billion by 1st January 2003 failing which the bank will be converted into a non-scheduled bank with restricted activities. The banks have been authorized to issue Term Finance Certificates (TFCs) as subordinated debt to raise their capital.

Fourth, the stock of non-performing loans (NPLs) is being tackled in several ways. Although gross NPLs amount to Rs 260 billion and account for 25 percent of the advances of the banking system and DFIs there has been aggressive provisioning carried out during the last three years. Almost 56 percent of the NPLs are fully provided for and net NPLs to total advances ratio has thus declined to 11 percent. Efforts are being made to further reduce this ratio through the active involvement of Corporate Industrial Restructuring Corporation (CIRC) and the Committee on Revival of Sick Units (CRSU). While the CRSU attempts to bring about financial restructuring with the help of banks and existing owners the CIRC auctions the units to general public divesting the ownership from the existing shareholders. Further guidelines to write off NPLs are being developed to enable them to get rid of the old stuck-up loans.

Fifth, the State Bank has removed restrictions imposed on nationalized commercial banks for consumer financing. The positive experience of auto financing gives a lot of hope that the middle class of this country will be able to access consumer durables through banks. This will at the same time boost the manufacturing of TVs, air-conditioners, VCRs, washing and drying machines, deep freezers etc. in the country.

Sixth, a number of incentives have been provided to encourage mortgage financing by the banks. The upper limit has been raised from Rs 500,000 to Rs 5 million. Tax deduction on interest payments on mortgage have been allowed upto a ceiling of Rs. 100,000. The new recovery law is also aimed at expediting repossession of property by the banks. The banks have been allowed to raise long term funds through rated and listed debt instruments like TFCs to match their long term mortgage assets with their liabilities.

Seventh, legal difficulties and time delays in recovery of defaulted laws have been removed through a new ordinance i.e. The Financial Institutions (Recovery of Finances) Ordinance, 2001. The new recovery laws ensures expeditious recovery of stuck up loans by the right of foreclosure and sale of mortgaged property with or without intervention of court and automatic transfer of case to execution court.

Eighth, the prudential regulations in force are mainly aimed at corporate and business financing. The SBP is working with the Pakistan Banking Association to develop a new set of regulations which can cater to the specific needs of consumer and SME financing. The new prudential regulations will enable the banks to expand their scope of lending and customer outreach.

Ninth, to provide widespread access to small borrowers particularly in the rural areas the licensing and regulatory environment for Micro Credit and Rural financial institutions have been relaxed and unlike the commercial banks these can be set up at district, provincial and national levels with varying capital requirements. There is less stringency and more facilitative thrust embedded in the prudential regulations designed for this type of institutions. Khushali Bank and the First Microfinance Bank in the private sector have already started working under this new regulatory environment.

Tenth, the access of small and medium entrepreneurs to credit has been a major constraint to expansion of their business and upgradation of their technology. A Small and Medium Enterprise (SME) Bank has been established to provide leadership in developing new products such as program lending, new credit appraisal and documentation techniques, and nurturing new skills in SME lending which can then be replicated and transferred to other banks in the country. Program lending, for example, can help upgradation of power looms to shuttle-less looms in Faisalabad area and contribute to the achievement of goal set under Textile Vision 2005.

Eleventh, the corporate tax rates on banks were exorbitantly high in Pakistan thus adversely affecting their profitability and attractiveness as an avenue for investment and new equity injection. The Government has already reduced the tax rate from 55 percent to 47 percent during the last two years and it is envisaged that the rate will be reduced gradually and brought at par with the corporate tax rate of 35 percent in the next three years. This will in turn help in reducing the spread between the deposit rate and lending rate and benefit financial savers.

Twelfth, a complete revamping of Agriculture Credit Scheme has been done recently with the help of commercial banks. The scope of the Scheme which was limited to production loans for inputs has been broadened to the whole value chain of agriculture sector. We have, with the grace of Allah, become a surplus country in foodgrains, livestock etc. and thus the needs of agriculture sector have also expanded. The SBP has included financing for silos, godowns, refrigerated vans, agro processing and distribution under the cover of this scheme. This broadening of the scope as well the removal of other restrictions have enabled the commercial banks to increase their lending for agriculture by 24 percent in fiscal year 2001-02 for the first time. Unlike the previous years when they were prepared to pay penalties for under performance they have set up higher targets for this year. The private commercial banks have also agreed to step in and increase their lending to agriculture.

Thirteenth, the banks are being encouraged to move towards Electronic banking. There is a big surge among the banks including NCBs to upgrade their technology and on-line banking services. During the last two years there has been a large expansion in the ATMs throughout the country. The recent decision mandating the banks to join one of either two ATM switches available in the country will provide a further boost. Progress in creating automated or on-line branches of banks has been quite significant so far and it is expected that by 2004 a majority of the bank branches will be on-line or automated. Utility bill payment and remittances would be handled through ATMs, Kiosks or Personal Computers reducing both time and cost. Investment in information technology is being undertaken by the banks to enhance efficiency, reduce transaction costs and promote E-Commerce. It has been estimated that a banking transaction through ATM costs one fourth as much a transaction conducted over the counter in a traditional branch – and the similar transaction over the internet costs a mere 1% of the traditional teller costs.

Fourteenth, the banks have recently embarked on merit based recruitment to built up their human resource base – an area which has been neglected so far. The private banks have taken lead in this respect by holding competitive examinations, interviews and selecting the most qualified candidates. The era of appointment on the basis of sifarish and nepotism has come to an end. This new generation of bankers will usher in a culture of professionalism and rigour in the banking industry and produce bankers of stature who will provide the leadership in the future.

Fifteenth, to facilitate the depositors to make informed judgments about placing their savings with the banks, it has been made mandatory for all banks to get themselves evaluation by credit rating agencies. These ratings are then disclosed to the general public by the SBP and also disseminated to the Chambers of Commerce and Trade bodies. Such public disclosure will allow the depositors to choose between various banks. For example, those who wish to get higher return may opt for banks with B or C rating. But those who want to play safe may decide to stick with only AAA or AA rated banks.

Finally, the country's payment system infrastructure is being strengthened to provide convenience in transfer of payments to the customers. The Real-Time Gross Settlement (RTGS) system will process large value and critical transactions on real time while electronic clearing systems will be established in all cities.

These reforms will go a long way in further strengthening the Banking sector but a vigilant supervisory regime by the State Bank will help steer the future direction.