Financial Sector – Ten Year Vision and Strategy
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(Abridged Version)

Honorable Prime Minister, Governor and Chief Minister, Sindh and Federal Ministers, Presidents of banks and chamber of industry and commerce, heads of corporate and other industrial organizations, other distinguished guests and my fellow colleagues of SBP, Assalam o Alekum.

Mr. Prime Minister we are honored to have you here amongst us to commemorate the 60th anniversary of SBP and to visit our Treasury operations area to launch the Pakistan Real Time Gross Settlement System -- a project that will settle on real time basis large value transaction and reduce the settlement risks.

On this special occasion, taking advantage of your presence, I would like to launch and share with the audience the ten year vision and strategy for Pakistan's financial sector. This vision that we are articulating, will take forward the banking sector to new heights, building on the outstanding performance of the sector in a short span of 4-5 years.

Within the region, Pakistan's banking sector stands out for its profitability (that has enabled it to contribute significantly to revenue generation for the FBR), for its low nonperforming loans and good corporate governance. As a central bank and regulator, SBP has earned respect and credibility in steering forward the reforms process and ensuring effective enforcement of regulations and supervision.

These achievements are impressive, however, there is need to position financial markets to :

- Better serve a large segment of population and geography and the growing demands for investment and infrastructure,
- Address the exposure associated with the emergence of financial conglomeration in the country that poses a systemic risk to banks, and
- Diversify financial markets by launching reforms of securities and debt markets, as well as the insurance and pension sectors,
- Within the region, Pakistan's financial system, despite its growth is still small relative to the Asian emerging financial markets that are twice or three times larger, and the Gulf States.

The objective of the financial sector strategy will be to broaden and deepen the financial system to help Pakistan to :

(i) Achieve higher and sustainable economic growth,
(ii) Develop a dynamic, robust and stronger system,

(iii) Mobilize the domestic and foreign resources for private investment (which has to be the key driver of the economy), and

(iv) Deepen financial penetration for the poor and underserved regions.

Prerequisite for financial sector growth however, is macroeconomic and political stability and augmentation of the enabling policy environment in the real sector. Assuming these preconditions are restored, the ten year strategy will stimulate sharper growth in financial assets and aim to double the private sector credit/GDP ratio. The strategy would be financially inclusive, supporting the small savers and meeting the requirements of small borrowers in the agriculture, housing, SME and microfinance sectors. It would aim to modernize the wholesale and retail markets and reduce the systemic risks of the financial system by developing an adequate safety net for the small depositors, while reforming the regulatory architecture to ensure that the central bank can play an effective regulatory and supervisory role.

No reforms are complete without also ensuring further strengthening of the central bank. In this context, SBP has launched worked to modernize the central bank legislation in line with the international best practices. Ours is one of the oldest laws in the world and as such it includes some outdated provisions, even though the law has served the central bank well in delivering several of its function, with a fair degree of autonomy under the oversight of its Central Board of Directors. At the same time, there is the need to launch comprehensive legislative reforms which would put in place an adequate framework for Consumer Protection, prevention of Financial Crimes, Financial Safety Nets and Lender of Last Resort Functions etc. that now have been adopted by most developed and developing countries.

Let me now share with you the major areas of reforms envisaged in the financial sector strategy. The strategy advocates:

(i) Adoption of a holistic financial inclusion program which is quite far reaching both in its depth and breadth. Recognizing how underserved people and the regions of Pakistan are by financial markets, SBP has advocated commercialization of the microfinance industry which will help provide financially and socially sustainable financial services. Under this program, effort will be made to enhance outreach to initially 3 million people relative to fewer than one million a year back, with the ultimate goal being to raise it to 10 million. In the same vein, SBP is steering the Islamic finance industry to also deepen financial penetration to serve the requirements of that segment of the population and industry which has excluded itself from accessing the financial services industry for faith reasons. SBP is planning to launch several initiatives to enhance SME financing and such initiatives include, among others, development of credit scoring, credit enhancement mechanisms, innovative products and modalities etc. The plan is also to meet 75-80% of agriculture requirements relative to 45% and SBP is steering several initiatives ranging from crop loan insurance to offering guidelines for financing livestock, fisheries and horticulture etc.

(ii) Strengthening consumer protection and financial education. Under this rubric, SBP plans to introduce a Consumer Protection Bill, requires PBA to adopt a Banking Code to commit banks to fair practices, disclosure and ethical standards, while nurturing competitive pricing of products, strengthen the Consumer Protection Department which was recently established in SBP, transforming banking sector ombudsman, introduce the small depositor protection scheme and launch a campaign of financial literacy.

(iii) Consolidating and strengthening the banking sector by promoting continued mergers and acquisitions, while seeking to restructure the outstanding public financial institutions. To promote consolidation, SBP will maintain its moratorium on new licenses, but will, on exceptional basis, issue licenses with capital requirements of $300 million – both existing conventional and Islamic banks will need to comply with these requirements over an agreed timetable. Licenses for Microfinance banks will continue, but will be confined to the national and provincial levels only.

(iv) Strengthening competition and efficiency. Among others, SBP will be seeking for removal of structural distortions facing the banking sector that have resulted in a suboptimal pricing regime for the depositors and borrowers. A major competitive force for banks would be to involve in a financial sector-wide campaign, to stimulate further equity and debt market reform, so that banks compete effectively with their competitor institutions.

(v) Strengthening prudential regulation and supervision – while reputable experts have confirmed the adequacy of the regulatory regime, there is in my view, a need for debate and reflection of an adequate balance to be struck between a rule- versus principle-based regulatory regime – but ultimately it's the right enforcement which will ensure that this regime is respected. In line with the global trend, SBP has launched Basel II implementation which requires banks to align their capital with the risks taken. Requirement of capital would be lowered only if banks work with the corporate sector to seek appropriate external ratings or credit scoring mechanisms. On its part, the central bank is launching a project to use e-CIB to develop an industry-wide scoring system based on credit history as captured by e-CIB.

(vi) Commercial banks now have de facto moved into a conglomerate structure with or without a holding companies framework. By and large banks have acquired stakes in Non-Banking Finance institutions including insurance, brokerage, financial advisory services etc. Financial conglomerates present a major regulatory and supervisory challenge, as such structures are prone to contagion risk.

(vii) To address these concerns, there is need to reconsider the regulatory architecture. Our current regulatory architecture is not well suited for consolidated supervision and no agency has powers to oversee both the financial and nonfinancial conglomerates. SBP proposes to transfer all deposit and lending institutions for oversight to SBP, and to entrust it with the responsibility of lead supervisor for consolidated supervision. This has been a major omission in financial sector laws and regulations.

(viii) Developing a financial safety net framework, which would entail the introduction of a small depositor protection scheme, empowering the central bank with lender of last resort functions and developing an appropriate bank exit framework. It is critical that all these schemes are developed in line with international best practices and avoiding the associated moral hazard consequences.

(ix) Development of core financial infrastructure is critical, which ranges from the development of the RTGS and retail payment system, to credit rating agencies, land and property registries and the judicial system.

In conclusion, Mr. Prime Minister, we count on your personal as well as your Governments' and Legislature's strong commitment and support to implement the vision and direction articulated in the financial sector strategy. Let me assure you that an effective governance of the regulator can catalyze strong reforms in the economy and the agenda we have laid out for your consideration, on which more elaborate discussions will follow, and will out rightly pave the way for a vibrant, healthy and dynamic banking sector which is key to supporting the broadening and deepening of financial markets that will serve well our large population and lift the poor out of the poverty trap, as well as meet the growing requirements of the economy. To deliver a substantive agenda like this will help restore international and domestic investor confidence in the democratic Government and the economy.