Financial Sector of Pakistan – The Roadmap

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The financial system in Pakistan has grown substantially, benefiting from multi-pronged financial reforms. These reforms have been pursued persistently and vigorously over a decade or so and have supported economic growth. The inefficiencies and weaknesses, which were typical of banks' operations in the pre-reforms era, have been reduced radically. We have now started to realize the dividends of reforms in the form of a healthier, sounder and stronger banking system. Liberalization and deregulation, core pillars of the reform measures, have served to enhance the size of the banking system both in terms of the number of banks and growth in credit, besides instilling a degree of competition in the banking industry.

However, the task of financial sector reforms is far from accomplished. Given the changing dynamics of the economy and its growing complexities and accompanying associated risks, the financial industry has to remain responsive and supportive of the broader economic ambitions and agenda. The country can neither afford slippages nor can we visualize the future dispensation of the banking system of Pakistan. All the major players and stakeholders in the banking system will have to strive for continuity, broadening and deepening of reforms, build and sustain the already implemented reforms and fill the remaining fissures. The growing competition along with increasingly diversified services, both across the regions and sectors, and improved access to customer-base on the back of progressive reliance on technology, are the harbingers of the changing and efficient intermediation role of banks in the days ahead.

In order to develop the future outlook, I will now examine both the emerging domestic and external trends, which potentially impact the future financial sector architecture: its structure, texture and the operations of financial institutions. In this respect, eight factors are generally believed to have been the major drivers of change in the financial industry the world over. They include:

1) Macroeconomic performance and priorities
2) Deregulation and market forces
3) Product innovation
4) Globalization
5) Technological advancements
6) Universal banking
7) Risk Management and Mitigation
8) Changing Role of and demands on the Regulator

These forces, to a varying degree, will play a more dominant role in shaping the future complexion of the financial sector and its institutions and entail far reaching implications in terms of stimulating increased competition, greater consolidation, increased diversification and enhanced dynamism in the financial players and markets. The central bank, along with major players in the market, will continue to develop and refine the mutual vision and plan for the financial system of Pakistan. All key players will have to correspondingly position themselves, change their attitudes, and be responsive to collectively transform the financial system of Pakistan

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into a dynamic and efficient arm of the economy. This can be attained if the financial system meets the divergent needs of all segments of the economy by providing a wide array of financial services based on the use of globally competitive technology, highly skilled human resources and harnessing global best practices. Equally critical for regulators, are the aspects of the stability and robustness of the financial system and as such there will have to be further refinements in the domestic regulatory and supervisory framework to align it more closely with international standards, while taking due notice of the attendant and emerging global and domestic challenge and risks.

I will now elaborate on the forces and factors which might be directly or indirectly related to the future performance and standing of the financial system of Pakistan.

Macroeconomic performance and Priorities

Financial system of any country has an intrinsic relationship and needs to be shaped in accordance with the broader economic needs, structure and policies. Considering this interdependence, it is imperative to assess the behavior and trends of the key macroeconomic indicators while drawing the emerging contours of the financial system. In this respect, the major indicators of the economy during the last few years have shown robust performance. GDP growth shot up to over 8 percent in FY05 and the current year also promises higher than 6 percent growth. Undoubtedly, consistent and stable economic policies provided the businesses with confidence. However, easy availability of funds on the back of historically low level of interest rates proved to be the real catalyst for the subsequent sharp growth in credit to the manufacturing sector and eventually proved to be the real determinant of high GDP growth. Strong credit demand of the manufacturing sector translated into a sharp increase in the interest income of the banking system, giving rise to unprecedented profits and healthier balance sheets during the last two years. Redeployment of these profits to augment financial services will help meet the growing economic requirements.

The near term economic prospects are promising. The continued strong pace of economic activities, and plans to launch widespread infrastructure reforms offer strong business prospects for the financial sector. Real interest rates remain at tolerable limits. Notwithstanding, there will be demand pressures in particular if the trade deficit grows out of proportion and inflationary tendencies continue to persist. A consequent fall in demand for credit or a possible impairment of the debt repayment capacity of borrowers does carry the risk of reversing the current gains enjoyed by the banking system. But these risks are being well managed and if the economy continues the growth momentum for the next decade or so, the financial system of Pakistan is expected to reap benefits out of rising incomes, consumption and emerging investment demands.

Traditionally, infrastructure projects fell in the public sector’s domain of activities. However, recent years have seen a paradigm shift in this area, with the growing interest of the private sector to undertake such projects. There exists immense potential for the financial institutions to finance such infrastructure projects built on public-private partnerships or even exclusively in the private sector. This will help diversify their activities as well as enhance their earnings. Similarly, financial institutions can take advantage of the changing demographic patterns, rising incomes and enhancement of policy priorities for various sectors. These trends are already visible as reflected by the increasing proportion of urban population, rising literacy rates, and the increasing share of the industrial and services sectors in GDP.

The financing to SME, Agriculture, and Micro finance segments of the economy carries special importance with respect to future economic growth and diversification of banks' loan portfolios. The State Bank will accord further priority to improving access of development finance to these segments and will work with the provincial and local governments to facilitate a conducive environment, and supportive financial and legal infrastructure to give impetus to economic growth and poverty alleviation. The banks will have to strengthen their systems to meet the challenges and opportunities arising out of their venture into these segments.

Deregulation, Market Forces and Consolidation

The spate of liberalization and deregulation measures in recent years has unleashed strong forces of competition. These are fast defining the future course of Pakistan's financial sector. Emerging role of the private sector has displaced the public sector from its dominant position, giving rise to aggressive competition across the market operators, and the market pressure by the stakeholders to perform is going to result in fiercer competition. This is expected to change the business landscape and chemistry of the competition as market players will have to use fresh thinking on financial products and the structure of the market, and focus on value creation to survive.

The stiffening licensing policy and regulatory capital requirements are already posing a great challenge to the small banks, and with gradual enhancement of the minimum capital requirements in the coming years, they will have to either inject more capital to become compliant or amalgamate with other financial institutions, or as a last option, exit the market. The current trend depicts that new entrants, only allowed by way of strategic partnership in existing banks and/or new Islamic banks, are coming in with higher capital. More so, consolidation of financial institutions is well underway and is likely to lead to the emergence of fewer but stronger institutions to meet the challenges of the increasingly complicated financial environment of the future. The competitive environment might also force financial institutions to specialize in offering certain types of services based on their respective expertise and market niches.

Product Innovation

In a sharp contrast to international trends, the financial system of Pakistan has been lacking in developing innovative products to meet the diversified needs of different customers. However, the emerging financial scenario characterized by intense competition leaves little room for complacency in developing new and attractive products on both the asset and liability sides. Product innovation and developing brand loyalty by creating specialized products will decide the volumes of business and market shares in the future. Presently, the absence of specialized liability products is most conspicuous. The growing awareness among investors and the expected development of other avenues of funds' deployment e.g. the long term fixed income and mutual funds market provide attractive alternatives. Thus the financial institutions which take initiative of these kinds are likely to grab greater market share of funds in the future.

Ideally, greater liberalization with ensuing competition should have led to a narrowing down of spreads. However, in case of Pakistan, there appears to exist a somewhat paradoxical situation, where banks are able to widen their spreads mainly because they enjoy comparative advantage in offering unique banking services, primarily because of the almost non-existent competition from non-bank finance companies and a dormant institutional finance industry as pension and insurance sector reforms have yet to catch up with other financial sector reforms. However, the future promises emergence of competitive non-bank companies which offer alternative sources of investments. And banks will need to generate fee-based income to fill the gap created by declining interest incomes.

Pakistan's market has a huge room for the development of derivatives and synthetic products. The growing financial engineering of services and products requires greater attention to the hedging of risks. Financial institutions need to increase their role as risk managers to corporate and other entities by offering a variety of derivative products.

Financial institutions are also expected to employ processes and practices, which could help them to become more cost effective and efficient. Certain traditional services might also be outsourced to gain efficiency and focus on core areas as competition might not be the only rule of the game. The financial institutions might also cooperate in offering certain types of services. Presently, this is reflected in the networking of ATMs. This co-optation is expected to become the order of the day as banks seek to enlarge their customer base and at the same time realize cost reduction and greater efficiency.

Globalization

With the falling barriers to capital mobility and opening up of financial services in the wake of WTO, globalization of financial services is expected to accelerate in coming days. As the financial institutions gains size, competitive edge and develop their systems at par with the global practices, it would be profitable to seek greater opportunities offered by the large financial markets around the globe. Particularly, opportunities in emerging and regional future economic power hubs are bright. Moreover, higher trade activities are also likely to give boost to banks' role in forex business and their support to corporate customers to expand their business across the borders.

So far, Pakistani banks have performed fairly well against the foreign banks operating in the country. Lately, under the intense competition put up by the local banks due to significant improvement in their processes, foreign banks have been on the retreat even in the areas where they used to enjoy virtual monopoly. However, with the increasing trade volumes in relation to GDP and growing overseas business opportunities for Pakistani corporates, as well as increasing capital flows, the large foreign banks would find considerable scope to capitalize on their expertise due to their established global position and awareness of different markets around the world.

Technology

Technology helps to catalyze efficiency in the provision of financial services and ultimately in determining the winners in the intensely competitive financial markets of the future. Technological breakthroughs have forced fundamental changes in the financial industry: strategic business plans have taken into account new ways of doing businesses, launching e-banking, and using information and technology for developing better internal controls, more sophisticated risk management systems and better and convenient customer services. Hence it is critical that Pakistan's financial industry adopts an appropriate organizational model that supports a customer-centric approach and reengineers business processes to exploit technology to derive economies of scale and create cost efficiencies.

The use of ATMs and e-banking products is gaining currency and almost all banks have established networking of their ATMs with the interconnectivity of switches. Better outreach offered by ATMs will enhance the customer base and offer more alternatives and choices to customers. Further development on e-banking and internet banking will open up new avenues like on-line banking. Among others, the relatively smaller size banks will be able to compete with the large banks and retain their market presence by using technology more effectively.

Technology tends to have a high degree of obsolescence. Thus, the financial institutions will have to invest heavily in the development of their IT systems, which might initially burden their resources. For this purpose, the financial industry will have to optimize its resources for technology applications. The immediate solution might lie in sharing of facilities. Banks in Pakistan are already cooperating extensively in using ATMs services. The future areas of cooperation might involve payment and settlement, back-office processing, data warehousing etc. At the same time, financial institutions will also have to raise adequate safeguards to deal with the associated operational risks. This would invite special focus of their management in the future.

Universal banking

Universal banking has gained sharp acceptance as traditional boundaries of financial service provision have become blurred. In addition to their conventional commercial banking services, banks have withdrawn from specialization to offering a broad menu of services. This presents the banks with opportunities as well as challenges and requires constant development of their expertise in the new areas of their operations.

The idea of universal banking, which is still evolving in Pakistan, is likely to galvanize the non-banking financial sector in developing competitive products and use modern technology to secure themselves against banks making inroads into their traditional areas of operations. This is likely to give further impetus to competition in the financial sector for the provision of quality financial services.

At the same time this might catalyze mergers among banks and non-bank financial institutions for their mutual survival. This trend may lead logically to promoting the concept of a financial super market chain, making available all types of credit and non-fund facilities under one roof or in terms of specialized subsidiaries under one over-arching organization. Consolidated accounting and supervisory techniques would have to evolve and appropriate firewalls built to address the risks underlying such large organizations and banking conglomerates.

Risk Management

The above-mentioned forces of change have significantly increased the importance of strengthening the risk-management practices of the financial system. With the proliferation of new techniques and financial institutions venturing into new areas, a whole range of market related risks have surfaced. This will render the traditional risk-management techniques obsolete as new derivative products and off-balance sheet operations become more common. The hitherto neglected area of operational risk management has also come to assume greater importance and the pervasive use of technology has multiplied the importance of managing this risk in tomorrow's more volatile banking environment. The financial institutions now have to have enough paraphernalia to tackle these risks in line with the international best practices. In this respect, risk-management tools built upon the latest technology would provide the financial institutions to manage the host of new risks in a more efficient manner. This will enable them to deploy resources more effectively.

The importance of sophisticated risk-management practices will become even more pronounced as the banks strive to implement the Basel II accord. The smooth switch over to Basel II will be a challenging task before the banks, and this has far-reaching implications for the future structure of the banking system. Basel II would require a heavy investment in technology and development of MIS tools to incorporate the internal risk-based approach. The risk-based approach to capital allocation will be the inherent theme, as each asset will be allocated a rating both externally and internally. This will ultimately influence the capital charge for each asset and would thus help minimize the reckless risk-taking by banks on account of the heavy capital charge.

As financial innovation becomes ubiquitous and new technology and standards evolve to make financial transactions more complex and volatile, the role of the regulators is going to become tougher in the days ahead. This brings me to the concluding, but not the least important section, i.e. the changing role of and expectations and demands for regulators.

Changing Role of Regulator

The central bank has been transformed substantially. It is today a very user friendly institution, based on feedback of the industry. It is candid in putting forth its views, and over the years has withstood a number of political challenges.

Over the next few years, we plan to : First, with the support of the Government, launch adequate initiatives to strengthen the governance of the central bank. In this context, SBP is in the process of benchmarking itself with the other central banks that have attained good governance standards. The evaluation of central banks' governance practices is judged on the basis of the roles and responsibilities of the Management and the Board of Directors, and the appropriate interaction and interface between the central bank and the government. In deciding an appropriate balance in these roles and responsibilities, it is critical that central bank's independence is not compromised in terms of the conduct of monetary policy as well as the oversight of the financial sector. In all contexts, it has to be recognized that independence has to be accompanied by effective accountability of the central bank. The institution has to be accountable to the Parliament and the Senate, and work in conformity with the Federal Government's goals, as the central bank, among other functions, also serves as an advisor to the Government.

Second, SBP needs to examine where there is further need for internal strengthening. Few areas where SBP will gear itself further would be in terms of increased responsive to industry changes in order to align prudential regulations accordingly. Among others, SBP needs to be equipped to assess banks when they adopt higher standards of risk management which will be promoted when Basel II is introduced. Another area would be for the central bank to strengthen its oversight and supervision, with particular emphasis on closer supervision of the emerging conglomerate structures in the banking industry as some of the commercial banks are now owned by industrial groups and brokers.

Third, in conclusion, the central bank should energize itself to finance the under-served areas, regions and segments. And, the central bank would like to promote the Islamic Banking Industry, as it has the potential to introduce innovations in the market. As part of the reorganization of the central bank, which is currently in process, we plan to set-up a separate department for development finance, which will push for this objective.

Having assumed office in January, I am in the midst of developing a strategy for the next ten years of the financial sector, and my talk today presents some ideological thoughts on the long-term vision paper for the central bank, which will be developed in consultation with the stakeholders. We then need to set up an implementation task force, which will be a combined effort of the banking industry and the central bank to take forward these reforms. There has been tremendous change in the banking industry in the last few years and we need to fine-tune our strategic direction as we go forward.

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