Keynote Address: **Mr. Qasim Nawaz, Managing Director, State Bank of Pakistan Banking Services Corporation**

International Conference on Banking, Insurance & Business Management (CBIBM) at HCBF, University of the Punjab: *Emerging Challenges & Opportunities in the Changing Business World*

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Honorable Chief Guest, Justice (R) Khalil-ur-Rehman!

Respected Vice Chancellor, Prof. Dr. Niaz Ahmed Akhtar!

Distinguished Speakers, Researchers, Guests, Faculty members and Dear Students;

Assalam-u-Alaikum and A Very Good Morning!

It gives me an immense pleasure to be here today and address this august forum.

First and foremost, I would like to congratulate Hailey College of Banking and Finance for successfully organizing a conference on a theme that is in sync with today's changing realities and contributes to an important discussion, **"Emerging Challenges & Opportunities in the Changing Business World".** As far as my topic is concerned in particular, I don't think I will be doing justice to this forum if I don't share my thoughts on **"Emerging Challenges in Our Banking Industry and the Role of SBP"**. This topic may also be of particular interest to the students of banking and finance, researchers as well as practitioners given the fundamental shifts taking place in the financial sector and the wider economy. I am confident that other discussions held during the event will also result in generation of innovative ideas and provide important insights on the challenges being faced by the business world today and in days ahead.

Ladies and Gentlemen; in my speech, I would therefore reflect on the prevailing course of banking and the emerging challenges that are reshaping the banks' business models along with developments in the supervisory approach of regulators. I will also briefly discuss the measures taken by State Bank of Pakistan (SBP) to keep up with the changing dynamics and in the end will make a few suggestions that can help prepare the banking industry to adjust to the new paradigms.

I will discuss the future of banks and banking by, **firstly,** focusing briefly on the Global Financial Crisis of 2007-8 which was perhaps the most significant event in recent financial history that presented challenges relating to financial stability to regulatory authorities around the globe.

Secondly, I would talk about the emerging need to improve access to finance in the light of SBP's priority development finance areas of Agriculture, SME and Low-cost Housing with cross-cutting themes of Financial Inclusion and Islamic Banking.

Thirdly, I would like to discuss the impact of technology on banks and their customers. As you all will appreciate, the bank customer of today, equipped with sophisticated gadgets and devices is demanding state of the art financial services from the comfort of their homes. Neither do they want to visit a branch, nor do they want to fill up long forms in order to open an account. Is this a threat for the banks or an opportunity to transform? I believe the latter is true which I will explain afterwards in my speech.

But let me begin by talking very briefly about the Global Financial Crisis and its impact. The decade preceding this crisis saw remarkable expansion in international banking. As a result, heightened cross border lending coupled with sizeable presence of international banks across the globe, and particularly in developing countries, manifested an increasingly integrated world of banking and finance. The financial crisis actually forced regulatory attention towards ensuring financial stability by beefing up capital and liquidity buffers, more stringent regulations, and introduction of macro prudential policy toolkit. There is no doubt, that the coordinated efforts made by the multilateral bodies and regulators have facilitated to better internalize systemic risk and strengthen the overall international financial system.

Ladies and Gentlemen; <u>while the post crisis regulatory response has resulted in a more robust financial system, it has also increased the complexity of regulatory framework through implementing **significant financial regulatory reforms**</u> such as; <u>**application of stringent AML/CFT regulations**</u> to prevent the use of banking channels for illicit transactions, and <u>**full and timely implementation of Basel III**</u> to ensure a sound and properly functioning banking system that is able to support economic recovery and growth on a sustainable basis.

Therefore, an important challenge and one of the top priorities of banking sector, is to adapt to the complex regulatory landscape while maintaining profitability. And let me tell you, this is a big challenge as not only the number of regulatory changes that banks need to comply with has more than tripled since the last decade but the scope and complexity of these regulations have expanded from multiple perspectives.

Ladies and Gentlemen; moving on, I would like to put some light on the persistence of financial exclusion in the face of long-standing efforts by SBP to promote inclusion vis-à-vis priority areas of development finance such as agriculture, SME and Low-cost housing as well as Islamic Banking.

<u>**Agriculture**</u> is an important sector for Pakistan's economy but 85% of farmers are financially excluded. Agriculture contributes around 21% of GDP, 16% of exports, and employs nearly 45% of

the labor force (60% of the rural population). Constraints to agricultural finance include; weak contract enforcement, limited knowledge and scarce use of alternative financing methodologies that substitute traditional collateralized lending for farmers (such as value chain finance, contract farming, warehouse receipt finance and cash-flow lending), and limited financial capacity of small farmers.

As far as **SME Finance** is concerned, banking industry of Pakistan started focusing on small and medium enterprise (SME) sector during the period of 2004-2006 because of which SME financing (Rs. 408 billion) reached at 17 percent of total private sector financing by banks & DFIs in December 2006. However, following the economic slowdown since 2007-08, SMEs became less profitable and highly risky ventures for bankers. A number of issues and challenges have been identified for the provision of credit to SMEs such as; (on the demand side) low financial literacy, lack of collateral and documentation, lack of awareness on SME financing products, complicated loan procedure, reluctance to tax filing, quick and easy access to informal finance and (on the supply side) high risk perception, asymmetric information, high administrative cost, corporate mindset, limited expertise w.r.t SME finance (such as products, cash flows, credit scoring, credit rating), heavy investments in govt. papers and unavailability of assessment of demand of SME financing.

Similarly, **Housing sector** in various economies serves as an engine of economic growth. It has the potential to generate employment, increase productivity, raise standard of living and alleviate poverty. Pakistan, like other developing countries, has been facing shortage of housing units; and this basic human need is felt more profoundly at the bottom-of-the-pyramid comprising of the poor and financially under-served segments of the society. One of the key constraints hampering supply of housing units is the unavailability of financing.

Moreover, **Islamic finance** is increasingly gaining importance on the global landscape as a viable alternate to the conventional financial system. Islamic finance industry, based on strong fundamentals due to its asset-backed nature and risk sharing principles, has witnessed significant growth. In Pakistan Islamic banking industry has shown significant progress since its re-launch in 2002. By the end of June 2018, the Islamic banking industry has acquired 12.9 percent share in assets and 14.8 percent share in deposits of overall banking industry. SBP conducted a survey based study; "Knowledge, Attitude and Practices of Islamic Finance in Pakistan (KAP)", during FY15. The survey findings reflect that there is a huge potential for further development of Islamic banking in Pakistan and a significant proportion of demand lies amongst those who are still financially excluded. We feel that competitive advantage of Islamic banking and finance is yet to be capitalized as depicted by its lower penetration into strategic sectors like agriculture, small & medium enterprises, microfinance, and low income housing.

Moreover, there is a dire need of developing skilled human resources in the area of Islamic Banking. For which, linkages should be developed between the banking industry and academia leading towards the development of specialized courses.

Ladies and Gentlemen; now I would like to switch to the **<u>third theme</u>** which is about the technological and digital revolution that may be threatening the very existence of banks today. Let me briefly describe some of the **<u>technological trends</u>** that our banks are facing today:

First is the **<u>rise of internet, Social Media and mobile devices</u>**. On one hand social media allows banks to reach their customers directly in ways that were not imagined before to offer them a variety of services like faster payments and instant credits while on the other, negative perceptions about banks and their services can also spread like wildfire. I therefore will not be surprised if Social Media becomes one of the most important sources of systemic risk going forward.

Second, there have been tremendous enhancements in **<u>tele-density and mobile broadband coverage while simultaneously the cost of not only these services but of end user mobile devices has also rapidly decreased</u>**. Customers can therefore afford smart cell phones, watches and other all-time connected gadgets and by using those can access their bank accounts, avail financial services and advice, and make payments anytime from anywhere.

Third, **Fintech** companies who are small start-ups are using technology to challenge banks in providing innovative financial services like digital nano credit, crowd funding, peer to peer lending, online payments and financial advisory services with enhanced customer experience and in a more cost effective manner. We would like to see the formation of partnerships of banks and these nonbank entities such as Fintechs for lowered costs and superior customer experience in the financial industry.

Fourth is the rise of what is called **cloud computing or cloud hosting**. These cloud based arrangements can offer extremely cost effective fully managed solutions including hardware and software as a service. Businesses now don't have to worry about high cost of managing their IT or managing the associated risks rather they can simply outsource them to these cloud based digital platforms. These platforms are now offering the concept of "Banking as a Service" or "**Digital Banking**" which usually runs on infrastructure provided by a licensed entity and offers services using an ecosystem of Fintech start-ups. These platforms have the potential to drive down cost of providing banking services, especially for smaller banks, and open new opportunities of product innovation and service delivery.

Fifth, **advancements in artificial intelligence, machine learning and big data analytics** are set to transform the financial industry in many ways especially in areas of intelligent customer relationship management systems, fraud detection and prevention, e-commerce and detection of AML/CFT issues.

Finally, many of the financial services customers around the world do not want to go to a brick and mortar branch to open a bank account or even conduct financial transactions; they would like to be identified, authorized and served digitally. So regulators and government authorities are now focusing on instituting **Digital on-boarding programs using National Identity Databases**.

While combination of all these aspects will likely drive down costs for the banks and help them improve their service delivery and product innovation capabilities and offer enhanced experience to the customer, we must be aware that **technology has its unintended consequences**. These unintended consequences will primarily be **related to consumer protection, data privacy and money laundering** which are easier to camouflage using sophisticated technology.

I must also mention that banks are facing aggravated challenges relating to **cyber security**. During the last decade or so, hackers and cyber terrorist have gained much superior capabilities of espionage and afflicting damage and are now targeting the financial industry. The theft of electronic identity through hacking could wipe off bank accounts of customers causing not only financial but reputational losses especially to larger banks and their regulators. The proactive detection and response to these cyber threats requires not only specialized security infrastructure within the organization but also enhanced mutual cooperation and information sharing among the banks.

Ladies and Gentlemen; Since I have discussed various challenges that the banking industry is facing and certain worrying developments that are threatening its performance, let me briefly share with you **what we at the State Bank of Pakistan (SBP) have done so far and plan to do in the future to transform our banking sector**.

In Pakistan, the banking sector constitutes around 74 percent of the country's financial sector with an asset base equivalent to almost 55 percent of the country's GDP. As such, the stability and buoyancy of the banking system is of critical importance.

Over the years, continuous improvements in prudential regulations in line with international best practices and capital strengthening measures have significantly improved the resilience of the banking system of Pakistan.

As per SBP's Half-Yearly Performance Review (HPR) of the Banking Sector for the 1st half of the calendar year (CY) 2018, Capital Adequacy Ratio (CAR) of the banking system has further strengthened to 15.9 per cent; well above the local and international benchmarks.

We are also looking towards **a sustainable financially inclusive system** which can spur socio-economic development in the country. Recognizing the gaps leading to financial exclusion, we have already developed **National Financial Inclusion Strategy**

(NFIS) 2020 which lays down sound foundations for promoting financial inclusion and identifies the gaps leading to persistent financial exclusion.

Our strategic approach to tackle financial exclusion is focused at creating a proportionate policy and regulatory framework that addresses sector-specific risks and strategies regarding infrastructure development and policy interventions – both on the supply and demand side for development finance sector such as **Microfinance, Agriculture, SMEs and Low-cost Housing, along with cross cutting themes of Islamic Banking and Financial Inclusion.**

Along with a number of key action points currently being implemented under different development finance areas, SBP has also launched a **Policy for Promotion of SME Finance** and is also in the process of drafting a **Policy for Promotion of Low-cost Housing Finance**. With such a regulatory support from SBP, banks will have to step forward and take initiative in terms of product development, program based lending and capacity building of their human resources.

Moreover, in order to create awareness about basic financial services and SBP's policies and schemes covering its priority areas of development finance, SBP is carrying out financial literacy and awareness programs all across Pakistan along with its policy implementation arm SBP BSC such as National Financial Literacy Program (NFLP), Farmers Financial Literacy Programs and Awareness Sessions on SME Finance etc. By indulging into such initiatives, SBP is playing more than a regulator's role and expects the banking industry to reach out to the public in a similar manner through handholding and creating awareness in addition to providing financial services only.

Ladies and Gentlemen; due to rapid technological progress, the global financial and payment landscape is transforming very rapidly. SBP has long recognized the importance of technology and has been facilitating banks and financial industry to reap the benefits of digitization. <u>To keep pace with technological transformation and mitigate the associated risks, SBP has issued various guidelines encompassing frameworks for Enterprise Technology Governance and Risk Management, Payment Systems' Designation, Security of Internet Banking, prevention against cyber-attack, Risk Management in Outsourcing Arrangements by Financial Institutions, etc.</u>

I am pleased to share that recently SBP facilitated the issuance of our domestic payment scheme called the **<u>PayPak</u>**. The encouraging aspect of PayPak is that it has been issued by a private entity that is owned by 11 private banks thus ensuring full blessing and participation of the private sector in this payment scheme. Moreover, SBP is developing a National Payment System Strategy to modernize the clearing and settlement infrastructure for reducing cost, improving efficiency, enhancing security, and strengthening its regulatory and supervisory oversight.

SBP is also playing a very important role of facilitator and catalyst and our doors are open to innovation and innovative ideas. SBP is also facilitating the entrance of non-banks particularly in payments arena and has issued **Rules for Payment System Operators and Service Providers**. We have seen encouraging response to these regulations and now a variety of nonbank, digitally enabled businesses have entered or are preparing to enter the Pakistani market with innovative and customer centric products. SBP also engages with the **Fintechs** in the country on regular basis to understand their business models and facilitate them if required.

Ladies and Gentlemen; keeping in view the discussed challenges and opportunities, banks need to devise certain strategies that can help them grow and stay on course. I must say that banks are essentially required to acknowledge that times have changed. And in order to stay competitive in the changing landscape of financial inclusion and Fintech, they must embrace technology, product innovation and forge new partnerships to re-invent their business models. I will go to the extent of saying that the upcoming age may become the age of less or even non-intermediation where role of intermediary institutions like banks and their regulators could become limited if they don’t embrace these changes pragmatically.

While the challenges are huge, I have full confidence in the skills and abilities of our banking community. I am sure that students attending this conference will soon become practitioners and professionals and will adapt to the changing realities of times ahead, take these challenges as opportunities and deliver the best of best to Pakistan.

Ladies and Gentlemen; in the end, I would like to once again thank the management of Hailey College of Banking and Finance for inviting me to deliver the Keynote Address for this year's conference.

Thank you for your attention!
