

## **BANKING CHALLENGES IN THE 21<sup>ST</sup> CENTURY**

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Distinguished Ladies and Gentlemen!

First of all I would like to congratulate the administration of Preston University Peshawar for organizing this Seminar.

It was the earlier part of the 1990s when the inherent weaknesses of the banking structure were recognized and a comprehensive reform process in the banking industry was initiated. The underlying objectives of the initiatives were to ensure and create a level-playing-field environment of competition in the market and to strengthen the governance and supervision of the financial institutions. In fact, the reforms were targeted to adopt a market-based indirect system of monetary, exchange and credit management to ensure the efficient allocation of financial resources.

Today, 15 years later, it would no longer be an exaggeration but a fair statement that the landscape of the banking system in Pakistan has changed. The country has made a significant progress in implementing financial sector reforms and has achieved a more competitive market structure with expanding market share of private sector banks. Moreover, significant gains have also been achieved in the form of better supervision and regulation of financial markets and institutions. Due to prudent

regulatory measures, the local banking industry is now considerably resilient in absorbing adverse shocks, both internal and external.

Please note that this progress does in no way mean the end of reforms, but provides great encouragement to capture and sustain the current momentum of progress. Time is ripe for further strengthening and reshaping of the reform process. This is not only to capitalize on the achieved robustness of the banking industry, but also to integrate it with the global economy deep into the 21<sup>st</sup> century.

The 21<sup>st</sup> century challenges for the Pakistani banking industry are broadly of internal and external nature. Internal challenges are the one that stem from within the banking industry and carry a profound effect on the long run robustness of the banking industry. External challenges are somewhat exogenous, being generated from the external environment of the banking industry, and require shrewd management for adaptability.

I would like to start with the internal challenges first.

**Technical Expertise:** Acquiring the technical expertise should be the focus of future human resource management given the changing paradigm of banking sector regulations. For instance, the implementation of the new Capital Accord (Basel II) whereby capital adequacy requirements have been made more risk-oriented by linking capital to operational risk and changing the risk measurement approaches for credit and market risks. However, its implementation is not going to be an easy task especially in countries (including Pakistan) where risk management systems are at nascent stage. This is because of one of the prerequisite for Basel II implementation which requires that the banking institutions should have a robust risk management

setup which is capable of effectively managing all major risks that an institution is exposed to.

Similarly, the banking institutions are also required to carry out stress testing, a technique used around the globe by financial institutions to assess risk exposures across the institution and to estimate the changes in the value of the portfolio, if exposed to various risk factors. Initially, although, SBP has advised banks to carry out the simple 'sensitivity analysis' keeping in the view the varying levels of skill and available resources among banks; however, going forward more sophisticated techniques will be adopted. Certainly, this process would require technical expertise at least in three areas: identifying, analyzing and proper recording of the assumptions used for stress testing; adjusting the situation or shocks applied to the data and interpreting the results; and an effective management information system that ensures flow of information to the senior management to take proper measures to avoid certain extreme conditions. Therefore, going forward, the focus of human resource management should be to acquire technical expertise if the institutions intend to go along with the changing regulatory environment.

**Infrastructure Development:** All around the world the share of private sector participation is increasing tremendously in the area of infrastructure development. Through most of 1990s, the investment in infrastructure projects with private participation rose steadily and of these the most successful projects were implemented in 136 low and middle income countries. In Pakistan, the conventional form of financing infrastructure projects only through Public Sector Development Programme has resulted in congestions and bottlenecks that have raised the need to find alternative way of fostering private-public partnership in the areas of infrastructure development. This success story of private sector in infrastructure development has also set challenges to the local banking industry to learn from the

experience of other emerging market economies and innovate and design the different modes of infrastructure financing and the associated risk management systems.

**Development of Liability Products:** It should be noted that although new products have been introduced in preceding three years on asset side, including, consumer finance, SME finance, etc, but little attention has been paid on developing and innovating the liability products. This one sided approach has proved adverse for the local banking industry as these are the savers and depositors that provide financial resources to the banks to perform their intermediation business. The stagnant financial savings in the economy for last few years is an outcome of this neglect and this has raised the need to design the lucrative savings products in the country so as to look after the interest of the small savers and mobilize their savings in an efficient way.

**Anti-Money Laundering:** As a result of increased integration in the global financial industry, the misuse of banking industry has been observed in recent years. These include the use of banking services for activities like, terrorist financing, drug trafficking and money laundering. In few countries although there is a comprehensive legislative systems and well defined enforcement mechanism; but there are a number of countries where the entire regulatory framework is at initial stage. In such countries, banking institutions are exposed to adverse consequences of these activities in the form of reputational, operational, legal and concentration risks. For instance, the institutions have to pay the investigations or the penalty charges, decline in the stock value, assets seizures, temporary termination of correspondent banking facilities, etc. the tackling of this issue requires a coordinated effort of the banking institutions, regulators, law enforcement agencies, etc. In this regard, SBP has already taken some viable steps to prevent the use of banking institutions for illegal activities.

**Operational Aspects:** It has been observed over time that banks put their focus on treasury & corporate business while the operational side is often ignored. I would like to emphasize that the importance of operational side should not be underestimated. It is as important as other segments of banking and banks should strengthen and give incentives to those persons who are under taking operational business.

**Human Resource Development:** According to the Labor Force Survey 2003-2004, the over all labor force participation rate is 30.41 percent. In today's era human resources are as important as financial resources to any organization. The Banks need to develop their human resources for future challenges and produce professionals having the desired expertise for specialized banking like Treasury functions, SME financing and Islamic Banking etc. This is the need of the hour that banks should develop their own Human Resources. To deal with this issue, Banks may enhance their collaboration with the educational institutions.

These challenges, ladies and gentlemen, as I mentioned before are crucial in determining the long run robustness of the banking industry. In addition to this, there are a number of challenges that have emerged following the most recent macroeconomic developments in the domestic and global economy. These are what I would like to call as external challenges.

**Interest Rate Variations:** Interest rates have been at historic low levels during the last three years and were therefore providing a conducive environment for the expansion of overall real economic activities. More importantly, smaller business entities which earlier could not afford bank financing were able to do so in this environment. However, since last fiscal year (2004) the interest rate structure is changing gradually. It has to be seen, therefore, whether banks would be able to continue the expansion in their businesses given that the fact in preceding three years,

low financial charges were one of the major factors for credit demand in the economy. In addition, the repayment capacity of the borrowers who borrowed at floating rates has also put a question mark on the asset quality of the banks.

**Consumer-Durable Demand:** The robust growth of auto and mortgage finance in preceding two years has significantly increased the prices of these assets, and thus has created inflationary pressures in the economy. The probability of default on these loans has a direct relation with the value and the nature of the underlying collateral as most of the consumer lending is secured. This said, asset prices play a crucial role in determining the size of the losses incurred by banks in case of default. In order to avoid such problems, banks have to rely more on the future income streams of the borrowers in making their credit assessment instead of the collateral value, until such time that the asset prices are rationalized.

**Equity Stock Investment:** Given the volatile nature of the equity markets, banks' investment in equity stocks needs a cautious approach.

**E-Banking:** Another area where still a lot of progress should be made is the E-banking. Although small and medium banks are now offering on-line services to their customers, the large banks, with more expanded branch network and number of customers, are required to move more expeditiously so as to optimally utilize the E-banking network. This will not only lower the transaction costs but will also help in improving the customer services. The ATM penetration ratio is still quite low in Pakistan and the efforts are needed to not only further expand the ATM network more aggressively but also to improve upon the security standards.

**Islamic Banking:** Islamic banking is a relatively new concept in our banking system. More and more banks are seeking license to open Islamic bank Branches. At present two full fledged Islamic banks having 37 branches are operating in Pakistan. SBP has

also issued license to three more full fledged Islamic Banks, named as: BankIslami Pakistan Limited, Emirates Global Islamic Bank Limited and Dubai Islamic Bank Pakistan Limited. Moreover, there are 34 stand alone branches of different banks which are operating successfully throughout Pakistan. The banks should be fully prepared to run Islamic branches with the help of their Shariah Board, Shariah Advisors, Auditors and trained staff. The Banking Industry should understand that Islamic Banking is still underdeveloped and we should not work half-heartedly towards the growth of Islamic Banking. This is a sector where growth is expected and the banks should capture this opportunity.

May the Almighty bestow us with His blessings.

Thank you.