The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

Post-webinar paper

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Financial Services Industry Challenges and The Way Forward

PROFESSIONAL ACCOUNTANTS IN BUSINESS (PAIB) COMMITTEE

Panelists

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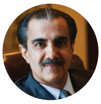

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COVID-19 is a crisis that has not only impacted one industry rather it has had colossal impact on the worldwide economy and the entire humanity.

Macro perspective of the financial services sector and strategizing for the future

Over the period of 20 years, there has been significant progress in the banking sector and financial services industry. In the last decade only, the assets, liabilities and investments of banks have almost doubled. However, at the same time, there are challenges in the financial inclusion aspect and lending to private sector, especially in Pakistan.

Covid-19 has distracted everyone but it has distracted some sectors more than others such as developing countries that have had contraction and economies that do not have strong and diversified financial system are facing more complexities. The pandemic and the adoption of sustainable development agenda ought to be a game changer for financial services. It should provide impetus to digital financial services which should be the corner store of the turnaround of the financial services industry. It should also provide impetus to digital financial services but to fully leverage the potential, this change needs to accompany and be an integral part of a deeper transformation of the financial intermediation process.

Pakistan 's financial sector has indeed great future and potential because of the rising middle income population of 40 million, youth population size, high consumerism, opportunities to harness domestic savings and wealth generation, opportunities to enhance financial inclusion.

> "Almost 3/4th of Pakistan's population is excluded from financial system with hundred million people unbanked. Only 21 million adults have transactional accounts from which only 7% are women as compared to Southeast Asia and lower-middle income countries whose averages are up to 53% and above."
>
> Dr. Shamshad Akhtar, Chairperson, Karandaaz

Despite this potential of finance sector, it has been substantially under performing and under serving people and the economy. Pakistan had decent entries of the foreign banks in the past followed by a very interesting mergers and acquisition process. Pakistan has also promoted alternate banking options and Islamic Banking has gained grounds as Islamic finance as a whole account for 15% of the deposits and 17% of the total bank deposits.

Pakistan had a major breakthrough in micro finance industry and branchless banking. The telecom and mobile operators are licensed and there has been growing initiatives recently for FinTech and affiliated technology, data services etc. The country managed to shift from the broker lead exchanges to unified corporate ties exchange by offering shareholding to Shanghai and Shenzhen which is not a small measure. Moreover, private sector is growing in the insurance sector.

Because of lags, system rigidities and severe bouts of macroeconomic instability, financial sector of Pakistan has yet to deliver in number of areas. Foremost is the gross domestic savings to GDP ratio which is barely 5.2%. It is the lowest in over three decades and amongst regional peers; Bangladesh is at 25%, India at 28% and so forth. The second concern is that as against regional comparatives, Pakistan's financial sector asset to GDP ratio is quite small; bank deposits to GDP ratio is about 35% relative to India's which is 64%.

The role of financial sectors is to help the economies grow and reduce poverty and make sure that demands is met. Unfortunately, the financial sector looks only on one side; market capitalization of Pakistan stock exchange is only 13% of GDP. We only have about 250,000 retail investors in the equity market and the business is concentrated in large brokers.

The development finance is not being serviced by the financial industry to the extent it should. The Country's annual infrastructure spending is about 2.5% of the GDP which is half of what they spend in Bangladesh and given our own requirements and if Pakistan is to remain at par with the region, we need to increase our annual infrastructure spending to 8% to 10% of GDP. This can't be done alone by the banking system but banks have to start lending loans and also blend it with other currency products.

Another key component of the development finance is the SME sector. Grossly undisturbed, outstanding SME bank credit fell by half from over 15% a decade or so ago, it is now barely 7.6%. The number of SME borrowers is barely 185,000 as per State Bank's statistics.

The last area on the development finance is that we don't have a strategy to finance sustainable development goals. There is lack of coverage of basic services and there is no concept of municipal finance consequently, in this country municipalities are in a dire state. Moreover, funding for climate adaptation and mitigation which is increasingly coming from the private sector, given that particularly our fiscal deficit is reaching 10% of GDP has yet to evolve. Financial system is not only under serving these but is losing the opportunity to exploit these businesses. Central Bank now has offered a range of refinancing facilities and the response of the central bank is diversified and it is compensating for the fiscal constraints but the refinancing facility is given because of the weak deposit phase and the low level of loanable base.

Having launched the reforms in the past, Pakistan needs to embark a comprehensive integrated financial sector strategy, not just banking strategy

Besides the resolution of inherent structural rigidities of the financial sector, Pakistan needs to recognize that there has been a sea of change in financial landscape of our regional competitors. Therefore, Pakistan has to have a standing in the region; it has to compete a vibrant and well diversified financial sector with stronger risk appetite. This is critical for leveraging funding for Short-term Grants (STGs) to mobilize the financing and also for sustainable infrastructure development. Moreover, companies should be seeking finance to comply with Environmental, Social and Governance (ESG) Guidelines.

The sector needs to more systematically embrace new technologies which is the corner stone of future transformation. There is a need for digital banks, contextual banking such as e-commerce and online industries. Banks have started to realize they are sitting on a gold mine in terms of customer data so we need to tap all of this; big data, artificial intelligence etc. Most of all, we need to get more involved in FinTech because Asia is now a leader in FinTech; its reliance and technology to automate financial services can offer a wide range of services provided by the financial ecosystem and they require ccess to the bank system to get real time customer information.

Karandaaz Pakistan promotes access to finance for micro, small and medium-sized businesses through a commercially directed investment platform, and financial inclusion for individuals by employing technology enabled solutions. It is working very closely with the government of Pakistan and the central bank to promote digital financial services as it is sponsored with the funding of DFID and Bill & Melinda Gates Foundation which is big on digital financial inclusion. The company is helping in the development of Micro Payment Gateway which hopefully should be operationalized by December this year. It is helping SECP digitize to enable electronic collection and storage of enterprise records. The Secured Transactions Registry (STR) is done jointly. Karandaaz has promoted Pakistan micro finance investment company which serves 20 borrowing institutions to provide liquidity. Pakistan Microfinance Investment Company (PMIC) has 7.3% of the micro finance market share. Karandaaz is promoting two credit enhancement bodies i.e. Infra Zamin Pakistan which is the for-profit Credit enhancement facility NBFC domiciled in Karachi with a capital base of PKR 15 billion its sole line of business would be to issue credit guarantees for infrastructure related to different instruments. The process of working on establishing a real loan bank SME institution and the regulatory framework for digital banks has also been started.

The future of financial sector lies in continuous strive to reform not only in the indigenous financial sector but to embrace the multiple frontier technologies because there is great potential to enhance financial inclusion and to do development finance.

The vision of State Bank of Pakistan, challenges of diversification, SME sector and undocumented economy

Initiatives by SBP

Over a period of 4 to 5 months, State Bank of Pakistan (SBP) has been operating in a different environment posing unique challenges. There have been considerable learnings based on which the State Bank has revised policies and took a number of initiatives to cope with the situation.

Firstly, SBP has taken a number of initiatives for the banking sector to address the issues faced by the banks and its customers, to reduce the impact of Covid on the larger economy and also to ensure that banks are in a position to provide the required flow of funds to various sectors of the economy, particularly the priority sectors.

Secondly, SBP has launched various schemes such as the Rozgar Scheme, focused on facilitating the corporates and small enterprises to withstand the shock of Covid, it has become a flagship scheme for receiving jobs in the country and is very successful.

> “Rozgar Scheme has already crossed Rs. 125-billion-mark refinance which is provided to banks to lend to various sectors of the economy including SMEs as well as large corporations. Consequently, 1.3 million jobs have been saved.”
>
> Mr. Jameel Ahmed, Deputy Governor, SBP

http://www.sbp.org.pk/ps/PDF/NPSS.pdf

For long-term economic development, SBP launched another scheme 'Temporary Economic Relief Facility' (TERF) which is a long term financing scheme similar to the existing Long-Term Financing Facility (LTFF) which was focused on specific sectors particularly the export oriented sectors. In contrast, TERF is more focused on all sectors of the economy. It is a ten-year scheme meant for not just launching of the greenfield projects but also for availing Balancing, Modernization and Replacement (BMR) for existing projects. With these schemes, industries will be able to take risk and will install new projects or modernize the existing projects so that they contribute in the economy activity more effectively. Applications for around Rs. 70 billion financing has already been received for the Scheme and there are a number of projects that have already been financed.

Another initiative by SBP is the Refinance Facility for Combating COVID -19 (RFCC) scheme which is an emergency funding facility to support hospitals and medical centers to develop their capacities for treatment of infected patients of COVID-19. Initially, the Scheme was focused on Covid related facilities but the scope is extended to include development of health infrastructure.

Another key initiative is the Deferment of Principal Amount Facility of loans and advances by banks and development finance institutions. Under the facility, businesses and households could request for the deferment of their loans and advances for a period of one year till September 30, albeit continuing to service the mark-up amount. The measure also ensured that the deferment of principal would not affect borrower's credit history and such facilities would not be reported as restructured/rescheduled in the credit bureau's data.

Other initiatives by the SBP includes certain type of reliefs and provision related reliefs for industry facing issues due to Covid so they can perform better in the existing environment.

Strategic vision of SBP

SBP is working on developing payment infrastructure and launched a National Payment Systems Strategy (NPSS) which lays out a road map and action plan for Pakistan to have a modern and robust digital payments network. The key goal of this strategy would be to make access to financial services easier for people and help improve financial inclusion, particularly for women, along with greater documentation of the economy. One of the key projects under this strategy is the Micropayment Gateway in collaboration with Bill and Melinda Gates Foundation and Karandaaz.

http://www.sbp.org.pk/ps/PDF/NPSS.pdf

Similarly, there are a number of initiatives in the payment system. In order to facilitate customers during Covid, SBP has requested banks to waive charges for internet banking and other relayed payments. This will contribute significantly in digital openness and there is already substantial increase in digital transactions.

On the financial inclusion side, SBP has a five-year strategy for promoting financial inclusion. There are a number of initiatives already taken reflected in the increase in number of bank accounts being opened. There are various categories of accounts including accounts meant for lower segments of the society whereby opening bank account for general public and its documentation is relatively simplified.

Financial Action Task Force (FATF) Agenda

The State Bank is not only undergoing the FATF action plan but is also undergoing Mutual Evaluation Report (MER). The requirements of both FATF and MER are different with different risks and teams. Moreover, FATF action plan is primarily focused on terrorist financing while MER is an overall compliance of Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT).

For the FATF action plan, the component that pertains to the financial sector which requires SBP to demonstrate understanding of risk, reach out to the bankers and the bankers reach out to the customers on the requirements of AML/CFT, has been rated as compliant by the FATF evaluation team.

The State Bank of Pakistan is trying to improve the position as far as overall AML/CFT is concerned. There is an oversight board which is looking after the AML/CFT part. Moreover, banks are being lined up to carry out the AML/CFT component.

Moreover, Financial Monitoring Unit (FMU) exists which is doing a great job as far as analysis of Suspicious Transaction Report (STR) is concerned so it is a combination of State Bank, FMU and the Financial Institutions that are taking all the necessary steps that would fulfill the requirements of FATF in the short term and MER (Asia Pacific group for money laundering) in the long term and two streams of processes that are going on simultaneously.

SBP perspective on keeping a balance in conversion rate, monetary policy rate, internal and external inflationary pressures

Considering the recent actions taken by the Monetary Policy Committee, SBP has reduced the policy rate by 625 basis points in a short span of time. The rate cut done in the short time span is quite historic and also compares positively with other countries actions. This has been partly facilitated by significant reduction in inflation rate and some of the other improvements seen particularly on the external front. There has been significant improvement whereby the current account deficit during the fiscal year 2020 decreased by around 78% as compared to last year.

> “For the first time foreign remittances have crossed the mark of $23 billion despite the World Bank projection that our remittances will decrease by 20% it has in fact increased by 6% during the fiscal year 2020.”
>
> Mr. Jameel Ahmed, Deputy Governor, SBP

In order to maintain and improve the level of foreign remittances, the central bank has taken considerable actions to facilitate the banks and their foreign tie ups. SBP is also in coordination with the concerned government ministries where a number of other actions are in progress to further strengthen the remittances flow.

Another area is the launch of digital account for non-resident Pakistanis which have been coordinated with selected number of banks and they are already in the process of testing their pilot project and it will be announced soon. This will enable the non-resident Pakistanis to open their accounts online so the formalities for opening accounts will be done very smoothly online and they will not be required to visit physically to any branch and documentation will also be simplified. Through those accounts overseas Pakistanis will be able to make investments in stock market, bond markets, properties and other avenues. This will contribute in the flow of remittances which is crucial for balance of payment issues.

Payment systems, e-wallets and EMI regulations digital banks shaping up in the next 2-3 years

During the last year SBP has given e-money institution licenses and the number of e-channels is increasing as digital thinking is evolving. SBP is working on Licensing Policy for digital banks and there is demand from venture capitalists to invest in the high-tech area. SBP is also working on the Micro Payment Gateway and the government/Ministry of IT is independently working on International Payment Gateway. The way these fundamental changes are coming in place, in the next couple of years there will be a major transformation from the conventional way of doing business to the digital way of doing business.

> “PKR 162 billion have been distributed among 14 million people through Ehsaas Program.”
>
> Syed Irfan Ali, Executive Director, SBP

Impact of Covid on people, processes, governance and overall system of the financial services and banking institutions

Covid-19 is a real opportunity to address some of the issues in the financial services sector such as lack of capital markets, lack of focus on SMEs and poor financial inclusion etc.

Clearly the short term objective has been to address the immediate issues that customers have faced that have been primarily around liquidity. The banks have come forth and supported the initiatives and relief packages taken by SBP but this is not enough. The economy and customers cannot revive solely on the basis of liquidity which has been in the form of incremental lending. Through this process the banks as well as customers have taken an increased risk on their balance sheets.

Banking institutions have the responsibility to make sure that their own operations are changed significantly and that they help their customers in different ways. How this temporary support that has been provided through the help of State Bank can be changed into a longer term way of thinking to provide longer term capital for the companies that are likely to come out of this Pandemic hopefully by end of this year or next year. How do the companies ensure that their capital structures are the right ones and that they have the support for the right instruments whether it is the debt instrument, equity instrument or the equity that comes into improving their balance sheets in the longer-term?

The future is different for each sector we have to really be looking at some sectors that will survive as is, some sectors will need to go through significant transformation to survive and there will be other sectors that will probably not survive. As bankers, lenders, capital providers and as funding providers this is one area that the focus should be on to change our thinking for the future and provide the companies with tools and capabilities needed to survive and thrive.

The second part is how do we make transactional convenience go to the next level. The finance and banking institutions have to step up as an industry. Today customers would much rather do transactions through digital channels. For instance, at Bank Alfalah, the ratio of in-branch transactions to digital transactions went through a significant shift. This shows that customers are willing and able to take on digital transactions if the push is there. We need to now take it to the next level and make transactional convenience much more easy for customers. This does not just mean to have an app or internet banking but it means fundamentally changing the processes that the banks/ customers currently go through i.e. paper-based and time consuming and convert them to digital transactions inside out. One of the conversations that is going on is related to the new income housing scheme that is being pushed aggressively by the government and being supported by the SBP and of course by the banks since it's being created from ground zero. This whole process needs to use technology and digitize so that transfer of titles is digital, transparency is ensured and the whole process in the end becomes digital.

Reassessing strategy to stay relevant, organic and futuristic

Bank Alfalah has just embarked its five-year strategy, the next five years are going to be vastly different from whatever the banks have been doing as compared to the strategy formulation of pre-COVID-19. The banks have now start looking at the areas of weakness for instance the SME sector; banks have tried and failed to make a significant dent in being relevant to the SME sector either as lenders or as providers of other banking services this is a time where the industry can actually try to assess how these value chains work which engulf the SME sector and have targeted services to address their needs. It is sad to see that less than 5% of SME have access to finance but more importantly they don't have access to basic banking services which can be changed through technology. One of the thing is to work with big corporate customers called the anchor customers and then dig deep into their supply and distribution chains where the SMEs reside and work through the anchor customers to go down and see what can be done for their suppliers and distributors vendors and various other people and to use technology to be able to deliver them services. It is very apparent that the space is absolutely huge and it's been intact so this is one example of to be able to start thinking differently.

The other thing is that the savings haven't really been promoted. Banks are partly to blame but there are far bigger things also in their plate. Approximately 44%-45% of total money supply is cash which doesn't come to the banks in terms of deposit mobilization. The banks have to create an ecosystem where cash is discouraged or if not discouraged but non-cash instruments become far more convenient to use and therefore cash will become irrelevant and will have to come to the banks. It is an important element to drive growth because one rupee coming to the banking sector multiplies the economic activity by 3.4 times - the multiplier effect of the banking system. The more cash lying outside the banking systems comes into the banking system; the more growth it creates.

The factor government is finally trying to fix through a push system is in the housing market so why is it that banks don't really lend aggressively in the mortgage sector because the ecosystem needs to be strengthened and that has to do with not only for closure but it has to do with also the titles transparency, the clarity of the titles and the speed with which things move. For the first time it seems that the government actually has a plan to address those things through planning creation of real state regulatory authority and fixing the laws and creating that environment. Banks have been given the target of 5% of total lending to the mortgage sector. Overtime mortgage lending growing means supporting the construction sector insurance sector and 40 different sectors get supported by construction, housing, etc.

Islamic banking and its role in the future of financial services sector

The journey of Islamic banking started as a thought process in 1995 which was purely driven by faith i.e. to move away from riba. Meezan Bank (MBL) started the journey as an investment bank named Al-Meezan Investment Bank and five years later had the opportunity to work with Society General of Pakistan which gave us the license for Islamic commercial banking in Pakistan. There was no concept of commercial banking in a truly sharia compliant way. Initially the bank started with 30 employees and it was a big challenge to attract talent as it was a new concept but today things have changed for good. Initially documentations weren't available, Sharia scholars were not trained but with perseverance in the team and hard work made the bank grow and the growth rate of Meezan Bank on the deposit side has been at least twice as much as the conventional banking industry this is because there was an unmet demand in Pakistan for Islamic banking.

The awareness about Islamic banking is getting greater. In 18 years of being a commercial bank, MBL have around 2 1/2 million accounts which is about 20% growth in year-round deposits just shows that there is a vacuum available and there is a need as well. From being the smallest in 2002, Meezan bank is now 6th or 7th biggest in terms of various benchmarks. Islamic banking is here to stay and it has got a lot of potential.

MBL needs to be more careful in terms of selection of customers and as a result our NPL is the lowest in the industry. MBL's emphasizes a lot on documentation in terms of availability of cash flows etc. because if there is a downside then Islamic bank will tend to lose faster than the conventional banking so it helps us to document things better.
In terms of deposit, about 66% to 67% of the deposit comes from retail customers so it's a very retail oriented bank. Although they are short term in nature but in terms of practice, it becomes a long-term deposit so then long-term exposure in long-term projects of 10 to 15 years is taken so it becomes easier.

Regional Expansion of Islamic Banking and Extending Product Portfolio

SBP has a proactive policy in terms of providing a short term breather. Although initially when Covid happened things looked grim but Pakistan managed it pretty well. All the schemes and relieves introduced by the government and the SBP helped to stabilize industry little bit. The exporters who were most prone and would have probably defaulted in open foreign exchange contract, however, nothing came in through. As a result of very quick portfolio review recently and it came to our knowledge that things are not as bad as we visualized originally. Pakistan is a land of opportunities and resilience is there but transparency and honesty is important. Banks feel comfortable in lending to companies and even to SMEs who are honest and transparent.

Putting capital abroad or opening a branch etc. is not feasible especially due to the covid situation. Even pre-covid, the capital requirements were quite high it doesn't become feasible. But in terms of transfer of technology, MBL is helping a lot of banks outside Pakistan in product development, providing training support and Shariah support etc. Meezan has got the largest sharia department in any Islamic bank around the world therefore, Meezan is equipped to take this technology abroad. With some hard work and consistency Pakistan can be in the hub of Islamic banking. Pakistan can step up efforts in contributing more towards Islamic banking across border.

Final thoughts

The dilemma right now is that Pakistan‘s demands are huge, it is a growing population i.e. 210 million with only 7% of women who have access to credit and less than 1% have access to women entrepreneurship programs.

some fundamental issues need to be looked at; first is the public private partnership. The key question is that if the financial institutions are taking risk than they want the policy environment to be supportive. If the banks get the housing legal and regulatory policies right, then they would like to lend to housing. There is a whole ecosystem and everything is integrated. At the top, there is need for macroeconomic stability and the fiscal temperature to reduce because if the fiscal temperature is high then ability to have efficient financial intermediation is limited. Because the banks end up having costlier processes of financial intermediation if they are going to invest 40% of their holdings into government securities and 20% in liabilities, there will be nothing left for mediation. It was surprising to see the figures of banks for the year ended December 2019; while the big banks were much lower in ADRs, the smaller banks are turning their money much more as they had 60% to 70% ADR relative to the bigger banks. It is crucial for all the banks to earn money, particularly the smaller banks, because they don’t have a bigger base to thrive on. Public-private partnership is great but if continues with the weak policy environment or solvency system it will end up in losses.

Pakistan should strive for much more ambitious aggressive progress in the financial industry as it is the lifeline. For instance, economic growth, poverty reduction, inclusive policies, sustainable development all are affected by the financial industry and climate finance haven’t even been touched.

There are issues in the system which is why SBP is introducing various initiatives to address those issues. Recently there is some stress around credit portfolio of banks but it is not a threat to the banking system. Banks are very stable with 17% capital adequacy ratio and 8.6% NPR ratio so they are still at a very manageable level. Likewise, with the increase in digital payments, cyber security issues have got much more significance now and that’s the reason the regulator has been coordinating with banks to introduce strategies to best manage the cyber security problem. Then there are health concerns regarding the bank staff because they have a higher risk of getting Covid than other sectors. All banks are instructed to take care of the safety and security of their employees.

Audience questions

The government is offering a much better rate of returns in the paper so how would banks be motivated to invest into real tangible businesses?
The banks will have to reshape their balance sheets if they intend to do so there's no doubt that the government borrowing is crowding out the private sector The banks don't have incentive to lend to the private sector but if you compare the smaller banks with the larger financial institutions you can see that the ADR is definitely getting better it is up to the banks themselves to strategize their balance sheets in a manner where they need better information to take better credit decisions so then they will be able to learn the SMEs and agriculture and personal loans. It really has to do with the way banks intend to shape their balance sheets if they intend to keep it low risk low return or if they want to make higher profits then they have to take a risk and will have to improve their information base to take better decisions.

It's about responsible banking it's about getting that purpose into the institution rather than purely looking at the financial outcome. They should also see how they can make impact and what the institution has to give back to the community and people to which they serve and to the country they operate in.

Syed Irfan Ali, Executive Director, State Bank of Pakistan

Why is Islamic banking rates tied to KIBOR, is there any alternate insight?
There needs to be an alternate benchmark globally. Financial services need to develop an alternate benchmark in terms of pricing liquidity, management tools etc. this is the right thing to ask but we aren't there yet in terms of desired state.

Armughan Kausar, FCA, Chief Internal Auditor, Habib Bank Limited

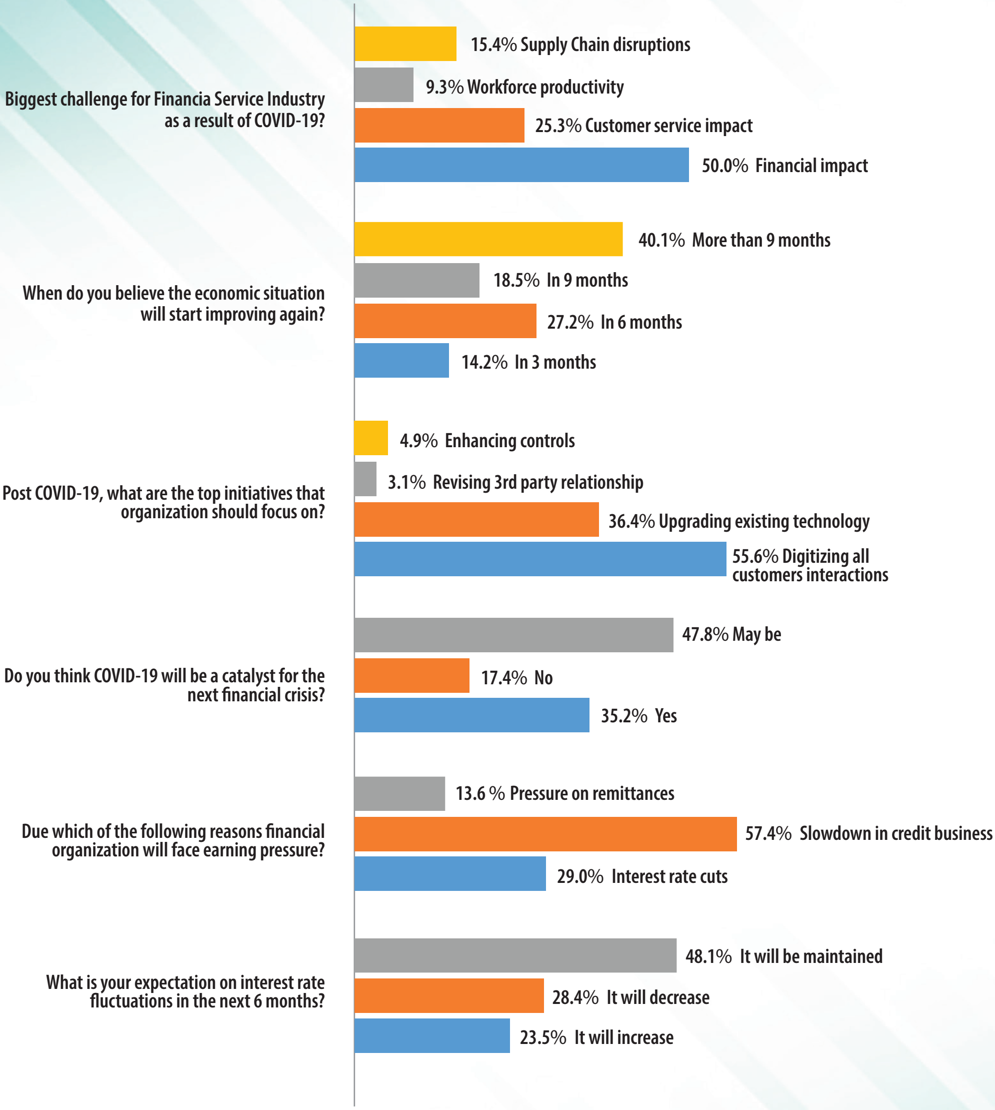
Government is giving relaxations/amnesties to the construction sector allowing them to invest without asking about the source of funds while there are stringent AML/CFT laws in the documented sectors, both regulated by the SECP and SBP. How can the economy be documented in such a situation?
This is tax amnesty so it has nothing to do with the fundamentals of AMLCFT that the banks have to follow.

Syed Irfan Ali, Executive Director, State Bank of Pakistan

More than four decades and loans disbursed are not encouraging whereas Microfinance Banks are relatively new and performing better than the NBFC sector. What is the reason for low performance of NBFC sector?
The banking sector is regulated sector and has overtime developed very strong mechanisms for Risk-taking in the lending process. while NBFC sector have attempted at various options, they have not been structured in the same way as banks have in terms of diversity of funding and also lending was not diverse enough to distribute risk effectively. They have not been able to create that size and scale. DFIs have been very successful and were largely responsible for the growth of industrial sector in Pakistan. Those were properly capitalized, they had adequate skills, they were funded and they had long term objective and they fulfilled their role extremely well.

Atif Bajwa, CEO, Bank Alfalah

Audience polls



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