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"The Rapid Growth of Banking Sector in Pakistan and its Impacts on Revenue Generation"

By

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The contents of this paper reflect the Group's own views and are not necessarily endorsed by the Academy.

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Preface

The objective of the syndicate research was to discuss the relationship and linkages between the rapid rise of banking sector in Pakistan and its resultant impacts on revenue generation. The primary role was to figure out the main factors which led to the increase in number of banks in Pakistan and then to investigate how these banks contribute to revenue generation.

The research paper is divided into three main sections. The first part deals with the description of the banking sector in Pakistan, its origination and subsequent evolution in Pakistan. The second part covers in detail the reasons of the rapid growth or in fact the mushrooming of the Banking Sector in Pakistan. Finally, the third section delves with an investigative intent into the impacts of growth of the banking sector on revenue generation. Emphasis has been laid in all the sections to be objective and to the point so as to avoid any ambiguity or repetition.

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Executive Summary

A growing and dynamic banking sector is essential for revenue generation in Pakistan because growth in the banking sector and the real economy mutually reinforce each other. The banking sector constitutes the core of the financial sectors in Pakistan. Private sector investment and consumption should be seen as the key drivers of the revenue generation and must be supported by growing financial intermediation and services, including not only banks but also non-bank financial institutions, and debt securities and the stock market. Pakistan's banking industry and the broader financial sector has enormous potential to support faster economic growth and revenue generation. When compared with other emerging market countries (EMCs), these sectors remain small in relation to the economy. In recent years, a wide range of important structural reforms already have taken place but more reforms are needed for the banking sector to grow into its full potential for supporting strong and sustained economic growth and revenue generation.

Glossary of Terms

Coefficient of Variance The coefficient of variance is the ratio of Standard Deviation to Arithmetic Mean. The coefficient is a useful statistical tool for comparing the degree of volatility of more than one data sets when their means are significantly different from each other.

Consumer Financing means any financing allowed to individuals for meeting their personal, family or household needs. The facilities categorized as Consumer Financing include credit cards, auto loans, housing finance, consumer durables and personal loans.

Corporate means and includes public limited companies and such entities, which do not come under the definition of SME.

Credit risk arises from the potential that a borrower or counter-party will fail to perform an obligation or repay a loan.

Discount rate is the rate at which SBP provides three-day repo facility to banks, acting as the lender of last resort.

Duration (Macaulay's Duration) is a time weighted present value measure of the cash flow of a loan or security that takes into account the amount and timing of all promised interest and principal payments associated with that loan or security. It shows how the price of a bond is likely to react to different interest rate environments. A bond's price is a function of its coupon, maturity and yield.

Force Sale Value (FSV) means the value that can currently be obtained by selling the mortgaged / pledged assets in a forced / distressed sale conditions. This value fully reflects the possibility of price fluctuations.

GAP is the term commonly used to describe the rupee volume of the interest-rate sensitive assets versus interest-rate sensitive liabilities mismatch for a specific time frame; often expressed as a percentage of total assets.

Gross income is the net interest income (before provisions) plus non-interest income; the income available to cover the operating expenses.

Interbank rates are the two-way quotes namely bid and offer rates quoted in interbank market are called as interbank rates.

Interest rate risk is the exposure of an institution's financial condition to adverse movement in interest rates, whether domestic or worldwide. The primary source of interest rate risk is difference in timing of the re-pricing of bank's assets, liabilities and off-balance sheet instruments.

Intermediation cost is the administrative expenses divided by the average deposits and borrowings.

Liquid assets are the assets that are easily and cheaply turned into cash – notably cash and short-term securities. It includes cash and balances with banks, call money lending, lending under repo and investment in government securities.

Liquidity risk is the risk that the bank will be unable to accommodate decreases in liabilities or to fund increases in assets. The liquidity represents the bank's ability to efficiently and economically accommodate decreases in deposits and to fund increases in loan demand without negatively affecting its earnings.

Market risk is the risk that changes in the market rates and prices will impair an obligor's ability to perform under the contract negotiated between the parties. Market risk reflects the degree to which changes in interest rates, foreign exchange rates, and equity prices can adversely affect the earnings of a bank.

Net interest income is the total interest income less total interest expense. This residual amount represents most of the income available to cover expenses other than the interest expense.

Net Interest Margin (NIM) is the net interest income as a percent of average earning assets. Net loans are the loans net of provision held for NPLs.

Paid-up capital is the equity amount actually paid by the shareholders to a company for acquiring its shares

Repricing risk arises from timing differences in the maturity of fixed rate and the repricing of floating rates as applied to banks' assets, liabilities and off-balance sheet positions

Return on assets measures the operating performance of an institution. It is the widely used indicator of earning and is calculated as net profit as percentage of average assets.

Return on equity is a measure that indicates the earning power of equity and is calculated as net income available for common stockholders to average equity

Secondary market is a market in which securities are traded following the time of their original issue.

SME means an entity, ideally not a public limited company, which does not employ more than 250 persons (if it is manufacturing/ service concern) and 50 persons (if it is trading concern) and also fulfils the following criteria of either 'a' and 'c' or 'b' and 'c' as relevant:

(a) A trading / service concern with total assets at cost excluding land and building upto Rs50 million.

(b) A manufacturing concern with total assets at cost excluding land and building upto Rs100 million.

(c) Any concern (trading, service or manufacturing) with net sales not exceeding Rs300 million as per latest financial statements.

Abbreviations

AFS Available For Sale	ALM Asset Liability Management
BIA Basic Indicator Approach	Bps Basis Points
CAR Capital Adequacy Ratio	CB Commercial Bank
CCF Credit Conversion Factor	CCS Cross Country Swaps
CDNS Central Directorate of National Saving	CPI Consumer Price Index
CPV Credit Portfolio View	CRR Cash Reserve Requirements
CRWA Credit Risk Weighted Amounts	CY Calendar Year
DFIs Development Finance Institutions	ERF Export Refinance
EURIBOR Euro Interbank Offered Rate	EXR Exchange Rate
FB Foreign Bank	FDBR Financial Derivatives Business Regulations
FDR Financing to Deposits Ratio	FRA Forward Rate Agreements
FSV Forced Sale Value	GDP Gross Domestic Product
GoP Government of Pakistan	HFT Held For Trading
HTM Held-to-Maturity	IBIs Islamic Banking Institutions
IRS Interest Rate Swaps	KIBOR Karachi Interbank Offered Rate
LIBOR London Inter Bank offered Rate	LPB Local Private Bank
LSM Large Scale Manufacturing	MCR Minimum Capital Requirement
MRWA Market Risk Weighted Amounts	MTB Market Treasury Bill
NII Net Interest Income	NMI Non-Market Maker Financial Institution
NOP Net Open Position	NPF Non Performing Finance
NPL Non Performing Loan	NPLR Loan Infection Ratio
NSS National Saving Scheme	OMO Open Market Operation
ORWA Operational Risk Weighted Amounts	OTC Over the Counter
PAT Profit After Tax	PIB Pakistan Investment Bond
PKR Pak Rupee	PSCB Public Sector Commercial Bank
PSE Public Sector Enterprise	PTCs Participation Term Certificates
QoQ Quarter on Quarter	QPR Quarterly Performance Review
QRC Quarterly Report of Condition	ROA Return on Asset
ROE Return on Equity	RSA Rate Sensitive Assets
RSL Rate Sensitive Liabilities	RWA Risk Weighted Assets
SA Standardized approach	SB Specialized Bank
SBP State Bank of Pakistan	SECP Securities and Exchange Commission of Pakistan
SLR Statutory Liquidity Requirements	SME Small and Medium Enterprise
TFCs Term Finance Certificates	USD United States Dollar
WALR Weighted Average Lending rate	WPI Wholesale Price Index
YoY Year on Year	

Significance and Scope of Study

The research paper will highlight the current issue of rapid growth of banking sector in Pakistan and its impacts on revenue generation. By comprehending the problem areas, the public will themselves be able to judge the various dimensions of the situation. This research paper will also help the policy framers to formulate policies under the light of the given facts. It will also be useful for others who are interested in doing such research or even to the general reader.

Methodology

Descriptive and analytical methodology has been applied in this research paper. Main emphasis has been given upon primary and secondary sources available. Primary sources include interview, lectures, telephonic and video conferences. The secondary sources comprise of books, articles, newspapers and websites.

Section 1: Overview of the Banking Sector of Pakistan

1.1 Description of the Banking Sector in Pakistan

The banking sector in Pakistan has witnessed drastic changes over a period of 64 years since country's independence in 1947. Initially it suffered from acute shortage of resources and uncertainty due to prevailing political and socioeconomic conditions. Lack of trained human resource and professionals resulted into poor quality of products and services. However, State Bank of Pakistan was established as the central bank on July 1, 1948 to control the financial sector. Subsequent amendments were made to extend the control and functions of SBP through State Bank of Pakistan Act 1956. SBP encouraged the private sector to establish banks and financial institutions in the country. It resulted into unhealthy competition and unlawful practices due to bribe and corruption during the decades of 1950s and 1960s. In 1974, all the existing banks were nationalized by the Government. The performance of nationalized banks deteriorated due to government protection to employees, resulting into the provision of inferior products and poor services. It also discouraged the private investors and foreign financial institutions. The poor performance of nationalized banks caused the reforms/privatization of banking sector in early 1990s. Today, the Banking sector of Pakistan is playing pivotal role in the growth of country's economy. In accordance with the State Bank of Pakistan Act, the banking system of Pakistan is a two-tier system including the State Bank of Pakistan (SBP), commercial banks, specialized banks, Development Finance Institutions (DFIs), Microfinance banks and Islamic banks. As of June 2010, the banking sector comprised 36 commercial banks (including 25 local private banks, 4 public sector commercial banks and 7 foreign banks) and 4 specialized banks with a total number of 9,087 branches throughout the country. Among the banks, there are 6 fully fledged Islamic banks as at end of June 2010.

In addition to the above, the SBP has granted licenses to the Industrial and Commercial Bank of China (ICBC) and Sindh Bank in December 2010. The ICBC aims to exploit opportunities in trade and project finance generated by a growing number of Chinese companies working in Pakistan while Sindh Bank aims to promote agricultural development and small scale businesses. Besides the commercial banks, 8 Microfinance banks and 7 Development Finance Institutions

(DFIs) are operating in the banking industry of Pakistan. Due to closing down of a number of Development Financial Institutions (DFIs) during the last decade, the government is currently re-considering to set-up either an "Infrastructure Bank" or "Infrastructure Institution" as this is requirement of the country. The banks in Pakistan provide settlement and cash services to individuals and companies, including correspondent-banking. Banks also offer domestic and cross-border remittance services to the population. Furthermore, they provide depository services for the accounting and safekeeping of securities. During the last few years, banks have been paying great attention to the expansion of services rendered to households and the enhancement of their quality and efficiency. New forms and channels of making payments have also been introduced. The services of State Bank of Pakistan include payments to banks, to and on behalf of the Federal and Provincial Governments, the Treasury and some other public institutes including collection of revenues etc., through its 16 field offices as well as through a countrywide network of currency chest/sub-chest branches of National Bank of Pakistan. As mentioned earlier that the financial landscape of the country which was significantly altered in early 1970s has been transformed - through sector reforms initiated in the early 1990s - into an efficient, sound and strong banking system. The reforms have resulted in an efficient and competitive financial system. In particular, the predominantly state-owned banking system has been transformed into one that is predominantly under the control of the private sector. The legislative framework and the State Bank of Pakistan's supervisory capacity have been improved substantially. As a result, the financial sector is sounder and exhibits an increased resilience to shocks. Today, almost 80 percent of the banking assets are held by the private sector banks and the privatization of nationalized commercial banks has brought about a culture of professionalism and service orientation in place of bureaucracy and apathy. Banking Technology that was almost non-existent in Pakistan until a few years ago has revolutionized the customer services and access on-line banking, Internet banking, ATMs, mobile phone banking/ branchless banking and other modes of delivery have made it possible to provide convenience to the customers while reducing the transaction costs to the banks. The Credit Cards, Debit Cards, Smart Cards etc. business has also expanded. The foreign exchange market that was highly regulated through a system of direct exchange controls over suppliers and users of foreign exchange has been liberalized and all purchases and sales take place through an active and vibrant inter-bank exchange market. All restrictions have been removed with full current account

convertibility and partial capital account convertibility. Since 1st July 2008 Real-Time Gross Settlement (RTGS) payment system has been put in place. The RTGS in Pakistan has been named as Pakistan Real-time Inter-bank Settlement Mechanism (PRISM). Using this system, the banks holding accounts at SBP are able to operate their accounts in real time from their own premises via computerized network between SBP and the participating Banks. Prior to the recent financial crisis, the excess liquidity and competition among the banks prompted them to move away from the traditional limited product range of credit to the government and the public sector enterprises, trade financing, big name corporate loans, and credit to multinationals to an ever-expanding menu of products and services. The borrower base of the banks expanded many folds as the banks diversified into agriculture, SMEs, Consumers financing, mortgages, etc. The middle class that could not afford to buy cars or houses/apartments as they did not have the financial strength for cash purchases had been the biggest beneficiaries of these new products and services. Since late 2007, Pakistan faced a difficult macroeconomic environment, not as such due to the global crisis but rather due to a confluence of factors which had been brewing for a while, particularly due to the gradual build up of macroeconomic imbalances which led the country to embark on a macroeconomic stabilization program in November 2008 with the support of the IMF SBA. The Global Financial Crisis (GFC) had an indirect impact in Pakistan which became evident in 2009 and manifested itself in various forms in the real sector of the economy. However, as said earlier, the major challenges facing the domestic economy can only be partly attributed to the GFC. Indeed there was a decline in exports due to recession in economies which are Pakistan's major trading partners, and there was pressure on capital flows where strained liquidity position in global financial markets impacted foreign portfolio investment.

However, factors such as the power shortages leading to under utilization of industrial capacity and rise in the cost of production, the long-standing issue of inter-corporate circular debt, considerable decline in foreign direct investment due to weak economic fundamentals, high inflation, security concerns and above all, the mounting fiscal deficit breaching previous records in the country's economic history, all had a role to play in keeping the process of economic recovery in Pakistan weak at best. The leading evidence of these various pressures on domestic

firms and industries is that their loan repayment capacity has been compromised, with a consequent rise of non-performing loans (NPLs) on the banks' balance sheets.

Furthermore, due to the deteriorated fiscal situation, public sector borrowed heavily from banks for budgetary support, financing needs of Public sector Enterprises (PSEs) and commodity operations. Accordingly, there has been a shift in banks' asset-mix towards credit to the public sector along with increased performance for top rated corporations – over Small and Medium Enterprises (SMEs) and consumer that are generally less resilient to economic slowdown and fragility in operating environment. The heightened credit risk is reflected in a noticeable and persistent increase in NPLs – doubling over two years by the end of calendar year 2009.

Nevertheless, it has tested the resilience of the banking sector in that banks have been forced to build contingency reserves and provide for infected assets. Such requirements have been affecting their dividend payments and consequently putting pressure on their share prices.

1.2 List of Operational Banks in Pakistan

Sr. No.	Name of Bank	Branches	Website
A.	**Public Sector Commercial Banks**	1,621	
1	First Women Bank Ltd.	39	www.fwbl.com.pk
2	National Bank of Pakistan	1,267	www.nbp.com.pk
3	The Bank of Khyber	42	www.bok.com.pk
4	The Bank of Punjab	273	www.bop.com.pk
B.	**Local Private Banks**	6,850	
1	Allied Bank Ltd.	786	www.abl.com.pk
2	Arif Habib Bank Ltd.*	36	www.summitbank.com.pk
3	Askari Bank Ltd.	204	www.askaribank.com.pk
4	Atlas Bank Ltd.*	40	www.atlasbank.com.pk
5	Bank Al-Falah Ltd.	309	www.bankalfalah.com
6	Bank Al-Habib Ltd.	267	www.bankalhabib.com
7	BankIslami Pakistan Ltd	70	www.bankislami.com.pk
8	Dawood Islamic Bank Ltd.	42	www.dawoodislamic.com
9	Dubai Islamic Bank Pakistan Ltd	36	www.dibpak.com
10	Emirates Global Islamic Bank Ltd.	58	www.egibl.com
11	Faysal Bank Ltd.	136	www.faysalbank.com.pk
12	Habib Bank Ltd.	1,457	www.habibbankltd.com
13	Habib Metropolitan Bank Ltd	120	www.hmb.com.pk
14	JS Bank Ltd.	40	www.jsbl.com
15	KASB Bank Ltd.	70	www.kasbbank.com
16	MCB Bank Ltd.	1,085	www.mcb.com.pk
17	Meezan Bank Ltd.	180	www.meezanbank.com
18	mybank Ltd.	80	www.mybankltd.com
19	NIB Bank Ltd.	204	www.nibpk.com
20	Samba Bank Ltd.	28	www.samba.com.pk
21	Silk Bank Ltd.	85	www.silkbank.com.pk

22	Soneri Bank Ltd.	156	www.soneri.com
23	Standard Chartered Bank (Pakistan) Ltd.	162	www.standardchartered.com
24	The Royal Bank of Scotland Ltd.	79	pwkww.rbs.com.pk
25	United Bank Ltd.	1,120	www.ubl.com.pk
C.	**Foreign Banks**	80	
1	Al-Baraka Islamic Bank B.S.C (E.C)	29	www.albaraka.com.pk
2	Barclays Bank PLC	15	www.barclays.pk
3	Citibank N.A	17	www.citibank.com.pk
4	Deutsche Bank AG	3	www.db.com
5	HSBC Bank Middle East Ltd.	12	www.hsbc.com.pk
6	Oman International Bank S.A.O.G	3	www.oiboman.com
7	The Bank of Tokyo-Mitsubishi UFJ, Ltd.	1	www.btm.co.jp
D.	**Specialized Banks**	536	
1	Industrial Development Bank of Pakistan	15	www.idbp.com.pk
	Ltd.		
2	Punjab Provincial Cooperative Bank Ltd.	159	www.ppcbl.punjab.gov.pk
3	SME Bank Ltd.	13	www.smebank.org
4	Zarai Traqiati Bank Ltd.	349	www.ztbl.com.pk
Commercial Banks (A+B+C)		8,551	
	All Banks (A+B+C+D)		**9087**

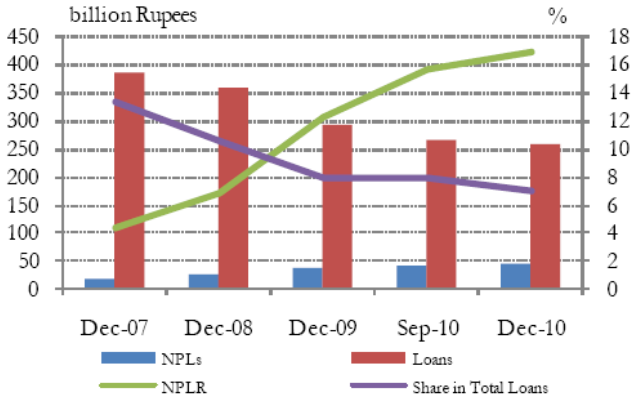
Source: State Bank of Pakistan

Section-2: Reasons for the Rapid Growth of Banking Sector in Pakistan

2.1 Consumer Financing:

By removing restrictions imposed on nationalized commercial banks for consumer financing, the State Bank of Pakistan has given a big boost to consumer financing. Middle income groups can now afford to purchase cars, TVs, air conditioners, VCRs, etc. on installment basis. This, in turn, has given a large stimulus to the domestic manufacturing of these products.

Figure 2.1.6: Trends in Consumer Finance



Source: State Bank of Pakistan

2.2 Micro Financing:

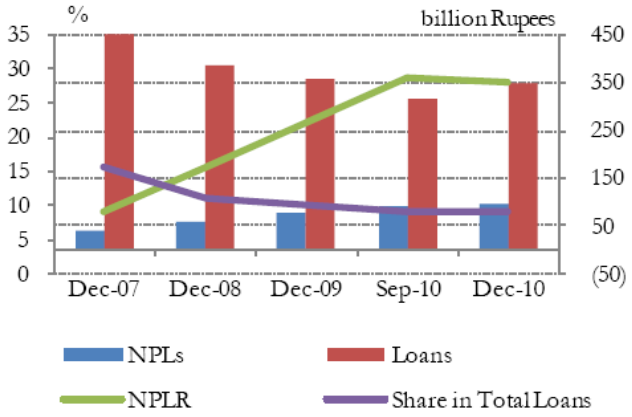
SBP has brought microfinance under the purview of its regulatory and supervisory ambit. However, the licensing and regulatory requirements for Micro Credit and Rural financial institutions have been relaxed and have been made simple to facilitate widespread access to small borrowers particularly in the rural areas. Unlike the commercial banks, the Microfinance Institutions (MFIs) can be set up at district, provincial and national levels with varying capital requirements. There is less stringency and more facilitative thrust embedded in the prudential regulations designed for this type of institutions. Six microfinance institutions are already

operating and then outreach has crossed half a million customers. But in this field we have to learn a lot from the Indonesian experience particularly the BRI and the regulatory set up in the Bank of Indonesia.

2.3 SME Financing:

The access of small and medium entrepreneurs to credit has been a major constraint to expansion of their business and up gradation of their technology. A Small and Medium Enterprise (SME) Bank has been established to provide leadership in developing new products such as program loans, new credit appraisal and documentation techniques, and nurturing new skills in SME lending which can then be replicated and transferred to other banks in the country. Program lending is the most appropriate method to assist the SME financing needs. The new prudential regulations for SMEs do not require collateral but asset conversion cycle and cash flow generation as the basis for loan approval. The State Bank is also helping the banks in developing their credit appraisal capacity for SME lending. Indonesian experience in this field will also be particularly helpful to us.

Figure 2.1.5: Trends in SME Finance



Source: State Bank of Pakistan

2.4 Policy of Taxation:

The Government has already reduced the corporate tax rate on banks from 58 percent to 35 percent during the last six years and brought at par with the general corporate tax rate. This has made banking a highly profitable business and the banks have earned about $ 1 billion of profits in 2005 - a big jump from the huge losses incurred until a few years ago.

2.5 Islamic Banking:

Indonesia and Pakistan have begun their journey in Islamic banking only recently. Pakistan has allowed Islamic banking system to operate in parallel with the conventional banking providing a choice to the consumers. A large number of Pakistanis have remained withdrawn from commercial banking because of their strong belief against riba-based banking. These individuals and firms - mainly middle and low class - will have the opportunity to invest in trade and businesses by availing of loans from Islamic banks and thus expand economic activity and employment. Several full-fledged Islamic banks have already opened the doors for business and many conventional banks have branches exclusively dedicated to Islamic banking products and services.

2.6 E-Banking:

There is a big surge among the banks to upgrade their technology platform, on-line banking services and move towards E-banking. During the last four years has been a large expansion in the ATMs and at present more than 1000 A TMs are working throughout the country. Progress in creating automated or on-line branches of banks has been quite significant so far and it is expected that by 2007 almost all the bank branches will be on-line or automated.

2.7 Strategic Human Resource Development (SHRD):

The banks have recently embarked on merit-based recruitment to build up their human resource base - an area which has been neglected so far. The private banks have taken a lead in this respect by holding competitive examinations, interviews and selecting the most qualified candidates. The era of appointment on the basis of connections and recommendations from the politicians has almost come to an end as the private owners want to attract and retain the best available talent which can maximize their profits. This new generation of bankers will usher in a culture of professionalism and rigor in the banking industry and produce bankers of stature who will provide leadership in the future.

2.8 Privatization of Nationalized Commercial Banks(NCBs):

All the Nationalized Commercial Banks (NCBs) under the public sector, except one, have been privatized. As a consequence the private sector owns, manages and controls about 80 percent of the banking assets in the country - a reversal of the situation since early 1990s when NCBs held 80 percent of total assets. Even in the case of National Bank of Pakistan 23.5 percent shares have been floated through Stock Market mainly aimed at small retail investors.

2.9 Corporate Governance:

Strong corporate governance promotes transparency, accountability and protects the depositors' interests. The SBP has taken several measures in the last four years to put in place and enforce good governance practices to improve internal controls, ensure strong oversight and bring about a change in the organizational culture.

2.10 Strengthening of the Capital Base:

Capital requirements of the banking sector have to be adequate to ensure a strong base, and withstand unanticipated shocks. The minimum paid-up capital requirements of the banks have

been gradually raised from $ 1 0 million to reach $ 100 million by 2009. This has already resulted in mergers and consolidation of many financial institutions and weeding out of several weaker banks from the financial system.

2.11 Improving Asset Quality:

The stock of gross non-performing loans (NPLs) that amounted to 2S percent of total advances of the banking system and DFls has been reduced to 9 percent by March 2006. More than two-thirds of these loans are fully provided for and net NPLs to net advances ratio has come down to as low as 2 percent for the commercial banks. The positive development is that the quality of new loans disbursed since 1997 has improved and recovery rate is 97 percent.

2.12 Liberalization of Foreign Exchange Regime:

Pakistan has further liberalized its foreign exchange regime and allowed setting up of foreign exchange companies in the private sector to meet the demands of Pakistani citizens for foreign exchange transactions. Pakistani Corporate sector companies have also been allowed to acquire equity abroad. Foreign registered investors can bring in and take back their capital, profits, dividends, remittances, royalties, ete. freely without any restrictions. There are no restrictions on the entry to any sector of the economy. Banking, insurance, real estate, retailing and all other sectors can be owned upto 100 percent by foreigners.

2.13 Mortgage Financing:

A number of incentives have been provided to encourage mortgage financing by the banks. The upper ceiling has been raised, tax deduction on interest payments on mortgage has been allowed, and a new recovery law aimed at expediting repossession of property by the banks has been promulgated. The banks have been allowed to raise long term funds through rated and listed debt instruments to match their long term mortgage assets with their liabilities.

2.14 Legal Reforms:

Legal difficulties and time delays in recovery of defaulted loans have been removed through a new ordinance namely, The Financial Institutions (Recovery of Finances) Ordinance, 2001. The new recovery laws ensure the right of foreclosure and sale of mortgaged property with or without intervention of court and automatic transfer of case to execution proceeding. A Banking Laws Reforms Commission has reviewed and revised several pieces of legislations and is drafting new laws such as bankruptcy law.

2.15 Prudential Regulations:

The prudential regulations in force were mainly aimed at corporate and business financing. The SBP in consultation with the Pakistan Banking Association and other stakeholders has developed a new set of regulations which cater to the specific separate needs of corporate, consumer and SME financing. The new prudential regulations have enabled the banks to expand their scope of lending and customer outreach.

2.16 Agriculture Credit:

A complete revamping of Agriculture Credit Scheme has been done recently with the help of commercial banks. The scope of the Scheme which was limited to production loans for inputs has been broadened to the whole value chain of agriculture sector. The broadening of the scope as well the removal of other restrictions have enabled the commercial banks to substantially increase their lending for agriculture by a multiple of five times compared to FY 1999-00 thus mainstreaming agriculture lending as part of their corporate business. Unlike the previous years when they were prepared to pay penalties for under performance under mandatory credit scheme the banks have achieved consistently rising higher targets every year. Small private commercial banks have also accelerated their agriculture lending as they face large unmet demand at remunerative margins.

2.17 Credit Rating:

To facilitate the depositors to make informed judgments about placing their savings with the banks, it has been made mandatory for all banks to get themselves evaluated by credit rating agencies. These ratings are then disclosed to the general public by the SBP and also disseminated to the Chambers of Commerce and Trade bodies. Such public disclosure will allow the depositors to choose between various banks.

2.18 Supervision and Regulatory Capacity:

The banking supervision and regulatory capacity of the Central Bank has been strengthened. Merit - based recruitment, competency - enhancing training, performance - linked promotion, technology - driven process, induction of skilled human resources and greater emphasis on values such as integrity, trust, team work have brought about a structural transformation in the character of the institution. The responsibility for supervision of non-bank finance companies has been separated and transferred to Securities Exchange Commission. The SSP itself has been divided into two parts - one looking after central banking and the other after retail banking for the government.

2.19 Payment Systems:

Finally, the country's payment system infrastructure is being strengthened to provide convenience in transfer of payments to the customers. The Real-Time Gross Settlement (RTGS) system will process large value and critical transactions on real time while electronic clearing systems will be established in all cities.

2.20 Positive Role of State Bank of Pakistan:

The above factors will go a long way in further strengthening the Banking sector in Pakistan but a vigilant supervisory regime by the State Bank will help steer the future direction. Accordingly, a strategy for banking sector reforms up to 2017 has been formulated by the State Bank of Pakistan (SBP). The Banking Sector Strategy (BSS) is centered on reforms involving the SBP

and the banking sector, which constitutes not only the core of the financial system in Pakistan but is also central to the monetary and financial stability responsibilities of the SBP. The BSS focuses on reforms that the SBP has the power and resources to implement or substantially influence. The BSS has been developed based on: (i) a comprehensive assessment of the banking and the broader financial sector to identify areas or issues limiting financial sector development; (ii) Pakistan's forward looking economic development strategy; and (iii) experiences of other emerging countries and international best practices. The BSS has been developed with external technical assistance to bring in international experiences.

Section-3 Effects of Rapid Growth of Banking Sector of Pakistan on Revenue Generation

3.1 Revenue Generation

Revenue Generation Defined:

Revenue can be defined as the increase in assets of governmental funds that do not increase liability or recovery of expenditure. This revenue is obtained from taxes, licenses and fees. The process by which a country earns this revenue is referred to as Revenue Generation.

3.2 Means of Revenue Generation in Pakistan

Revenue generation is basically achieved by the application of the following means:

- Agriculture
- Banking
- Industry
- SME Sector
- Automotive industry
- CNG industry
- Cement industry
- IT industry
- Textiles
- Mining
- Services
- Communication
- Railways
- Aviation
- Wholesale and retail trade
- Finance and insurance
- Ownership of dwellings

- Public administration and defence
- Social, community and personal services
- Electricity
- Chemicals and pharmaceuticals
- Investment
- Exports
- Remittances
- Revenues and taxation, etc.

Although the country is a Federation with constitutional division of taxation powers between the Federal Government and the four provinces, the revenue department of the Federal Government, the Federal board of Revenue(FBR), collects almost 95% of the entire national revenue. The Federal Board of Revenue collected nearly one trillion rupees ($14.1 billion) in taxes in the 2007–2008 financial year, while it collected about 1558 billion ($18.3 billion) during FY 2010–2011. The revenue collection has hovered below 10% of the GDP for the past several years. The Federal Board of Revenue mainly relies on indirect taxation, and most of the Income Tax is also collected indirectly, in the form of withholding taxes.

3.3 Revenue Generation through Banks:

- The primary way is through lending money to their customers,
- A second way would be to issue bonds, and
- A third way would be to sell stock.

A bank can generate revenue in a variety of different ways including interest, transaction fees and financial advice. The main method is via charging interest on the capital it lends out to customers. The banks make profits from the differential between the level of interest it pays for deposits and other sources of funds, and the level of interest it charges in its lending activities. Banks also make their profit through interest from loans, credit cards etc. and also from the fees from having a bank account and other transactions etc. This difference is referred to as the *spread* between the cost of funds and the loan interest rate. Historically, profitability from lending activities has been cyclical and dependent on the needs and strengths of loan customers

and the stage of the economic cycle. Fees and financial advice constitute a more stable revenue stream and banks have therefore placed more emphasis on these revenue lines to smooth their financial performance.

As a further example of how banks generate revenue, investment banks generate revenue by the financial services they provide to their customers by means of fee, commission, brokerage etc. For every service a customer gets out of an investment bank, he/she is charged a fee based on the type of service and the amount that is being transacted. So the more customers they have and more business they make, the more revenue they generate.

3.4 Impacts of the Rapid Growth of Banking Sector on Revenue Generation in Pakistan

The banking sector in Pakistan has grown and expanded extensively during the past ten years and this fact has had and is still continuing to have a positive impact on revenue generation. During the world financial crisis in 2008–09, banking sector in Pakistan has served to attract a substantial amount of FDI in the sector. Stress tests conducted on June 2008 data indicate that the large banks are relatively robust, with the medium and small-sized banks positioning themselves in niche markets. Banking sector turned profitable in 2002. Their profits continued to rise for the next five years and peaked to Rs 84.1 ($1.1 billion) billion in 2006. The credit card market continued its strong growth with sales crossing the 1 million mark in mid-2005. Since 2000 Pakistani banks have begun aggressive marketing of consumer finance to the emerging middle class, allowing for consumption boom (more than a 7-month waiting list for certain car models) as well as a construction bonanza. The Federal Bureau of Statistics provisionally valued this sector at Rs. 311,741 million in 2005 thus registering over 166% growth since 2000. The following are some of the impacts of the rapid growth of banking sector on the overall revenue generation in Pakistan:

1. Banking sector of Pakistan has been transformed within a short period of 5 years (CY2000-05) from a sluggish and government-dominated sector to a much more agile, competitive and

profitable industry. Speed and sequencing of banking sector transformation and its role in promoting economic growth is now a leading story of a sector success. Within Pakistan it offers a story of what effective leadership of regulator and change management and corporate governance can achieve and offer. Outside Pakistan it is serving to offer rich lessons in what difference governance of regulator can make and how bank restructuring and privatization can change the landscape of the industry.

2. The banking industry in Pakistan will continue to enjoy these trends and has promising prospects. However, sustainability of banking sector performance is dependent on continued macroeconomic stability, stronger vigilance on the sector to ensure effective compliance of industry with the prudential regulatory and supervisory framework, and banking sector's maturity to reorient their business models to enhance their penetration ratio and address the asset: liability mismatches. At Pakistan to ensure macroeconomic stability coupled with effective risk management and mitigation will be critical to Pakistan's future and a precondition for sustainability of banking sector reforms.

3. The astounding growth of banking sector has stimulated and leveraged growth across the board. Major reforms in the banking sector have resulted in a more resilient and efficient financial system that is better placed to absorb significant macroeconomic shocks. Confidence in banking sector performance and prospects remains strong and scope for expansion and diversification remains phenomenal. This is supported by a combination of factors:

4. Banking sector liberalization and restructuring was well sequenced and well designed. In early 2000, financial sector reforms received strong impetus from high degree of political commitment as well as macroeconomic stability, both a prerequisite for smooth and effective implementation of financial sector reforms. The pace and sequence of bank restructuring was possible as the Government created fiscal space for absorbing the costs of the nonperforming and legacy loans. In parallel the financial deepening process triggered by financial liberalization reinforced and was supported by the rising economic growth and activity.

5. Financial liberalization process in Pakistan has been remarkable. It not only resulted in privatization of large public sector banks but the process of privatization was effectively

conducted offering new management in most cases relatively cleaner bank where the key issues of NPL resolution and rationalization of work force were dealt with upfront or ongoing flexibility is awarded through special schemes to deal with the outstanding issues. Augmenting the private sector involvement, the entry requirements for new private banks were relaxed but made more stringent --both in terms of capital requirements and fit and proper criteria for both management and Board of Directors.

6. Accompanying financial liberalization process was a strong effort on the part of central bank to bring the prudential regulatory and supervisory framework for banks at par with the BIS standards. Pakistan is fully/largely compliance with the 28 of the 30 Basel Core Principles for effective Banking Supervision and the remaining 2 principles relate to consolidated supervision, and are under consideration for future compliance.

7. Growth in Banking Sector and its profitability is unprecedented. Banking assets rose three-fold over the last 5 years and industry size is reaching Rs4 trillion. The banking sector's assets to GDP ratio grew from 47.2% in CY00 to 55.6% in CY05 since the growth in banking assets outpaced the nominal GDP; these trends are in sharp contrast from the declining trend in banks' assets to GDP ratio during the second half of the 1990s. Supported by privatization and consolidation, assets of the banking sector have shifted from public to private sector and there is a decline in asset concentration within the banking sector. This changing structure had far-reaching implications for the banking sector profitability.

8. Return on banking assets before taxes have grown to 2.6% (1.8% after tax) relative to 0.2% in CY00 and return on equity has been 25.4%. Improvement in profitability has been supported by high economic activity but it is important to recognize that sustained economic growth, rather than sporadic improvement in real GDP, helps the financial institutions to earn higher profits. In quantitative terms, one percent rise in the real GDP growth tends to improve the profitability by 113 basis points. In addition, low interest rates and inflation for most of the period in the last four years also supported the financial sector profitability, as one percentage point increase in real interest rates and inflation tends to reduce the ROA by 27 basis points in each case. Pakistan's economy to a higher growth trajectory during the last four years contributed significantly

towards the improved profitability of the financial sector. As per the latest study conducted by the World Bank, Pakistan has been ranked second in performance and efficiency indicators (India being the first) among the South Asian countries.

9. Bank's profitability has also been driven by changes in assets and liability management; key trends in this area have involved:

(i) rise in share of earning assets to 82% indicating a rise of 7% over CY00 but much more relative to pre-reform period;

(ii) rising focus on business income has helped raise advances/total asset ratio from 43.8% in CY03 to 54.4%;

(iii) while corporate loans remain an important share of lending, the rise in share of SME, consumer finance and agriculture which typically carry higher charge than corporate loans;

(iv) deposit as a % of liabilities rose by almost 10% since CY00 and reached 84% in CY05 consequently borrowing to liability ratio declined and banks have access to cheaper deposit funds as a large proportion of deposits were either non-interest or low interest bearing short term deposits, while the share of fixed-term deposits of six-month and above has witnessed a substantial decline. The average cost of resource mobilization for banks (deposits plus borrowings) has fallen from 6.6% in CY00 to 2.5% in CY05; and

(v) Operating expenses to income declines from 106% in CY98 to 91% in CY00 and to further 51.2% in CY05 and total expense to income is in the range of 65%. Privatization has significantly contributed in improving profitability of privatized banks, though it has not reduced but enhanced the intermediation spread.

10. Improvements in financial health of banking sector continue. On the wake of this reforms process overall financial health of the banking system improved well and further strengthened since year 2000. Capital adequacy ratio of the banking system now stands at 11.9 percent from

10.9 percent in year 1999. Loan infection ratio has significantly came down to 2.1 percent closer to the internationally acceptable level, as compared to very high infection ratio (at 15.3 percent) in year 1999. These indicators seem more attractive while looking at the commercial banks perspective only and loan infection ratio for commercial banks stands as low as 1.4 percent in June 2006. Profitability indicators have significantly outpaced the international averages and the ROA after tax of all banks in Pakis tan now stands at 2.1 percent as compared to net losses in year 1999. In terms of their core business activity, the banks are now operating at the capacity significantly higher than was in 90s and the loan to deposit ratio now is around 70 percent. A recently released study conducted by the World Bank on "Getting Finance in South Asia" also evaluates Pakistan, after India, as having higher capital adequacy, lower nonperforming loans and stable liquidity position among the South Asian countries.

11. To tackle the problem of non-performing loans, a multi-track strategy was adopted which included enacting of new laws, creation of institutions to pursue recovery of bad loans, and an incentive package for genuine cases (rescheduling of loans of those borrowers who were unable to pay due to economic constraints). Specifically, a new law under the title "The Financial Institutions (Recovery of Finance) Ordinance 2001" was promulgated.1 The new recovery law provided a mechanism for expeditious recovery of stuck up loans, e.g., the law provided a comprehensive procedure for the foreclosure and sale of mortgaged property, without the interventions of a court of law, and automatic transfer of all cases pending in any other courts to banking courts for their early resolution.

12. Furthermore, amendments were made in the Banking Companies Ordinance 1962 (BCO) to; provide legal coverage for expeditious recovery of loans. To deal with the historical portfolio of stuck-up loans of the nationalized commercial banks and DFIs, the Corporate and Industrial Restructuring Corporation (CIRC) and Committee on Revival of Sick Industrial Units (CRSIU) were set up. While NCBs and DFIs were able to clean their balance sheets by transferring a part of their historically stuck up loans to CIRC which would then pursue their recovery independently, CRSIU was set up to evaluate the possibilities of restructuring the loans of those industrial units that had became nonoperational due to unsustainable debt and were otherwise viable. On the incentive side, while concessions were offered to those borrowers who were keen

to regularize themselves, cases of willful defaulters, after due course of law were referred to the National Accountability Bureau (NAB).

13. While political resolve was necessary to tackle the issue of the NPLs, it was equally important to have a dependable infrastructure to provide accurate information on the past credit history of the borrowers. Such information generation entails substantial cost for the lenders, and at times, a lender may opt not to incur this cost, thereby exposing itself to credit risks. The need for setting up a centralized database of the borrower's credit history was realized early in the reform process and the Credit Information Bureau was set up at SBP. Over the years, the scope, coverage and efficiency of this bureau has been enhanced to meet the needs of the growing financial sector.

14. Within South Asia, Pakistan's banking industry fares well relative to all financial indicators too. Stepping back, the disproportionately high growth in advances, while improving the profitability, has raised the risk exposure for financial institutions. However, the simultaneous improvements in capital adequacy and relatively better quality of the fresh loans have mitigated the risk so far. Sustainability of Banking Sector Reforms requires second tier of reforms

15. To ensure growth, high profitability and improvements in financial health are sustainable, it is critical that Pakistan maintains macroeconomic stability which lends investor confidence. Not only have the first phase of structural reforms launched in 1999 still to be completed and impact of its implementation yet to take firm roots, SBP has recognized the added urgency to take stock of our achievements and to evaluate where gaps still exist and to design the strategy and road map for the next phase of reforms. Pakistan banking sector is about to enter a long-term secular growth trajectory (Merill Lynch, 2006).

16. Explosion in banking industry has proven that the sector potential is high. The sector is further expected to receive an impetus as Pakistan has a large base of young population (69.5 million- having less than 19 years of age- as per Census of 1998) and the country's per capita income have risen to US $ 526 doubling relative to FY2000 and reaching US $ 847 annually

with promising prospects of these levels set to double by 2015. An evaluation of banking sector reforms reveals that preoccupation with the privatization of banking industry and clean up of past nonperforming loans, the reforms executed thus far are partial and incomplete. The diagnosis reveals that while there remain outstanding issues in Pakistan's banking industry resolution of these offer significant opportunity to the banks to exploit the untapped markets.

17. First, although the banks have witnessed a substantial rise in profitability and improvement in capital adequacy ratios, the asset: liability management practices discussed above have increased the risk exposure of the banking sector, especially in the wake of monetary tightening since Q4-FY04. Few trends were noteworthy:

(i) The fall in the share of longer-tenor fixed deposits led to an emergence of maturity mismatch in banks' balance sheets. In particular, the incremental advances and investment had longer maturity compared with the incremental bank deposits. SBP encourage banks to attract long term deposits by reducing cash reserve requirements (CRR) for long tenor deposit while raising CRR on shorter tenor deposits. Besides improving the maturity profile of banks' liabilities, this measure was intended to reduce the stickiness of bank deposits.
Responsiveness of bank depositor to interest rates is expected to drive down the interest rate spreads.

(ii) Advances to total assets rose due to strong credit growth and impacted banking systems credit risk and liquidity indicators considerably from CY03 onward as reflected by the rise in advances to deposit ratios and decline in liquid assets to total assets ratios. Surge in advances, with a relatively larger exposure towards high-risk cliental (such as agriculture, SME and household sector) also exposed the banking sector to higher credit risk; the increased maturity mismatches, i.e., higher average maturity of assets than liabilities, have raised liquidity risk. So far the banking sector has effectively coped with the increased risk exposure. While non performing assets registered a downward trend from FY01 onward; banks witnessed a strong growth in capital, which stemmed from substantial improvement in profitability and increased in minimum-paid capital requirement.

18. As expected, the indicators for productivity and capital adequacy have shown a positive relationship with ROA of financial institutions. The latter reflects that a well capitalized financial sector is able to tap business opportunities more efficiently and have a lot of promise. In order to avoid the simultaneity problem between equity ratio and profitability, we have included one period lag of EAT as an explanatory variable in the equation. more flexibility in dealing with problems arising from adverse developments in the operating environment of the financial sector. This also supports the ongoing policy of strengthening the capital base of financial institutions through raising paid-up capital requirement.

19. Second, banking sector reforms have not penetrated deep down or spread across population and regions. Vast majority of the population does not have access to financial services. Country is characterized by lowest savings rates and access to finance remains weak. Few selected indicators are quite illustrative of the situation: Of the 156 million people, the number of deposit holder as per Statistical Bulletin is 26,321,688 which also include multiple accounts by same persons/entities. For a country with a population of approximately 156 million these numbers are abysmally low since it only accounts for less than 17 percent of total population. Enhancement in deposit mobilization and in particular promoting long term resource mobilization – this will require banks to raise deposit rates to stimulate low savings rate which have been partly hurt by low returns and partly by high propensity to consumption. Equally important are steps being taken by central bank to stretch maturity of deposit by charging lower reserve ratio's for long dated deposits.

20. As per Credit Information Bureau (CIB) records the number of borrowers from the banking system is under five million i.e. 4,781,509 as of end June 2006, which accounts for only 3 percent of the population. Not only is the population underserved but banks are catering to largely urban or semi urban areas and concentrating in similar locations/segments with limited reach to the middle and lower strata of society. Notwithstanding credit to previously underserved markets such as consumer, housing, small- and medium-sized enterprises (SME) and agricultural sectors has expanded markedly and is now being provided by a broad range of financial institutions. Despite this large segments of the economy continue to operate with little formal credit. Credit penetration of banking sector is lowest in Asia pacific: number of borrowers is

barely 5 million. Credit/GDP ratio is only 27% of GDP. While rising from under half a percent total consumer loans remains only 3.9% of GDP. Mortgage market currently is only $1 billion. Formal microfinance network which has witnessed significant growth reaches only 770 households with limited coverage to women.

21. In developing a program for access to development finance, SBP is adopting a four- pronged approach:

(i) Encouraging the Government to divest its remaining stake in banks. Plans to privatize Small- and Medium-sized Enterprise Bank (SMEB), Industrial Development Bank of Pakistan (IDBP), House Building Finance Corporation (HBFC), Investment Corporation of Pakistan (ICP), and National Investment Trust (NIT) are on cards.

(ii) Promoting microfinance industry development

(iii) Leveraging Islamic finance to extend outreach to unbanked people and regions where Shariah compliance products may offer an incentive and appeal to augmentation of financial services

(iv) Launching efforts to promote new business models and technologies that will broaden access to financial services in a sustainable and cost-efficient manner. This will require some adaptation of relevant regulations. The progress achieved thus far can be solidified by revising key financial sector legislation, most notably the SBP Act and Banking Companies Act, in accordance with best practice to avoid relapsing into past practices and unwarranted government interference.

22. Third, Banking consolidation is critical to enhance bank's economies of scale and cost effectiveness while developing strong and robust banks that can withstand business cycle downturns. Central bank has encouraged the consolidation process by enhancement of minimum capital requirement (MCR) in a phased manner to be raised each year by Rs1 billion from Rs2 billion to Rs6 billion by 2009. As of end of September 2006, all the banks, except four, were meeting the Rs2 billion capital requirement and the average capital held by the banks remains

higher than Rs3 billion. The process of banking sector consolidation is ongoing but is yet to fully unfold. While some banks have already complied with new MCR, others are following the timetable and another set is seeking mergers with stronger banks. The mergers and acquisition wave is facilitating the process of consolidation. While some small banks are up for sale as they cannot meet capital requirements or do not see themselves as withstanding competition, others like foreign banks are acquiring banks given the attractiveness of Pakistani banks and their profitability and their desire to expand their outreach. Several mergers have taken place and more are expected in near future. The way the financial sector scenario has emerged over the past few years with number of mergers and acquisitions, it is expected that the process would continue at least for the next 5 years. We would have even fewer banks than today owing to capital requirement of 6 billion rupees by the year 2009. A typical figure could be 25 to 30 banks by end of year 2010. In the near future, we foresee at least three mergers/acquisitions transactions per year. Although number of small banks would reduce but the number of foreign institutions are likely to increase.

23. This is largely because while conventional banks are being consolidated, SBP has been licensing both Islamic and Microfinance Banks. The ultimate aim is to have fewer and well capitalized banks of sound repute having a broad based clientele and geographical reach. It is only the sound, and adequately capitalized banks that can take up the dynamic role required in a developing economy like Pakistan. Consolidation is also critical factor to deal with any effects of the reversal of business cycle. At the moment, the economy is enjoying high growth, and the future outlook is quite buoyant. Sound policy making, however, demands that the institutions are strengthened during the boom period to make them resilient against cycle reversal. The rise in interest rates can become a forbearer of economic contraction or at least limited market correction. As such it is important to pursue policies that encourage creation of reserves on the balance sheets of the banks that will act as a cushion in the time of crisis. The recent step of tightening up of classification criteria of NPLs is very timely.

24. Fourth, while banking sector's profitability has improved, there is need to further enhance competitiveness in the industry Currently, there is high sector concentration as the top five banks (out of total 39 banks) hold more than 50 percent of the industry assets, advance and deposits.

The wave towards consolidation of banks is expected to enhance competitive pressures – for instance foreign banks are enhancing their outreach by acquisition of some strategic small banks which have a good branch network and few newer, relatively smaller, private banks have spread their reach to most major cities. These banks are now providing clients an option to diversify their business and not exclusively dependent on nationalized and large privatized banks that were the only subgroups that had nation-wide branch network. The following figures show the profitability, profitability indicators and investments of banks in Pakistan. These stats further elaborate the impacts of banking sectors' role in revenue generation.

Figure 3.1.1: Banking Sector Profitability

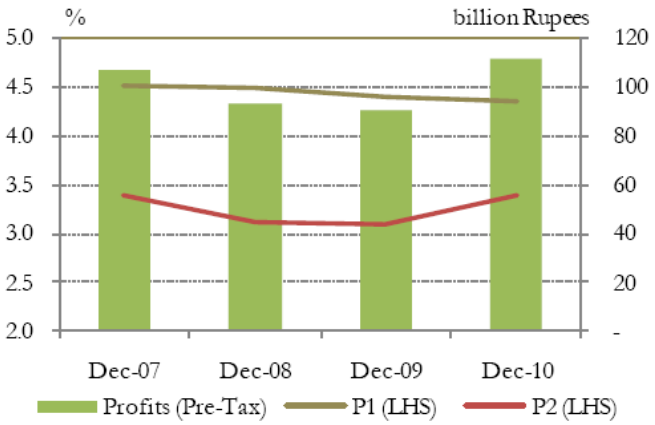


Figure 3.1.2: Profitability Indicators (Pre-Tax)

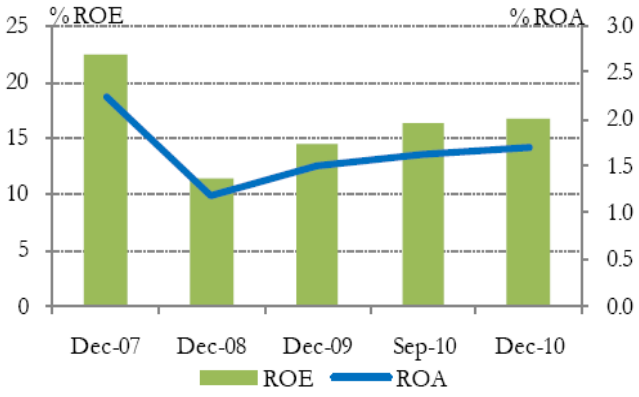
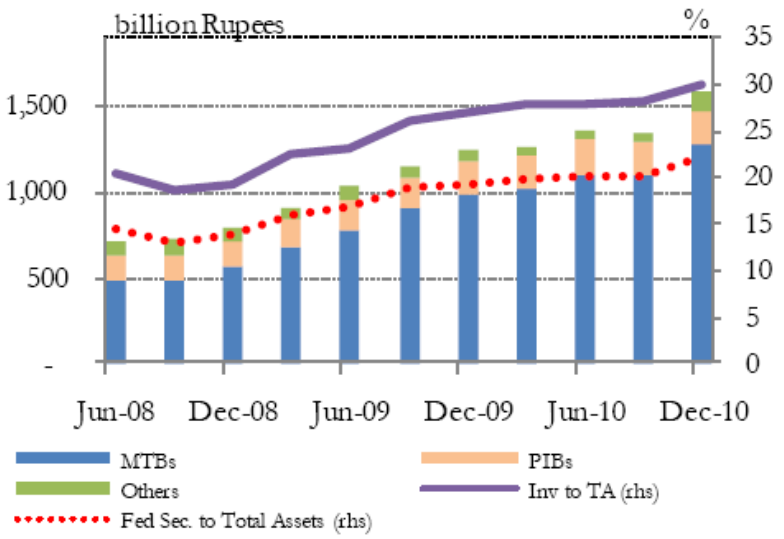


Figure 1.2: Banks' Investments



Sources: State Bank of Pakistan

Conclusion

To sum up, it is paramount to revisit the fact that banking sector in Pakistan is very resilient and has future prospects that have and are playing a vital role when it comes to revenue generation. Not only do the banks lend money to the GoP, they also invest their assets in such securities and avenues that yield the best results. The banking sector in Pakistan has had its share of ups and downs especially under the current economic hardships but none the less this sector is a model which is characterized by further expansion. The banking sector even then has plenty of room to grow and enhance as compared to other countries in the region. The steps which have been mentioned in this research paper, and which are meant to depict the role of rapid rise of banking sector in revenue generation have been a harbinger of change for the economy of Pakistan. If these change management steps are allowed to mature to their highest potential, the conclusion of this syndicate will surely be evident that this sector will surely help in bringing about even more revenue yield and hence a better economic output.

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