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From editor's desk

The publication of Banking Review in your hand has taken place in less than one month after the death of pioneer of economic and financial journalism in Pakistan M. A. Zuberi. This occasion, therefore, affords us an opportunity to take a leaf out of the late doyen's book with a renewed commitment to upholding the lofty ideals that he espoused throughout his life. M. A. Zuberi was an ardent champion of private enterprise, free trade and free markets, democratic system of government, and an unwavering advocate of agrarian reforms. According to him, the objectives of financial and monetary stability should complement each other given that the financial sector is an important component of the transmission mechanism and implementation of monetary policy framework in the country. He would often make it clear to the authorities that the country's Central Bank - the State Bank of Pakistan - should have the pulse of the economy and must be given the freedom to strictly pursue monetary policy objectives enunciated in the SBP Act.

It is no longer a secret that it was due to his concerted and painstaking efforts that resulted in protecting the privately-owned and operated textile sector against the spate of nationalization unleashed by Z.A. Bhutto. Similarly, many in the banking industry of the country are aware of the fact that it was he who successfully persuaded the then president of Pakistan, Gen Ziaul Haq, not to destroy the banking structure of the country which was, and is, based on international rules of economics and finance, through his flawed, myopic and obscurantist view of religion.

It is important to understand that since the monetary and fiscal policies are significant determinants of the current account balance, deficits need to be accompanied by improved fiscal discipline. There has always been a plausible argument that the effectiveness and credibility of government policies depends crucially on the availability of timely and accurate financial and management information supplemented by a framework of financial and accounting principles designed according to internationally accepted and practiced standards. Moreover, a system of public accountability, that includes a strong and an independent legislative oversight and audit function, ensures fiscal discipline by the executive branch. Strengthened and prudent financial management practices will always increase the effectiveness of development programmes and related external assistance.

In Pakistan, like many other developing countries, banking is a highly regulated industry, and government restrictions on financial activities by banks have varied over time and location. The present day banking (which is presently suffering from a high incidence of NPLs in particular owing to a variety of factors) is characterized, largely because of technological innovation, by an increasingly sophisticated provision of banking services and an expansion of consumer credit. Banking laws that regulate the banking industry in Pakistan are not discrete areas of legal principles which impact on banking transactions and on the banker-customer relationship. In that sense, the realm of banking, the location at which a diverse range of principles intersect is what we refer to as banking law.

The inclusion of fairness reasonably and comfortably sits with a bank's existing obligations. Acting ethically is no more than an obligation to act fairly and honestly. Banking law is a wide-ranging and constantly changing area of the law. It focuses on an activity which has been at the heart of a strong and vibrant economy since ancient times and which intersects with the lives of most individuals - anyone with a bank account.

While he favoured the idea of a sound banking system, free from unnecessary government intervention, he was also a great proponent of its effective role in ensuring balanced growth and a fair deal to all segments of society. For such a strategy to succeed, it was considered vital to expand the outreach of the commercial banks to rural or unbanked areas in various regions of the country through policy intervention or moral suasion by the Central Bank. The usefulness of such a policy has been evident, overtime, in a number of ways. More deposits could be mobilized, and high level of loans could be disbursed in comparatively less developed areas of the country to enhance their growth rates and reform their social structures. The exercise could be more fruitful if local educated people, who are familiar with conditions of their respective areas, are inducted in new branches. In short, the spread of banks to unbanked areas could help change the life styles of people residing, particularly those in small villages.

The founder-Editor of Business Recorder was highly critical of successive governments' proclivity to use banks purely .for fiscal considerations at the cost of ordinary savers. It was argued that withholding tax on interest income and penalty on withdrawals beyond a certain amount would discourage banking habit, promote consumption and encourage activities in the informal sector. Such a policy was all the more risky when rates of return were already negative and the country needed to have a much higher saving rate to attain self-sufficiency. Even now, authorities of the country can benefit from his ideas to harness the capacity of the financial system to improve the economy on a sound footing.

In conclusion, Business Recorder wishes to underline the fact that although the fall in effective CRR (Cash Reserve Ratio) often adds to the market liquidity, the excessive government borrowing from the Central Bank is usually a dominant factor that offsets the impact of, among other things, strong private sector credit demand. A tight monetary policy regime notwithstanding, the banks, nevertheless, are required to be more sympathetic towards private sector, which is undoubtedly any country's engine of growth, an important creator of wealth, a traditional provider of much-needed capital to promote investment and a dependable source of employment for people.

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Banks need to **shift gears**

Ali Khizar Aslam

In the race of the financial sector growth and evolution, the discontinuity and unpredictability of government policies has kept Pakistan far behind other developing and emerging economies.

Unlike others, the absence of debt capital markets and the natural death of Development Financial Institutions have virtually shifted all the financing needs and saving instruments on the plates of commercial banks.

The commercial banks have made windfall gains amid privatisation of the big banks, emergence of new players, and growing interest of foreign players during the boom days of the last decade.

But nationalisation has its hangover; the banks have indulged into 'lazy behaviour' due to a host of reasons including the monopoly of big banks, excessive prudence of foreign banks, and lack of initiative to find a niche on part of the smaller players.

Lack of awareness in the masses as well as religious reasons have helped the big banks raise low cost deposits. Over 85 percent of bank deposits are of less than one-year maturity, which doesn't allow banks freedom to go for long-term project financing.

The sticky nature of those deposits facilitated the banks to finance -- even 20-year projects in some cases – the expansion seen in the last decade or so. However, infrastructure financing that requires public private partnership and long-term funding from the DFIs or direct fund raising from capital markets largely remained absent.

This problem mainly stems from a lack of funding avenues, the absence of political will to reform the financial industry and the dearth of innovation.

Since the infrastructure, including power and industry supply, could not match the demand of the boom era, the output gap expanded, to eventually be filled by imports. That triggered the worst economic downturn in the country at a time when the world also faced a dreadful recession.

The last two years of crises in Pakistan primarily emanated from fiscal issues and myopic government policies. Had we had strong and sophisticated financial intermediation, the gravity of the crises could have been less.

More than half of the banks' earning assets still revolve around a few big names in the corporate sector. This behaviour not only keeps corporations from directly going to the savers, but it also leaves the small and medium enterprises largely out of the equation.

Another problem seen in the booming days of the last decade was the lack of experienced bankers at the helm of affairs. The lack of domestic banking experience in the private sector gave the employees of foreign banks - especially the Citibank - almost an overnight jump, as local banks paid hefty premiums to get the right man in.

These ex-Citi bankers attempted to replicate the Citi's global banking model of programme lending into the consumer sector and largely bypassed the SME segment. A few even tried the score-model, bypassing the Know Your Costumer model that is more applicable in Pakistan's SME sector.

While this worked well in an upward economic cycle when inflation was low and growth was high, it fell like a pack of cards as the economy took a U-turn in the rising interest rates scenario.

Bad loans started mounting and are still on the rise. While the banks are left with a sour aftertaste of aggressive lending to the consumer segment and advances to SMEs, they are even becoming shy of lending to the big names after a few names went down with the economic downturn.

Then comes a new player in the equation, the government, whose growing needs and sovereign nature made it the biggest occupant of the assets side of banks' balance sheets. With low costs of deposits, big banks started enjoying decent spreads in facilitating short-term government borrowings, an ideal case in the rising interest rate scenario.

Whatever remained was taken up by quasi-fiscal operations in the form of power sector financing to plug the circular debt and commodity operations for procurement of food commodities by government agencies.

This is highly inefficient, as circular debt financing is done merely to plug in the difference between the cost and the recovery of power generation and distribution, while the financing of wheat stocks by the government is clogging the liquidity in the system.

The banks demanded Kibor plus three percent on commodity financing, as they knew that at the time of repayment, the loans would be rolled over. In essence, it meant long term lending to the government.

The stuck liquidity is forcing interest rates upwards and making it even harder for the private sector to borrow. At the same time, lack of consistency of government policies as well as the bleak law and order situation is also keeping private corporations at bay from initiating new projects or expansions.

At this juncture, due to the growing fiscal deficit amid lack of financing avenues and tight monetary policy, the banks' focus on government papers is likely to continue. With the likely passage of the SBP Act, the government will have to reduce its Rs1.4 trillion central bank's borrowing to10 percent of its tax revenues in five years.

This means an average offloading of Rs230-250 billion yearly is on the cards for the next five years, which would significantly increase the government's reliance on commercial banks. Thus, although the economy is expected to regain its course towards recovery, the crowding out of private credit is imminent.

It's going to be a huge challenge for the State Bank to device a policy for liquidity management as well as reduce friction for private lending. An out-of-the-box solution is required to solve this puzzle.

It is pertinent to note that this challenge is confined to only corporate lending and trade financing; to ensure commercial banking reforms to tap the unbanked private savers and broad base the lending structure towards long-term financing, there are other serious challenges too.

The SBP has to devise a combination of administrative measures and incentives to dilute the stronghold of the big five banks and concurrently entice small and medium sized banks to create their own niche. Today, most banks, irrespective of their size, are in the same business of lending to the government and running after a few big corporate names.

The existing banking model makes sense for giants with very low cost of funds, but for tiny players, the cost of funds is high, so their profitability is squeezed in competition with big players.

Some banks are even marked with negative spreads. This cannot continue for long, some are merging and a few are available for acquisitions. However, it is hard to find buyers for these ailing banks. They have to create a niche to survive; for example, becoming a regional bank, an SME bank or a specialised agri bank are just a few of the options.

In recent years, we have seen two banks jumping on the ladder to become medium-sized banks with a focus on trade finance and warm services to attract customers. Another merged entity of three small banks is working on the same model. Then, a long existing foreign bank, after being badly hurt by its aggressive programme lending, is now focusing on gaining dividends from its reach in over 100 countries.

At the same time, the development of a corporate debt market is imperative. The SBP in coordination with the SECP should incentivise corporations to bypass the intermediation role of commercial banks for their financing needs.

There is a need to separate investment banking from the arm of commercial banks as investment banks, being independent identities, would be in competition with commercial banks for finding their niche and would be instrumental in the development of the corporate debt market and listing of new entities in the equity market.

This will sow the seeds for the development of venture capital firms and private equity funds. It would also foster entrepreneurship in the country - which was a major stepping-stone for fast track growth in India and China.

The transition to a knowledge-based economy surely needs supportive government policies with more budget allocation towards education; but nonetheless, the financial sector must also play its role.

The success of Engro's Rupiya may entice other big names to go directly to savers for their financing needs. Such practices will push the banks to be innovative and to tap the SME sector and consumers more.

But it will be unfair to put all the blames on banks, as slow enforcement of foreclosure laws dilutes the pressure on borrowers and make banks shy of aggressive lending in consumer and SMEs.

SBP should join hands with the government to work on better laws to safeguard the interest of banks in case of defaults. Banks should have the ability to pass on the business to new people in case of failure of one to repay.

Moreover, better zoning and land laws should be in place to tap the much-needed mortgage financing. High interest rate is another impediment for house financing to meet the rising demand for the low and upper middle class. Refinance facilities with IFC and other multilateral agencies should be obtained for adjusting the interest costs in line with the rental yields.

These are medium to long-term solutions. In the immediate short-term, given the constraints of poor law and order situation and growing government needs on commercial banks, the concentration should be towards reaching the untapped areas.

Floods should be seen as a window of opportunity to tap the growing rural economy and the SBP is cognizant of it, as it's working on Export Refinance Schemes in the flood-hit areas and providing first loss guarantees to lenders advancing credit to the flood-hit areas. The focus is to inculcate a culture amongst banks to penetrate the rural areas.

But then again, for this idea to flourish, documentation of the economy is imperative. Although the government's efforts under the umbrella of the IMF to implement RGST will go a long way in documentation of the economy, other technological and institutional upgradation for land titles will help in giving comfort to lenders and lower the borrowing cost as well as expand banking in the unbanked areas.

A marriage of telcos with banks is the need of the hour to ensure service delivery in small far-flung areas financially viable for commercial banks.

Branchless banking is the future of banks - already there are a few products in the market including easypaisa and UBL Omni with many other products of other banks in the pipeline. With the passage of time, the branchless banking should also offer other products such as consumer assets while catering to the S part of SMEs segment at the same time.

The government and the SBP should work closely to make agri lending viable for banks by eliminating the role of middle man - arthi. Warehouses should be made available and commodity exchanges should be established to have the requisite documentation and hedging instruments for banks to cover risks. Crop insurance should follow.

In a nutshell, the concept of financial inclusion has to be flourished. The vertical integration of products including deposits, lending and insurance should reach the far-flung areas. On the other hand, infrastructure-financing companies should follow the public private partnership model; they should acquire long-term financing from international agencies to provide adequate infrastructure domestically.

Then again, the biggest impediment to Pakistan's growth is the discontinuity and unpredictability of government policies. Yet, there is hope that the democratic process will flourish and the political goals of various parties will converge with the economic needs of the masses.

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Kardar banking on **government reforms**

An interview with Shahid Hafiz Kardar, Governor, State Bank of Pakistan

Ali Khizar & Haider Nawab

In his first detailed interview to a Pakistani publication, after becoming the governor, Kardar talks candidly about how the government's failure to reform is raising obstacles in the country's path to economic growth. He also sheds light on the culture of lazy banking in Pakistan, while sharing his view on the interest rate outlook and the private sector credit offtake. Below are the edited transcripts.

BR Research: DFIs are supposed to be for long term projects including infrastructure financing, but lately these institutions have simply died down. How would you formulate strategy to revive the much-needed long-term project financing?

Shahid Kardar: There are two issues involved here. The only institutions available after the death of DFIs are the commercial banks. This is because commercial banks were functioning and had been privatised by the time DFIs were wound up or became dysfunctional. They were more aggressive in offering the financing being sought.

However, commercial banks, by definition, have an asset liability maturity mismatch. If you look at the deposit side of commercial banks, 85 percent of them have a maturity of less than one year, whereas they have to have an asset profile which is not completely out of sync with the maturity profile of liabilities.

The other issue is that all projects with a long gestation periods require three things; first, a stable political and economic environment; second the continuity and predictability of government policies. I think this is an area that is beginning to become more entrenched.

The third area is concerned with the development and functioning of capital markets, which is linked to the predictability of policies, the government's financial management strategy and its efforts to create a yield curve for its own instruments.

BRR: Can you elaborate on the development of the yield curve?

SK: For a variety of reasons, the government has not been able to create a proper yield curve for its PIBs; 76 percent of government domestic debt is short term, partly because offer rates for PIBs in recent auctions were being rejected. So when there is no benchmark available for sovereign debt, it hinders the development of a market for long-term financing in the shape of a corporate bond.

BRR: What is being done about it?

SK: We have created certain institutional grounds, and now the government has to pass certain tests. The government has passed one test recently. For example, it has raised money from Sukuk, where out of the Rs 80 billion target, Rs 52 billion have already been mobilized.

There is a much greater degree of engagement and discussion between SBP and the government. We are hoping this will bear fruit. We have transferred the rights to accept offers in auctions to the Ministry of Finance, which is the right approach in my view.

> **The government's heavy borrowing is not helping the creation of a market for the corporate sector to raise long term financing.**

They are the borrowers and hence should adopt their own debt management strategy and decide the quantity of debt or the rate at which they are willing to raise debt. We believe, the Ministry of Finance is adequately equipped to take this decision.

BRR: Does heavy government borrowing hinder the long term infrastructural financing?

SK: Yes, if the role of government was to recede then you would see a variety of developments that would facilitate the creation of a market for corporate debt. If the government is taken out of commodity financing, and if the government reduces its reliance on bank borrowing and prohibits institutional investors and pension funds to invest in the NSS, new opportunities would be created.

This will help develop a body of corporate investors, seeking financing through corporate debt markets. For example, the government has raised commodity financing in excess of Rs390 billion from scheduled banks. And more importantly, if the sovereign is borrowing for such operations at just under 16 percent, naturally the private sector will only be able to borrow at a premium.

Also, the pace of growth of the economy is good, which would facilitate the creation of a market for corporate debt. On the other hand, non-performing loans are on the rise, having reached Rs500 billion. With this kind of risk profile amid heavy government borrowing from banking sources, not only are banks risk-averse, but also there is little appetite for long-term financing. Under such circumstances it is going to be an uphill task, at least in the foreseeable future, unless the situation changes dramatically.

BRR: What can change things dramatically?

SK: The major changes that we are hoping for are: a) the amendments in the State Bank Act; once they're in place, we will be adequately empowered legally to check government borrowings; b) a significant reduction in the government's fiscal deficit, through an effective implementation of RGST which will enable the government to reduce its borrowing, and c) a pick-up in economic activities.

To summarize, the government's heavy borrowing is not helping the creation of a market for the corporate sector to raise long term financing.

BRR: Have you incorporated RGST in your monetary policy model?

SK: Yes we are hoping that RGST will be implemented; we have also weaved its impact in our recent Monetary Policy Statement.

BRR: Do you think that reducing the fiscal gap to 4.7 percent is too optimistic?

SK: I agree it looks somewhat ambitious at this stage. But I do not lack confidence in the government. It has indicated its intention and has given a commitment to change the tax regime and mobilize additional resources and I hope that it will be able to deliver on this front.

Part of the reason for the slippage in the fiscal deficit is additional expenditure on security and flood related rehabilitation. What needs to be seen is the extent to which the Federal and Provincial Governments will be able to adjust the deficit under such challenging circumstances. We expect that as we move forward, the demand of funds by the government from banks will begin to decelerate.

BRR: With the amendments in SBP Act in place, government borrowing from central bank would have to come down to 10 percent of government revenues. How much will the government have to repay?

SK: Under the Act, the Government of Pakistan needs to offload the stock of SBP's lending in five years, from the date of passage of the Act. Just to give you an example, the stock of MRTBs on the date the Act was passed by the National Assembly, was Rs1,355 billion. So by the time it will be passed by the National Assembly after its approval by the Senate, the stock may touch Rs1.5 trillion. That will place a huge demand on the financial system and managing it will be a challenging task.

BRR: If Rs250 billion per annum is offloaded on average, the government will have to go more to the commercial banks, hence, more crowding out of private sector. Doesn't that add to the woes?

SK: Yes. When the Act's amendments were actually drafted, the borrowings were lower. Now that the Act is about to be passed, the stock has piled up. So, today it won't be that easy. We will have to manage liquidity without seriously crowding out the private sector, a formidable challenge.

BRR: When would you think Act will be effective?

SK: Full credit must go to the Finance Minister and his team who are piloting it through the Parliament. We hope that by mid-January, we will be ready to start implementing it.

BRR: In the last six months government borrowing has increased by more than Rs200 billion, whereas external flows have remained lacklustre. How will the government manage it?

SK: External flows are not what had been predicted. Greater clarity is required on potential flows, for instance, on the revenue likely to be raised to the tune of Rs50 billion through the issuance of 3G licences.

BRR: 3G licenses! Really? We are half way to the year and there is no development in it?

SK: The government insists that it will be able to raise this amount. We must incorporate it in our model. We cannot challenge them on this when they argue that their initial discussions have been rather promising and that they are well placed to mobilize the amount projected in the budget.

BRR: What other avenues the government is eyeing on?

SK: The reimbursements under the Coalition Support Fund is one area. Claims of $2.5 billion are being processed by the US, out of which US$110 million have arrived and an additional amount of US$700 million is expected by the end of December, The government is confident that it will try to get more from the CSF during the second half of the fiscal year.

BRR: Is there a lack of coordination between the State Bank and MoF?

SK: In some cases yes. For instance, we mentioned in our last monetary policy statement that since the government raised less money than the target under the announced auction despite higher participation in a previous T-Bills auction, it added unnecessary pressure on its borrowings from us. Our view is that you cannot fix both quantity and price simultaneously. Now they are accepting our argument and have raised more than the target in the most recent T-Bills auction.

The Finance Minister, the Deputy Chairman, Planning Commission and I are on the same wavelength. We have similar mindsets and views. We also know each other socially and there is a high level of trust and comfort amongst us. It may be a sheer coincidence, but it is a great opportunity that will go a long way in building trust and coordination at the institutional level. Even at the bureaucratic and administrative levels, there is good coordination, partly also because I have known the key players over the years both professionally and socially.

This is a huge window of opportunity for improving co-ordinations at all levels. My plan is not to create linkages at a personal level but try to institutionalize the processes. We have cleared the first test of our institutional understanding with the government meeting its T-bills target in the recent auction. We have four more tests just in December including a PIB and a Sukuk auction.

We are also providing first loss guarantee for agricultural lending in flood-affected areas. We are hoping to incentivise banks to develop some products.

BRR: Do you think that the RGST has been unnecessarily delayed?

SK: Yes, it has taken much longer than had been envisaged. But look at the positive side. The legislation has been passed by Senate and there is an agreement amongst the provinces on 99 percent of the issues, a minor matter remains to be resolved and that shouldn't take long. All that is required is the processing time for it to be passed by the National Assembly. I believe that the government has taken 1.5-2 years in implementing RGST because they were preparing themselves; as it is not that simple to get all the stakeholders on board.

BRR: How can we increase the presence of venture capital, private equity and investment banks? Their role was envisaged in the five year road maps of your forerunners. What is your take on it?

SK: If the role of government recedes, we can probably get venture capital firms rolling in. Much of it also has to do with greater political stability, improved law and order conditions and the predictability of government policies, lack of which naturally forces economic actors to think in the short term. The lead has to be taken by the government by giving a long-term sustainable direction.

BRR: The gap between demand and supply of low cost housing for middle class is increasing. Under high interest rates scenario, how would you work in this area?

SK: There is no denying that at these interest rates, it's difficult to create a market for housing finance. But there are other issues as well. For example, the provincial or local governments are required to ensure a decent system for title veracity, provide primary infrastructure to enable development of land for housing, in which neither the Federal Government nor the State Bank has any role.

Then there is the question of the structure of taxation; stamp duties, property taxes, charges for commercial development, rent control laws, foreclosure, etc. Investors will not develop a property for rental purposes if they cannot get a tenant to vacate.

On the issue of foreclosure, it's just not the legal aspect but also the behaviour of the courts. And, last but not the least, there is the question of building and zoning regulations, considering that there is a need for flats for middle and lower income households.

BRR: What is being done about it?

SK: One, we are working with the International Finance Corporation (IFC) on a mortgage refinance facility. Second, we are trying to learn from the Indian model. One of our teams visited India and now we are inviting the Indian HBFC team. We are working with Indians because they have similar issues as us, other than the issue of interest rates. We hope to learn from them on how to manage such hurdles.

Third, I met an investor group that has set up a mortgage refinancing facility with the IFC in Saudi Arabia. So, instead of reinventing the wheel, we will try to learn from their experiences. We lost the opportunity to develop a housing finance industry when interest rates and inflation were low.

BRR: Bank lending to big corporate has been crowding out the small and medium enterprises. What can be done to turn the situation around?

SK: We feel that the most neglected part of SMEs is the 'M' part. A part of the 'S' is being catered by microfinance or other similar concessional lending. But we think greatest potential lies in the 'M' part and that's a niche that we will target in future policies and initiatives.

We are in discussions with the IFC to provide credit lines to commercial banks. We are also in negotiations with the USAID on development of incentive packages and instruments for mid-sized enterprises that banks would find attractive to market more aggressively. We have also invited the Asian Development Bank for discussions on this subject.

We hope that by mid-January, we will be ready to start implementing the amended SBP Act.

BRR: How do you plan to go about?

SK: Our aim is to devise an incentive structure for the banks that would entice them to target the SMEs. The flood affected areas have provided us an opportunity to test our strategy. Our NPLs in flood-affected areas are at 22-23 percent, but just to make these areas functional again, we have frozen the NPLs in those areas with relaxed provisioning requirements for overdue amounts.

Since the banks were reluctant to lend in the flood hit areas, we have asked the banks to continue doing so, on the promise that we will provide them 30 percent guarantee on first loss. So initially, the scheme will over-compensate the banks, but with a very clear strategy that as we move forward this over-compensation will be phased out in a year and a half or two, and help us develop other incentives packages and instruments. Having learnt this from our experiences in flood-affected areas we can refine the packages and roll out models for the rest of the country to cover areas other than the flood-affected areas.

Moreover, we are looking at the whole business of Export Refinance Schemes for SMEs. The modalities and the allocations have not been decided yet on how to support SMEs as they are more likely to be exporting non-traditional items.

We are hoping that RGST will be implemented; we have also weaved its impact in our recent Monetary Policy Statement.

BRR: But EFS has traditionally been misused for example buying a property in Dubai?

SK: It is less likely to be misused by SMEs for the simple reason that they don't have access to other funding. Those with deep pockets and access to other funding are better placed to abuse this facility since money is fungible. The stakes for SMEs not to run foul of the scheme rules will be much higher.

BRR: How would you incentivise commercial banks to finance SMEs?

SK: We are giving first loss guarantee and arranging funding from DFID and, hopefully, USAID. We have to change the mindset. I am hoping that with these incentive structures, we will be able to change the way the banks view SMEs. Commercial banks argue that transaction costs are high for them to deal with SMEs. This is lazy banking, as today banks are not even looking at corporate clients, all they are doing is filling the appetite of government. And once the economy revives, banks will have to revert again to the private corporate sector.

BRR: Do you think there is some responsibility on the part of corporate sector as well to take an initiative and go to the public themselves, like Engro has ventured with Rupiya?

SK: I agree. The Engro management comprises of dynamic individuals. It's a great idea; I am a great supporter of it. Interestingly, Engro is borrowing from the public at a cheaper rate than the government is borrowing for commodity finance from the commercial banks. You may well ask if this is good evidence that they are better and more creditworthy borrowers than the government. This leaves one wondering if these are the early signs of whether the appetite is weakening for lending to government.

What we need to do in coordination with the SECP is to try and build a corporate debt market. We need to urge the corporate sector to raise capital from the market in a variety of ways.

BRR: Since some of the small banks are yet to meet the MCR requirement, there is likely case of more mergers and acquisitions. How are you facilitating that?

SK: There are ten banks in Pakistan, apart from three public sector banks, which are falling short of capital. Two of them are merged and three are in the process of mergers. We are closely monitoring them and are conscious of it. The most difficult case is of public sector banks.

We are looking to launch Export Refinance Schemes specifically for SMEs, though the modalities and the allocations have not been decided yet.

We need to find out what is making it difficult for them to comply with the MCR while realising that the current environment for raising capital is not favourable. So we are looking at them on a case by case basis as most of the banks have already met the MCR requirement. Some have even complied with the future requirement.

BRR: Does SBP plan to slash the MCR requirement further?

SK: We will revisit it only if necessary. At this point in time, I don't think it is necessary.

BRR: Do you think CAR is a better measure than the MCR, especially after Basel III?

SK: After the global financial crisis, the view is changing worldwide. I am of the view that we need both CAR and MCR. Nonetheless, at the moment, we believe that MCR as a measure is imperative to ensure good quality capital, although we can discuss the definition of what should constitute capital.

We are working with the International Finance Corporation (IFC) on a mortgage refinance facility.

That's because for small banks to be able to survive and generate profits on a sustainable basis, they require to invest in IT, risk-management, human resources and a branch network; there is a need for a minimum size to operate. For that particular reason, for us, MCR is important.

Most jurisdictions work with MCR, though some might place more and some might have less emphasis on it. Also, small banks, with limited capital, face difficulties in withstanding the risk of major borrowers defaulting or a large depositor withdrawing unexpectedly. We have seen repeated pressures on small banks both from the asset and liabilities sides.

External flows are not what had been predicted. Greater clarity is required on potential flows.

BRR: Shouldn't small banks be finding their own niche?

SK: They should, but they haven't done so. There is a culture of lazy banking in Pakistan.

BRR: There is problem of high currency-in-circulation. It has remained historically high in Pakistan and it has increased significantly in the past two years; what is the solution?

SK: One reason is the fact that most part of the agri-sector is undocumented. But there are other reasons as well, for instance, 0.3 percent tax on cash transactions is a deterrent, as is the high level of government borrowing from SBP. Increasing documentation is a solution and RGST will go a long way to address this issue. The second solution is for banks to set up more branches in rural areas, because the farm sector is now booming. The third solution is branchless and mobile banking which, to me, is the future.

Finally, tightening of monetary policy will also bring Currency in Circulation (CIC) back to the system if we pack it up with administrative measures. Banks' deposit rates will also have to respond to it. That would mean people holding cash would see a decent return and revert to the banking system.

BRR: There is a lot of potential in lending to agriculture sector. How are you looking to tap it?

SK: The trouble is that although Zarai Taraqiati Bank is prominent in rural areas, it doesn't have the financial wherewithal to provide adequate credit. We need to work in certain areas. We are looking at the whole issue of crop insurance plus the concept of warehouse receipts. In case of warehouse receipts, the root of all problems can be traced to the government policy to fix the issue price of wheat for the entire season. Fixation of prices kills the incentive for the private sector to build storage. So we are pursuing the government to get out of the price fixation mode. The other aspect is the establishment of the commodity exchange.

We are also providing first loss guarantee for agricultural lending in flood-affected areas. We are hoping to incentivize banks to develop some products. As of today, branchless banking is confined to the liability side including remittances, utility bills payment, etc. With time, as this industry grows, financial services will also increase.

BRR: Continuous monetary tightening is aimed at curtailing inflation through demand management. But critics argue that inflation in Pakistan is primarily due to high powered money creation and cost push factors. Can monetary policy be used to address these issues, as government may continue borrowing despite the increase in rates? SBP's mandate is to control prices while spurring growth. How do you address this dichotomy?

SK: Let's look at three indicators. Although private investments may have fallen, I don't think we know enough about private consumption demand. Private sector credit has grown in the last month or so, partially due to the sharp increase in the price of cotton.

Private sector demand is strong in some areas. Although, so far this year, industrial sector growth has been weak, some sub-sectors are exhibiting handsome growth due to the boom in rural areas following the increase in prices received by the farming community for their rice, cotton and sugar cane. The retail sector has also been showing decent growth. We need to be careful in analyzing this decline sector by sector.

Industrial growth is not taking place at the pace private consumption is growing. That gap is worrying us and could put a strain on the current account, which will have to be financed. Had we not adjusted the interest rates, the need to finance the gap would have added some stress.

Private demand, which is perhaps not fully serviced by the domestic sector, may have spilled over on the external account, increasing the gap between imports and exports. Although it's being narrowed down by higher cotton prices that are boosting exports, we are watching these developments closely.

Profile: Shahid Hafiz Kardar

Kardar had served at various ministerial positions in the government, including finance, excise and taxation, before his recent appointment as the 16th Governor of State Bank of Pakistan.

A chartered accountant, and a graduate from the University of Oxford in politics, philosophy and economics, has also authored three books on Pakistan's economic and political environment. Kardar was also a member of various commissions and government committees and task forces set up by the Federal and Punjab governments at various points in time since the mid 1980s.

Added to his diverse experience are consultancy services for multilateral and bilateral donors like the World Bank, the Asian Development Bank, and the Department for International Development (DFID), UK. He has also led several projects and studies on key socio-economic issues facing the country.

Consumer banking - the boom and the bane

Sijal Fawad

The exalted grandeur of consumer banking in Pakistan was very short-lived; the anti-climax hit the sector in 2008 amid falling economic growth and rising interest rates, and there was no coming back for consumer lending. All the banks have been busy managing consumer delinquencies since then.

Still, with all its ups and downs, and despite the pause that seems here to stay for a foreseeable future, the best days of consumer banking in Pakistan lie ahead.

Anecdotal evidence suggests that a junior officer at one bank became the consumer head in another bank in literally a snap of the fingers.

1990s was a period that did not assign a lot of value to consumer financing. Only the fortunate few had the luxury of carrying credit cards in their wallets. But a sweeping turnaround took place after misfortune struck the twin towers in Manhattan in 2001 -- forcing Pakistan to play a role in the war against terror that in turn paved way for a wave of foreign inflows in the form of investments as well as remittances.

The excess liquidity prompted banks in Pakistan to knock the doors of what was previously treated as the ugly duckling - the consumer sector. A series of aggressive marketing campaigns commenced, with banks lending out to consumers almost incessantly. As a result, the share of consumer loans increased form 9.4 percent in 2004 to 14.7 percent by 2007 with Rs357 billion forming the total consumer portfolio by September 2007.

Of the five main categories of loans in the consumer sector, personal loans has always had the largest slice of the pie, followed by auto loans, mortgage loans, credit cards, and consumer durable loans in that order. Of these, the consumer durables category has a very small share of the total consumer loan portfolio, with a share of less than 0.5 percent of the total loan portfolio of banks, according to the State Bank of Pakistan's (SBP) latest quarterly review of the banking system.

Led by a foreign bank, the programme-based, direct-sales model, whereby sales agents were compensated chiefly against the number of transactions made, adopted a very aggressive stance in a relatively nascent market. Naturally, with such a myopic evaluation criteria, the motivation was more to grab the maximum numbers of customers, without paying much heed to their individual risk profiles.

This model did wonders during the booming days of the economy when interest rates were at their ebb. Anecdotal evidence suggests that a junior officer at one bank became the consumer head in another bank in literally a snap of the fingers.

"Pakistani bankers were mostly corporate bankers; consumer banking was not their forte. There was only one international institution that had launched consumer banking, and a large majority associated with consumer banking in any bank in Pakistan had been trained by that institution. So they all had one fixed business model and implemented the same model without knowing it fully well and how it would pan out," describes Atif Bokhari, President and CEO United Bank Limited.

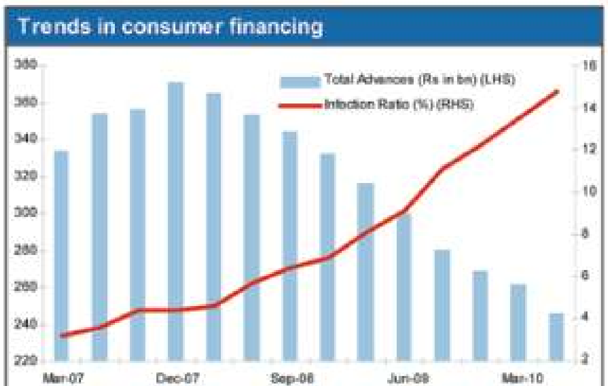
Aside from the unbridled lending by banks which were caught in a rat race called 'who lends the most', rising interest rates was a major reason for the doom of the sector.

The mark-up rates charged by many banks are pegged with the Kibor, with rates hovering around the range of 4 to 6 percent over Kibor. With the Kibor nearing 14 percent in the tightening stance taken by the central bank, consumer loans have been rendered quite pricey, and beyond the reach of many. Further, with the variable nature of interest rates, consumers are also deterred by the uncertainty of the interest expense they'd have to bear in a particular period.

The high interest charges, quite obviously, took their toll from poor consumers and the infection ratios of consumer loans soared considerably since 2008, and have been on a northward trajectory since then. The infection ratio of the consumer sector soared from 3.2 percent in March 2007 to as high as nearly 15 percent by June 2010.

In addition to these, the quality of services of consumer banking has also witnessed some deterioration. The Banking Ombudsman Report of 2009 quoted the highest number of complaints from consumer products, around 28 percent of the total number of complaints. Of that, the highest number of complaints was in the credit cards category, which made up 63 percent of the total complaints related to consumer banking.

Trends in consumer financing



Source: SBP Banking Quarterly Reviews

The lack of consumer education aggravated this problem even more as most consumers were lured by banks' attractive offers. In most cases, the use of technical jargon in banking terms and conditions precluded the consumers from understanding the nitty-gritty of obtaining a bank loan, or, the consequences of defaulting against it, in the worst case scenario.

Faced with rising delinquencies, banks' only way out is a swift recourse to the law, especially in cases that involve significant amount of financing, such as the mortgage loans. However, from banks' perspective, the tardy implementation of law is to be blamed for their reluctance to give out house loans.

"I think the laws in Pakistan will have to be far more enabling to bring about an advancement of mortgage financing in the country. The process of repossession must be swift because banks will only lend if they are comfortable that the banks will be able to recover in case of a default," says Sultan Allana, Chairman, Habib Bank Limited, adding that a lack of long term funding sources for mortgage finance, which is a long-term loan liability, is also a reason for the diminished loan payout for house financing.

Initially, the availability and ease of access to bank loans spurred consumer spending in the country. This led to increased demand for many consumer items, the prices of which also increased, consequently, in the absence of adequate supply enhancement.

A 2008 report by the Consumer Rights Commission of Pakistan in sponsorship with the Asia Foundation, also said, "The demand for road networks and fuel imports has increased due to growth in auto financing. These developments have an overall inflation impact, which is affecting the purchasing capacities of the poor."

Consequently, the failure to set up adequate infrastructure to meet the requirements of the consumer boom stoked inflation which wiggled its way back to borrowing rates and hence consumer finance rates.

Thus, lack of coordination of fiscal and monetary policies during the first half of the last decade has had its share of battering in the whole saga of the boom and burst of consumer financing.

OUTLOOK

Contrary to experts' opinion, the share of consumer banking in the big five banks is not proportionate to the size of their assets. The aversion of the top banks to consumer loans can be explained by the low cost of funds of these banks, which prompted them to lend to the less risky corporations and the government in order to enjoy higher spreads.

Eventually, small and medium sized banks, with their high operational costs, will have to revert to consumer financing to prop up their profits, and might end up taking excess risk. The top 5 banks carry 49 percent of the total share of consumer loans while their total advances share is 53 percent - implying that there is still enough room for big banks to increase their consumer portfolio.

"You need scale in the consumer business," Arif Usmani, Country Officer for Citibank (N.A) points out.

The failure to set up adequate infrastructure to meet the requirements of the consumer boom stoked inflation.

Although, the high interest rate environment poses a big challenge, the consumer sector continues to be of importance as it serves the retail end of the market and many people do benefit from consumer financing services.

Consequently, steps should be taken to revamp this sector, albeit, cautiously. SBP will need to intervene to facilitate foreclosure laws and should work with government entities to have better laws.

"It's just not the legal aspect but also the behaviour of the courts," says SBP Governor, Shahid Kardar on foreclosure laws in Pakistan. He adds that there is also the question of building and zoning regulations, considering that there is a need for flats for middle and lower income households, which need to be addressed to support mortgage financing business in the country.

Banks will have to do their share by developing sound lending strategies to manage their risks well. After all, "we have 170 million people who are potential consumer loan customers," according to Shaukat Tarin, Director, Silkbank. And simply closing the doors on a market of this size may not be the best strategy.

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Betting on **service**

An interview with Shaukat Tarin, Director, Silkbank Limited

Ali Khizar & Haider Nawab

In his conversation with BR Research Tarin touches his plans to expand Silkbank, the returns he eyes and how he intends to leverage on his strengths in the consumer assets segment. Tarin also shares his views on Pakistan's macro economic situation, the turnaround of public sector entities and the taxation system. Below are edited transcripts of the conversation.

BR Research: You did a great job at deposit mobilization while you were at HBL in the 90s, can we expect something similar now?

Shaukat Tarin: Definitely, we are coming up with products that are innovative. The problem is that our deposit base is highly skewed towards costly time deposits. Therefore, we are introducing unique and innovative customer centric products to increase our current and saving account deposit base.

Our motto here is that we need to differentiate ourselves on service, because nobody else can replicate consistent service quality. After HBL, other banks also created Crorepati schemes that were quite successful. But, when we created a service culture at Union Bank, not many institutions could match our service delivery.

We are striving hard to create a similar culture at Silkbank. We are putting in a lot of resources to help change the mindset of our employees in the way they serve customers, reduce problem occurrence and ensure a quick and timely resolution.

BRR: What kind of innovation can Silkbank offer?

ST: There is no magic wand; we are working in many different areas to re-engineer and improve processes.

On the liabilities side, we have to establish ourselves as a bank that provides excellent service. Our cost of doing business has to come down. Our cost of funds will not be as low as that of the large commercial banks, but we aim at bringing our average cost of funds down to below 6 percent from the existing 8 percent.

On the asset side, we need to mobilize consumer lending. Others are afraid of doing that right now, but we know how to do it. We've done it at Citibank and Union, so we are confident we can do it here as well. We can improve our yield on the asset side by 2 or 3 percent on the entire book, together with reduction in the NPLs.

These initiatives will take us to a 5 percent spread. Then we also have to work on our intermediation costs; they cannot be more than 200-250 basis points, because I'm left with nothing to play with if my intermediation costs are any higher. As we go along, our 4-5 year strategy is to improve our spread by making sure our yield on assets continues to increase.

State Bank requires banks to write off 60 percent of bad loans from the SME sector if it is not paid within 90 days.....this needs to be removed if banks are to lend to small businesses.

BRR: What are you focusing on to achieve higher spreads?

ST: Our focus is to improve the CASA ratio which has now gone up to 35-40 percent. We want to take this up to 60-70 percent in the next couple of years. That's one front. Our cost of funds has already dropped by nearly 1 percent during this year. And we would like to drop our costs by another 1 to 1.5 percent in the next year.

On the assets side, as we liquidate our non-performing loans, and introduce new products in consumer and SME segments, our asset yield will enhance by another 1 to 1.5 percent.

So, overall we are looking at about 3 to 3.5 percent growth in yield in 12-18 months, which in my opinion is not bad, considering where we started.

My objective is to achieve a net spread of about 5 percent in 3 years, if by that time we haven't gone through a merger or an acquisition. On top of that we expect about 1 percent through other income. That combined should enable us to create a 20 to 25 percent return on equity.

BRR: Is Silkbank looking to merge or acquire another bank?

ST: It is early days right now. We are not looking at potential partners at this point. First stage for us is to become profitable. And our target is to report profits next year.

Once we are profitable, scaling up the balance sheet will be our next priority, not only organically but also through a merger or acquisition of another bank. If it is a smaller bank, we could acquire it but if it is a larger bank then we would merge.

BRR: How will you be better than other banks that saw a lot of bad assets in the current economic crisis?

ST: Local banks lost because they were not prepared; those that were prepared did well. But no one can deny the fact that all over the world, 60-70 percent of a bank's assets are in the consumer segment. So we can't be much different. After all, we have 170 million people who are potential consumer loan customers.

We believe we know this market and we also know that bankers are shy of advancing loans to the consumer market. So we will cherry pick the best customers and provide them with products that they need and an unmatched level of service.

BRR: Any specific products?

ST: We are going to do personal loans, credit cards, and home equity loans.

BRR: Is home equity the same as mortgage finance?

ST: Home equity is overdraft against a property. It's a product well suited for small business owners looking for financing. We will start there and as inflation eases off and interest rates come down, we will develop products for mortgage finance as well.

Our focus is to improve the CASA ratio which has now gone up to 35-40 percent. We want to take this up to 60-70 percent in the next couple of years.

BRR: Rental yields are too low, is that the reason why mortgage financing doesn't pick up in Pakistan?

ST: Yes, if mortgage rates go beyond 12 percent, it ceases to remain a business proposition and people prefer to pay rent. But, if the difference between the rent and mortgage payment is minimal, the mortgage option will make more sense.

BRR: Commercial banks are used to collateral based lending, how are SMEs going to get funding, most of them are too small to have any collateral?

ST: It's gotten even worse now that the State Bank requires banks to write off 60 percent of bad loans from the SME sector if it is not paid within 90 days. This rule was implemented during Dr. Akhtar's tenure and I feel it needs to be removed if banks are to lend to small businesses.

I believe that before this rule was changed, banks had started lending to SMEs. My own sense is that banks will revert to lending to SMEs once the rules of the game are rationalised.

All over the world, governments play an instrumental role in supporting the SMEs. When I was the Finance Minister, we announced credit enhancement incentives and venture capital in the budget to support this segment.

BRR: DFIs are a dying business in Pakistan whereas banks are focussing on short term deposits. How can long term infrastructural financing be generated in this environment?

ST: DFIs should not be dying businesses. We set up Joint Venture Investment Banks to fulfil this role, but unfortunately they have become commercial banks when they should have focused on creating a bond market. They were supposed to finance long term projects and to do that, they needed a bond market.

What to do now? I planned two organizations for infrastructure funding while I was Finance Minister. They are still on the drawing board like so many other projects. They just need to be pushed through by the government.

We need to have a holding company, similar to Malaysia's Khazana, which brings together all the public sector corporations under one umbrella.

BRR: What do you feel the scope is for private equity and venture capital in Pakistan?

ST: We need to pass the Corporate Rehabilitation Act (CRA) quickly. Once this law is approved, we can set up a Resolution Trust Corporation to consolidate our industry. This will propel the private sector to follow suit.

As of right now, there are no incentives that the government offers to the private sector. As Finance Minster, I had proposed the creation of two funds in the budget of Rs2.5 billion each for SME Capital & Credit Support, with the recommendation that this number should be doubled every year. However, the last budget was silent on both accounts.

BRR: What is your view on the banking industry's consolidation and how many banks do you think should there be in Pakistan?

ST: It's a moot point. I don't agree with those who say there should only be 10 banks, like Malaysia. The number of banks can be more, if they can find a market.

Moreover, we should not have MCR. We should have capital adequacy ratios that are risk weighted. The central bank can start assigning higher CARs to different institutions. Mergers will happen, because larger banks have a clear advantage in cost of funds and the smaller banks will be unable to compete.

BRR: Could small banks cater to niche markets where large banks aren't as focussed?

ST: If they want to survive with their current size, they have to specialize. If they are conducting businesses that are primarily off balance sheet then they can survive. But if they come into mainstream banking then they have to deal with the cost of funds.

BRR: What is the sustainable size for a bank in the medium term?

Scaling up the balance sheet will be our next priority, not only organically but also through a merger or acquisition of another bank.

ST: A Rs200 billion balance sheet and 150 plus branches.

BRR: Your view on the public private partnerships for public sector entities?

ST: I am of the firm belief that public sector entities are national assets. So strategic privatisation which gives management control to the private sector is what I am in favour of.

But then, who is going to do it. The ministries have their own vested interests and they want to use them for various purposes. So my plan was that the cabinet committee should appoint directors who would in turn appoint competent management.

We need to pass the Corporate Rehabilitation Act (CRA) quickly. Once this law is approved, we can set up a Resolution Trust Corporation to consolidate our industry.

In three years time, 26 percent of the company would be sold after cleaning up the balance sheets and operations. Thus, the country could retain about three quarters of the assets and future generations could benefit.

Now, I believe even that would not work. We need to have a holding company, similar to Malaysia's Khazana, which brings together all the public sector corporations under one umbrella, even the profitable ones. It should have a private sector board with a limited mandate to turn these companies around, make strategic sales to the private sector and self--destruct in three years. It should report directly to the Prime Minister's office.

BRR: How do you think the current economic problems can be fixed from a policy perspective?

ST: We need to have a well thought out economic plan, like the nine point agenda we proposed for an equitable and sustainable economic growth in the country. To start with, everybody has to pay taxes.

We need to raise the tax-to-GDP ratio to 15 percent in 5 years and 20 percent in 10 years. Then we have to cut our expenses and losses in public sector companies. This will give us the financial space to spend on development of the social sectors such as poverty reduction, education & health. This will also improve agriculture, manufacturing as well as energy sectors. The surplus will also allow us to support, infrastructure, capital markets and administration. There are no shortcuts.

The other challenge is that we have to now develop long term funding for the economy. We had laid the ground work for the development of a long term bond market for the country. The State Bank can play an instrumental role, where it can guarantee some of these bonds which will become benchmarks. Then people will be able to use them to fund long term assets, such as 30-year mortgages.

If long-term borrowing rates are brought down to 8 to 10 percent by SBP, banks will be able to provide competitive mortgages to people and you will see a dynamic change. Other countries have employed this model as well, such as Cagamas of Malaysia and Fannie Mae and Freddie Mac of the US.

BRR: What is your view on the latest developments on taxation?

ST: RGST is a step in the right direction. It broadens the tax net. More importantly, we have to increase the tax coverage to include people who are currently not paying taxes.

Measures such as the flood tax are squeezing the same pool of people. I don't see why agriculture is still exempt, by just saying that it's a provincial tax. Provinces are run by the same political parties, so it is only a matter of implementation, the laws are already there. There are two taxes, one based on production index and second on income. Why is it that the provinces are not collecting taxes? Not collecting tax on agriculture means 65 percent of the population and 22 percent of the GDP is not paying any taxes.

Then, you move on to the service sector, which is 55 percent of the GDP and contributes only 18 percent to tax revenue. So 37 percent of the service sector is not paying taxes. That is a huge area for improvement, where both collection and coverage can be enhanced.

Stock market investors are now being taxed on capital gains; I think real estate transactions should also be brought into this fold. During my tenure, we introduced CVT on real estate and I argued that it was a regressive tax. Now that NFC has been signed, we can make taxation on real estate transactions progressive and tax capital gains.

Finally, all the taxes are being collected at the federal level and the provinces only collect 0.7 percent of GDP in taxes. With the new NFC, it is imperative that the provinces improve on their tax collection as well.

Profile: Shaukat Tarin

A business graduate, who majored in finance, Tarin started his career in 1975 with Citibank, with which he had almost 22 years of association, both locally and internationally. He also served at leading positions at renowned banks in the country such as Habib Bank, Union Bank (later sold to Standard Chartered Bank) and Saudi Pak Commercial Bank. Tarin has also been the Chairman of Pakistan Banks Association and Chairman of the Karachi Stock Exchange

Tarin had also been instrumental in various governmental positions, having served as the Finance Minister in 2009-2010. One of his noteworthy achievements was the successful consensus on the 7th National Finance Commission Award. He was awarded then Sitara-e-Imtiaz and Quaid-e-Azam, Gold Medal Award for his services.

Tarin currently serves as a Director of Silkbank Limited.

Bonding the bond market

Haider Nawab

It's difficult to find an issue that the community of financiers agree upon. But one thing just about every top level decision maker on the market agrees is that the role of commercial banks is not to finance long term projects.

While most infrastructure and development projects in the country today seek funding from a consortium of commercial banks, each pitching in a small piece of the pie, they are merely filling in for the lack of a mature corporate debt market. Commercial bank advances are focussed towards big ticker multinationals or established family empires.

Around the world, hybrid models of debt and equity financing are employed when launching projects whose gestation periods extend beyond the short term. Taking the example of setting up an industry, commercial banks issue debt for the initial stages, but as cash flows start rolling in, the company issues debt to sustain longer term operations and goes for a public offering of its equity through capital markets.

Moreover, highly rated companies have the ability to use the strength of their balance sheets to go directly to the public and raise funds for investment projects.

Interestingly, Engro is borrowing from the public at a cheaper rate than the government is borrowing for commodity finance from the commercial banks.

In Pakistan, "when a large AA rated company needs financing, it goes to an A-rated bank and takes a loan. In the outside world, a high rated, a AA-rated company would take it as an insult to go to an A-rated bank and ask for a loan," Amjad Waheed, CEO of National Asset Fullerton Asset Management told BR Research in an interview earlier this year.

A well functioning bond market also serves as competition, for assets, to the banking system. When investors have the ability to seek other avenues to place their funds, outside of bank deposits, they are better able to match their risk and return profile.

In a 2006 research paper written for the Ministry of Finance, Farhan Hameed contends that a bond market offers a more efficient avenue for asset allocation. In an economy skewed towards banking, credit decision making is concentrated amongst a few individuals, and the risk of 'crony capitalism' allows toxic assets to remain on banks' balance sheets. "In contrast, bond holders immediately realize if a bond is not being serviced and can hold the issuer to account," writes Hameed.

Similarly, bank lending is typically of shorter term, a look at the banking system's credit advances the last year shows that almost one half of all advances are used for working capital requirements. Investment attracts less than half that proportion.

Comparatively cheaper than equity financing, long term bond issuances provide an efficient vehicle for long term project financing, such as dams, highways, fertilizer plants and so on.

Corporate bond markets also act as a stabilizing agent for the country's financial system. The flight of capital from equity to bond markets in the financial meltdown of 2008 is the most recent case.

The lack of development of debt markets in Asia are cited as one of the reasons of the severity of the East Asian crisis of 1997. Since then, the economies of Korea, Malaysia, Thailand and Philippines have successfully encouraged companies to issue debt capital.

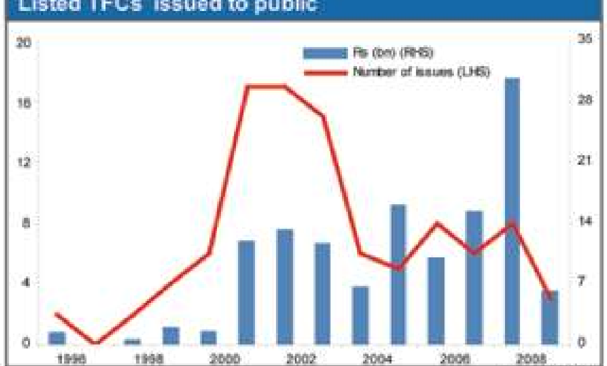
The development of debt markets in Pakistan is still in nascent stages. That being said, debt is not new to the markets. As early as the 1960s and 70s, prior to nationalization of financial institutions, debentures were listed on the stock exchanges with limited trading.

"The level of innovation in the financial sector in those early days attracted policy makers from all over Asia; that leadership is now almost non existent" Ali Raza, President of NBP, said in a recent interview for the Banking Review 2010.

Public sector companies, such as WAPDA, listed TFCs - bond equivalents in Pakistan - as early as 1988. The private sector stepped in with the issuance of a privately placed TFC by Packages Limited in February 1995.

Debt issuance took off in the first half of the last decade. In 2003, PIA launched the largest issuance with an outstanding amount of Rs15.4 billion. The average, though, remained around Rs660 million, according to SECP data. Issuances have been linked largely towards the 6-month Kibor in the absence of a long term benchmark rate in the secondary market.

Listed TFCs issued to public



Source: SECP

Consequently, high interest rate environments have played a role in slowing the number of new issues since 2007. "Stable macroeconomic and political environment is a prerequisite for the development of debt markets then. Only then will companies move ahead with issuing debt instruments," an official at the SECP said in a recent chat with BR Research.

Among other factors cited as the hindrance to potential issuers are administrative hiccups that include prohibitively high costs of listing. Unlike many other countries, Pakistan imposes a stamp duty on the issuance and transfer of debt securities. "SECP has negotiated a lowering of stamp duty with the federal and provincial governments to more reasonable levels in an effort to encourage companies to issue their debt to the public," the SECP official added.

A bond market offers a more efficient avenue for asset allocation...corporate bond markets also act as a stabilizing agent for the financial system.

Liquidity, or the lack thereof, and the underdevelopment of a secondary market where investors have the opportunity to trade their assets over the counter are major issues. Industry experts suggest that while trading occurs at the institutional level, even if at low volumes, there is no central data collection organization that would enable better price discovery when calculating net asset values (NAVs).

An online bond trading system introduced by the KSE, Bond Automated Trading System (BATS), might not be enough to get fixed income traders on to the system since there is no compulsion in sharing the data on a daily basis at the moment. First steps in that direction are being taken in terms of collecting information by the SECP, but they are far from being effective just yet.

Choking liquidity from bond markets is the government's decision to allow institutional investors to invest in National Saving Schemes, a government sponsored saving scheme, which competes with private sector debt issues.

This had been disallowed in the early years of the last decade, a time which saw the highest number of debt issues in the history of the country, averaging 14 issuances per year from 2001 to 2004. At the same time, NSS funds are used for budgetary support, so private sector projects get elbowed out, due the risk free nature of government debt.

Long term sovereign debt, provides a benchmark rate for the industry to price similar securities in the private sector. Unfortunately, in Pakistan, interest rates on Pakistan Investment Bonds (PIBSs) are not entirely market driven. The government must take the lead in picking up its debt from the market instead of borrowing directly from the SBP.

Choking liquidity from bond markets is the government's decision to allow institutional investors to invest in National Saving Schemes.

"76 percent of government domestic debt is short term, partly because offer rates for PIBs in recent auctions were being rejected. So when there is no benchmark available for sovereign debt, it hinders the development of a market for long-term financing in the shape of a corporate bond." SBP Governor, Shahid Kardar told BR Research in a recent interview.

Despite the many issues that hinder private sectors from entering the fixed income domain, Engro Corporation has successfully led a debt issue that was directly offered to the retail investor. "We wanted to provide an alternative to depositors," said Hafsa Shamsi, who managed the launch of Engro Rupiya.

Rupiya offered a fixed rate of 14.5 percent for a three-year tenor and aimed to raise Rs2 billion, with a green shoe option of another Rs2 billion. To placate investor concerns, the company threw in a put option that allows investors to redeem their investments at a 98 percent of the face value.

"Interestingly, Engro is borrowing from the public at a cheaper rate than the government is borrowing for commodity finance from the commercial banks" SBP Governor commented when asked about corporate bond issues.

Even though the market was apprehensive, the launch was successful and Engro is now half way through funding the green shoe option. "The experience was very rewarding and we hope it will serve as a stepping stone for other companies to move forward," Hafsa told BR Research.

A well-structured product from a reputed company is definitely going to whet the appetite of the retail consumer. Leadership from policy makers in streamlining the issuance requirements and working towards a stable and predictable macro-economy will go miles in developing both investor confidence and the debt market of the country.

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Structure of Financial Systems in Selected Asian Economies (% of GDP)

	Bank Deposits		Equity Market		Bond Market	
	1990	2006	1990	2006	1990	2005
China	75.6	177.8	1.4	60.4	5.9	34.1
India	31.4	53.2	10.4	76.2	19.8	33.0
Indonesia	30.0	34.7	4.4	30.4	0.1	20.3
Korea	32.6	66.1	48.2	88.2	44.3	102.0
Malaysia	80.6	115.9	100.7	141.0	69.9	90.5
Pakistan	23.6	34.0	6.7	35.8	29.0	29.7
Philippines	24.7	46.7	20.6	46.7	25.8	38.9

Source: Infrastructure of Seamless Asia , ADB

Home-ownership must for better democracy

An interview with Syed Ali Raza, President & Chairman, National Bank of Pakistan

Haider Nawab

In this interview, Ali Raza highlights the need to develop bond markets while lamenting the lost years of financial innovation in Pakistan. Talking about the financing structure in Pakistan, Raza stresses on public-private partnerships to raise finances for projects and also to execute the projects. The following is the edited transcripts.

BR Research: Please walk us through your outlook of the banking sector?

Ali Raza: The health of the banking system is related to the state of industries and economy. So, if a country is not doing well, banks don't do well.

Global economic crises, high interest rates in the local economy, law and order situation -- all of these pressures had led to increases in non-performing loans. Now, though the absolute number is still increasing, I would imagine we are past the peak in NPLs.

Two years on from the economic crisis, the banking sector has done remarkably well in the light of these stresses. Banks' numbers are looking good this year compared to the last.

Scale is becoming a critical prerequisite for success in the banking sector.

There will be more consolidation in the market. Small banks have realized that their stock prices have gone down quite substantially. Some sponsors are not willing to put in more finances. We are already hearing about a few deals but that momentum will probably pick up.

Scale is becoming a critical prerequisite for success in the banking sector.

BRR: What kind of synergies or business niche can small banks offer in any M&A story?

AR: Banks that want to compete need a sizeable balance sheet and delivery capability in the form of branches. A bank that has less than Rs100-120 billion in assets and has less than 250-300 branches just cannot compete. So, for small banks to compete they have to increase their asset size.

In Pakistan, we do not have small banks that are specialized in niche businesses. There are other sectors currently in Pakistan where specialized banks can make their niches.

Take Agriculture and SME for example. ZTBL is a bank that exclusively finances the agricultural sector. Agriculture being the back-bone of Pakistan's economy and presenting the greatest growth potential. Yet, for the past few years it has been in a very difficult financial position.

BRR: Is NBP interested in buying a small bank?

AR: We looked at all the smaller financial institutions and we arrived at the conclusion that acquiring a small bank does not add value to our shareholders. We already have 1250 branches. So if we buy a bank that has 80 branches -- mostly in the same places as ours -- where is the synergy?

We are almost a trillion rupee bank and to buy a Rs60 billion bank (which is 6 percent of our size) doesn't make sense when you factor in the incremental earnings from a shareholder's point of view.

Secondly, you have to take on a fair amount of staff, which you then have to restructure through golden handshakes and retrenchment, which is not a very pleasant thing to do. Plus, there isn't any lucrative small bank with specialised or attractive business niche in the market.

BRR: Your opinion on financing structure in Pakistan?

AR: A major risk to our economy is that our businesses are overly dependent on banks. Raising of capital in Pakistan is highly restricted. A classic example of that is how the dichotomy in the financial services sector is manifested. From 2004-08 Pakistan was regarded as the best performing stock market in Asia.

In a scenario where the stock market was skyrocketing, new companies should have been going public in droves in that era. But, during that time, there were only 6 IPOs and 12 de-listings.

Back in the late 1950-60s Pakistan was a hub for financial innovation in Asia. Countries that are power houses now sought working relationships with Pakistan. But over time, that innovation has withered away.

In other countries, diversified sources of capital are available to companies. Bank financing, corporate bonds and private equity are just some of the avenues. That makes them somewhat insulated to interest rate shocks.

BRR: Capital markets are then the answer?

AR: Yes, until there is depth in the capital markets, there will never be sizeable project financing activity in Pakistan.

Banks' appetite for long term loans is low because our deposit base is of a rather short term nature. By capital markets I don't just mean the stock markets but other avenues as well, that need to be activated.

BRR: Are capital markets then the panacea for infrastructural financing?

AR: Improving and developing infrastructure like highways, ports, desalination plants, mining -- are multi-billion dollar projects and the model for financing is a marriage of public private partnerships and the capital markets. The role of the banking system comes into play only in the first 3-4 years. Even if they partake, their lending is for the shorter term.

I headed the Middle East and Africa division of Bank of America in the mid to late 90s, when a lot of infrastructure development was taking place in the region. All of these projects were financed on this model. Capital markets were not developed enough in the Middle East at the time, so capital markets in London were involved. Of course, all of these countries have higher credit ratings and lower political risk.

Pakistan has high political risk and a lower credit rating. Yet, we need all of these things and we need to figure out ways to get them; the central bank, the finance ministry and large private banks ought to brainstorm.

BRR: So Pakistan's capital market is not highly developed, the DFIs are dying, and it's difficult to raise financing from global capital markets; does the onus lie with commercial banks, or multilateral agencies?

AR: Commercial banks have a very important role to play in the development of the economy. That is very different from saying that the highest priority of a bank's management is working for the shareholders.

Recently, NBP took a lead in arranging finances for Fauji-Akbar terminal, which is a public private partnership. We have taken both equity and a stake on the debt side of the project. When the cash flows start flowing in, the project will go for an IPO, and that will be our exit on the equity side. This is the only PPP project in the last 12 months.

Looking towards multilaterals is futile, because their focus has now shifted towards the social sector. They will give money towards literacy, education and reforms, but not towards building factories.

BRR: There is a proposal for an infrastructure bank making the rounds. What is your take on it?

AR: I think much more needs to be done, not just in infrastructure financing but also mortgage refinancing. Unless we encourage home ownership, we will remain a stake-less society. Someone who doesn't own a house doesn't have a stake in where they are living.

One of the reasons countries in the West were able to take off as industrial economies was that right from the 30s and 40s they had started providing products for home financing.

Mortgage Finance Corporation is essential; consumers need to be able to fix their rate. With a fixed mortgage, the consumer will know what the expected rate is going to be for a number of years. At the end of the day the micro economy is connected to macroeconomics. And until, we resolve issues at the macro level, pressures will still remain.

BRR: Do you think NBP should be privatized?

AR: Privatized? If by privatization you mean that the NBP should be handed over to an anchor investor such as the other banks, I would argue that the model we are following right now is working just as well.

We are performing as well as the private banks, despite all the pressures. In our model, the government is reducing its shareholding through the stock market. Our board is a combination of government and private shareholders. I think it's a good model.

BRR: Technology enhanced banking services have started emerging. What is the NBP doing about this?

AR: We are upgrading our technology platform. We are about 8-10 months away from achieving the technological platforms already acquired by our competitors. But the amount we are investing and the technology we are bringing in, is probably the single biggest differentiator. In fact, I am taking charge of this project myself.

BRR: In the last eighteen months, banks have parked their funds in government securities, what's your take on private sector crowding out?

AR: Banks respond to credit demand. If the private sector is shying away from taking on more credit, there is not much that banks can do about it.

If the need from the private sector picks up, which it should, bank will facilitate as they are intermediaries. The demand for credit will go if there is macroeconomic stability. If the differential between lending to corporate and sovereign is at least 3-4 percent then banks will move back. Currently it stands at 1.5 percent so they would rather put their money and take less risk.

Profile: Syed Ali Raza

A seasoned banker with more than 30 years of banking experience, Raza has been the Chairman and President of National Bank of Pakistan since July, 2000. Prior to joining the NBP, Raza had held several senior positions including Regional Manager, Pakistan, Middle East and North Africa at the Bank of America (BOA).

He also holds directorship of many domestic and international organizations like Hub Power, Pakistan Refinery, National Investment Trust (NIT), National Academy of Performing Arts (NAPA), Institute of Business Administration, Karachi, Higher Education Commission, and the Task Force on Remittances.

In recognition of his outstanding and meritorious services in the banking sector of Pakistan, Raza has been honoured with a number of prestigious awards and accolades by different fora. He was awarded 'The Asian Banker Leadership Achievement Award 2007' by Asian Banker in its issue of June 2007.

Bank treasury's role in Pakistan

Asad Rizvi

Banks' treasury departments have a wide variety of functions. The primary role of any treasury function is to manage bank's assets and liabilities, and existent risk arising from them. The responsibility of treasury includes efficient management of reserves, balance sheet, meeting the bank's capital and liquidity requirements.

A bank's treasury manages and monitors interest rate risk, as adverse interest rate move could impact the asset and liability side of balance sheet. Therefore, the function of a treasury is of critical importance regardless of the type of institution, be it financial institution, corporate or central bank.

Discontinuation of forward cover for import is not a market friendly move, as it has adversely impacted the inter-bank foreign exchange market and money market.

Since managing a balance sheet is a huge responsibility, almost every bank or financial institution has a committee, which is commonly known as ALCO (Asset/Liability Management Committee). The function of ALCO is to formulate a risk guideline that could take decisions and manage investments and associated risks in line with the objectives of the institution.

Commercial bank's treasury performs several key functions, which could include managing of liquidity or cash management and managing of exchange rate risk. Fund management is another key area that requires the treasury to proactively manage short-term, medium-term and long term investment and liquidity requirements.

From an advisory perspective, commercial banks treasuries also provide support to corporate finance and provide input on mergers and acquisitions and also when deciding on capital structures. In addition, treasury plays vital role in establishment of transparent Funds Transfer Pricing (FTP) process, which is essential for banks to measure the funding utilization mechanism to evaluate the efficiency of the liquidity provider, the user of liquidity and the manager of funds. A transparent FTP helps evaluate pricing and the performance of the contributor.

But the biggest challenge is managing a bank's risk involved in its capital protection and funding of its balance sheet. Hence, the treasury head has a huge responsibility, as the treasurer, he/she has to a play the role of a watchdog for financial management to safeguard the bank's finances.

Treasury head of a bank has to manage all types of risk which could include currency risk, interest rate risk, liquidity risk or credit risk.

Similarly, the central bank's treasury plays a vital role in the development and smooth functioning of the country's financial system. It is required to ensure that it formulates such a policy mix that it is able to contain inflation, maintain price stability and help boost economic growth.

To make it possible, the central bank should use its monetary tools effectively. It is expected that the central bank would maintain stable foreign exchange rate and the exchange rate policy would be consistent to support export growth.

COMMERCIAL BANK'S TREASURY/DEALING ROOM

Treasury/Dealing room of commercial banks plays vital role, as it has to manage bank's assets and liabilities and to protect the institution from interest rate and liquidity risk. Liquidity management is the key to ensure that funds are available to meet the bank's obligations and to maintain mandatory reserves and liquidity ratios.

The job includes maximising bank's earnings over and servicing bank's relationships with efficient pricing of all its products, be it foreign exchange, deposit, advances or pertaining to fixed income instruments. By virtue of its trading activities from customer flows, the treasury function is expected to add to the institution's bottom-line and to ensure that all financial risk is appropriately managed.

Daily commentary and market report should be made available to the customers, which would further strengthen the relationship between the bank and its customer. Treasury functions should be broadly segregated as the corporate desk plays a vital role. It must ensure that all customer related transactions are properly deployed and maximum return is extracted with calculated risk by the ALM funding desk according to the ALCO guideline, which looks after the bank's balance sheet.

ROLE OF SBP TREASURY

State Bank of Pakistan as the central bank of the country works as an independent entity that is responsible to regulate all the monetary and credit systems of the country to ensure stability in the economy. SBP has a board that formulates monetary policy and credit policy with the coordination of Ministry of Finance.

In 2009, the inter-bank money market activity continued to hover around the mid-point making it least attractive for trading purposes

Like a treasury's role within any financial institution, the central bank as well plays vital role in ensuring stability in the domestic financial market. But the major difference is that the central bank is the regulator and supervisor and hence, has to ensure the smooth functioning of the financial market. SBP has to make sure that it uses its entire available tools like Open Market Operations (OMOs), foreign exchange activity and reserve requirement effectively.

SBP's treasury department is playing a key role for the development of financial markets that has produced positive results to a great extent and has helped in the period of distress. Its initiative with calendarization of government securities, reopening of past issues is a move in the right direction. Electronic bond trading platform was introduced to increase trading activities and bringing more transparency of information, which is yet to make inroads.

RTGS system (Real Time Gross Settlement System) was launched by the SBP, which became fully operative in March 2009, and allows direct payment to banks instead of cheques for inter-bank transactions and all security transactions that has certainly brought efficiency into the payment system.

While, the economy was facing hardships due to drop in foreign investments, liquidity constraints, rising inflation and slow growth, SBP introduced a corridor with the objective of providing opportunity to anchor short-term interest rates, to help extend the yield curve and improve monetary policy transmission.

This was an unnecessary move, which gave no respite and instead choked the inter-bank market. Despite high interest rate environment and with a 3 percent spread, the inter-bank money market activity continued to hover around the mid-point making it least attractive for trading purposes. It had failed to deliver the desired result, as there is no genuine liquidity in the market, since the deposit had dried in the absence of fresh money.

Furthermore, all the available liquidity generated through interest accruals is easily absorbed by banks for the purchase of government securities, which offer lucrative return. Market estimates are that the inter-bank trading volume fell by around 35 to 40 percent. This is quite a serious issue, which requires immediate attention.

Some more measures taken by the SBP are debatable, as they do not suit our market conditions, though the central bank may have a different perspective. Discontinuation of forward cover for import is not a market friendly move, as it has adversely impacted the inter-bank foreign exchange market and money market due to sharp fall in foreign exchange trading volume.

The SBP should consider lowering the floor to 5 percent to match with PLS Rate. This would force banks to buy government securities from the inter-bank market.

There could be two reasons, because soon after discontinuation of forward cover, SBP was aggressively engaged in a Buy/Sell (B/S) swap and forward outright trades. B/S swap means injection of Rupee liquidity in the inter-bank market and it simultaneously fattens the central bank reserve position. The other factor is that SBP B/S swap provides cheap forward cover to foreign currency (F/C) borrowers, which could be annually 5 percent costlier if cross border hedge is obtained due to country risk and customer risk.

Corridor as a monetary tool could only be successful in a zero or low interest rate environment. But in Pakistan, where the discount rate has been hovering in double digits for the last four years, it had pushed the yield on government securities lower, which makes it extremely attractive for the banks to invest in low risk papers and thus introduction of corridor in a higher interest rate scenario is a blessing for the bank.

Corridor is also one of the hindering factors for the failure of Electronic Bond Trading (EBND), as banks have a floor available to make last moment investment with their excess money.

Hence, it is suggested that SBP should consider lowering the floor to 5 percent to match with PLS Rate. This would force banks to buy government securities from the inter-bank market and EBND trading will pick up. Or SBP should raise the PLS floor to 10 percent and maintain adjusting the advance/deposit spread of 4 percent in line with discount rate move that will certainly tempt the depositor, which will not only see a halt in the rise of currency in circulation, but would also encourage the depositors to put their money in banks that offer lucrative return, resulting in a rise in the national savings ratio.

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Financial inclusion holds the key

An interview with Sultan Ali Allana, Chairman, HBL

Ali Khizar & Sijal Fawad

For Allana, financial inclusion is the panacea for economic growth in Pakistan. Stressing on the subject, Allana points out how financial inclusion is imperative for increasing the savings rate. In this interview, he also talks about the expansion plans of HBL and that of its subsidiaries. Below are the edited transcripts.

BR Research: What is HBL's strategy in the present times of economic uncertainty?

Sultan Ali Allana: We are optimistic on the long-term outlook, given Pakistan's resources and the room for tapping the economic potential. There may be short-term issues; however, the future of banking in Pakistan appears positive.

HBL will continue to move forward on its growth trajectory and is now well poised to pursue financial inclusion in all aspects on the asset side as well as the liability side, and also in ancillary businesses, such as insurance and asset management. To progress as a nation we must think in terms of financial inclusion and HBL is developing a particular focus on financial inclusion.

Profitability is important for us, but financial inclusion is paramount; as the largest bank with an extensive branch network that has a presence in the remotest regions of Pakistan, HBL is obligated to deliver financial products and solutions for the benefit of the entire spectrum of society. This is integral to the future growth of HBL.

In my opinion, HBL's focus on financial inclusion may not result in higher returns, but I think it is our moral obligation to work for the betterment of the people - as such, we are fully committed to this. We would like HBL to be judged not on the basis of our earnings and returns, but on what we deliver to the society and people.

We are looking at expanding our insurance in the emerging markets. South Asia is of particular interest to us; we are also looking into Central Asia.

BRR: Is this the philosophy of the Aga Khan Fund for Economic Development (AKFED) or the government shareholders?

SA: AKFED is a fund, which invests in emerging markets and its role is to promote economic development. Financial inclusion is very much part of our strategy. Having said this, I would also say that this objective is at the core of the government's thinking as well; the SBP has long been urging for more and more people to be included in the banking network. Watan card is one such step in that direction.

BRR: What measures are you taking to include people from far-reached areas into the financial hub?

SA: HBL's network coverage with over 1,400 branches reaches even the most rural population in the country. However, the success of this outreach is that people also should use the banking system - this is critical for its success.

It is also important to reach out to people in the urban areas, particularly those in the low-income brackets. We are constantly reviewing our branch footprint and are conscious of our role. Going forward, we intend to set up new branches where necessary. In addition, Alternate Delivery Channels (ADC) are being actively pursued as a strategy in order to enhance our coverage.

BRR: Since these people may not be well-versed with technology, what level of education and training will be needed to achieve this?

SA: The "training myth" has been eliminated by the outreach achieved by the telecom firms. When telecom came, everyone wondered as to how they would operate across the spectrum of the population. Now nobody questions this. People are using cell phones to top up their accounts, send SMS's, obtain education and medical assistance etc. Some are now also using mobile phones for fund transfer purposes.

It is true that product offerings and solutions will have to be made simple, but if you make the product user-friendly, people will use it. Case in point: Watan card - people are using the cards. Making the product simple and user-friendly can help bring about financial inclusion.

Technology, in our view, will play a key role - this will enable banks to deliver products and solutions widely and effectively. Making branches and customers' experience efficient and user friendly is also important - we have started a process where we have engaged female staff as tellers in some of our branches.

This measure has resulted in a greater flow of female customers to the branches, as they felt comfortable in transacting with female staff who are well-trained and knowledgeable.

BRR: Let's talk about the SME sector. Banks are currently concentrating on big corporations, and that has somewhat crowded out of the SME sector. How do you propose to address this issue?

SA: SME is a complicated topic. The phrase "SME" needs to be reviewed - this is a very wide term. To explain, micro-banking starts at, say, a Rs5000 level up to, say, Rs200,000-Rs300,000. Technically, the SME spectrum should start after that and continue up to where the corporate sector begins.

Banks interpret the category differently, and have varying limits for the "S" part and the "M" part in the SME spectrum. Some will start SMEs at one level and end at another; some will start at a lower or higher level etc.

If you do a survey of banks on their limits of "S" and "M" and you will most likely get very different answers. For some "S" begins at Rs5 million and ends at Rs30 million, for others it begins at Rs1 million and ends at Rs10 million. I feel that this wide definition creates some confusion and perhaps creates gaps, which essentially do not get financed. We need to, therefore, develop an industry-wide definition of each segment, so that the banking industry is able to provide coverage to the entire spectrum.

BRR: In your opinion, how would you define the "S" segment?

SA: Technically, the "S" should start where the micro tapers off. The banking industry as a whole are not in this segment in a meaningful way - HBL is working towards providing credit to this segment in a systematic way.

Most of the large banks in Pakistan, in my opinion, are what maybe termed as "SME" but are essentially positioned in the "M" segment; starting from the mid-M to the high-M. They're not on the lower side of the range either. For us to be able to cover the entire spectrum, we have to also cover the lower side of the range.

While there are limitations, or perhaps constraints, in the "S" area, e.g., one is essentially without any tangible security or collateral in the "S" side and the lower end of the "M" side, we will have to find innovative ways to address this limitation. Otherwise, on a national level, we may not be able to fully address the needs of this segment. There are also issues of security and of credible financials and also, many times, lack of a proper recovery process.

We hope to be able to bring other quality of life products, e.g. educational insurance. We don't have them yet, but we're looking into them actively.

BRR: Can you elaborate on the situation of collateral in the S part of SME?

SA: In our economic spectrum, a person may not have business related assets but they may have personal assets such as residential property or land. In other countries, such form of personal collateral is used - enforceability is key - if processes and systems are strengthened to enable quick and timely enforcements, banks may be comfortable in lending.

Another aspect, which may contribute and facilitate in the development of the "S" and the lower-end "M" segments is the availability of venture capital. Unfortunately, we don't have institutions in the country which offer this form of support.

BRR: What are your views on the synergies between NJI and HBL?

SA: There is excellent synergy. Today, through collaboration, we are offering services, which we couldn't in the past, e.g. life and health insurance to our customers. In future, we hope to be able to bring other quality of life products, e.g. educational insurance. We don't have them yet, but we're looking into them actively.

BRR: You have a presence in many countries. Where are you planning to expand next?

SA: We have a sizeable presence in the Gulf where we have branches in the UAE, Bahrain and Oman - so Gulf is a very important cluster for us and we will continue to expand in this region. We have a solid presence in the UK and that presence will grow because we are embarking on inorganic growth. The 3rd cluster is South Asia, which includes Bangladesh, Sri Lanka and Maldives. Here, again, we are growing.

In addition to these clusters, there are some high-growth markets that we've identified; one being Central Asia and the other being Africa. Our presence there is not in the form of HBL but through shareholdings in other major regional banks. These again are high-growth areas and we intend to further solidify our position in the coming years.

BRR: Do you plan to expand your insurance business as well?

SA: We are looking at expanding our insurance in the emerging markets. South Asia is of particular interest to us. We're also looking into Central Asia as there is market demand.

BRR: Any plans of venturing into private equity funds?

SA: We've been thinking. There was a time when we were at an advanced stage with international financial institutions for launching an infrastructure fund, but the project did not move forward because of the global economic challenges. So, yes, when economic conditions are better and there is growth, we might look into it.

BRR: Any plans for acquiring banks in Pakistan?

SA: Not at this point in time, although we are always open to examining opportunities when they arise. We have a fairly large presence and are achieving reasonable growth - so there is no rush or compulsion at this stage.

BRR: But you were looking at RBS?

SA: We looked at it and then decided it was not a good fit for us. As I have said, we will look at opportunities, but we'll evaluate if they add to our franchise value. We looked at RBS, and we came to a conclusion that it did not add value to our franchise and so we did not pursue it further.

BRR: HBL has a stake of about 16 percent in the Khushhaali bank; do you wish to increase your presence in the microfinance industry?

SA: Micro banking is an integral part of financial inclusion, and as the largest private bank in the country, we cannot leave it out of our portfolio. My personal view is that in the long run, i.e. in the next 4-5 years, we would have to look at this in a serious manner as this is very much a part of financial inclusion. I think that as the country's largest bank, we cannot stay out of it, but, again, this is my personal opinion.

Over the next 4-5 years, we would have to look at microfinance in a serious manner ….. as the country's largest bank, we cannot stay out of it.

BRR: What about acquiring one?

SA: At some stage, we will have to look at this issue closely - our direction is financial inclusion and this is an integral part of financial inclusion.

BRR: What are your suggestions for increasing the savings rate in Pakistan?

SA: One way is financial inclusion. The other is documentation of the economy. If you document the economy, savings will most likely grow. Innovative products to fit different profiles is also essential.

BRR: Why isn't your penetration high on the mortgage side?

SA: I think the laws in Pakistan will have to be far more enabling to bring about an advancement of mortgage financing in the country. The process of repossession must be swift because banks will only lend if they are comfortable that the banks will be able to recover in case of a default.

Another aspect is that you will also need sources of long-term funding to support mortgage financing. In the absence of strongly enforceable foreclosure laws and long-term funding, it may also be difficult for the mortgage industry to develop in a meaningful manner.

BRR: But why aren't you aggressive in car financing or credit cards either?

SA: We are there, but not very aggressively. We are risk-averse, being cautious bankers. We will do business, but are cautious in our appetite for risk.

BRR: What is your view on the trend of NPLs?

SA: My sense is that the banking sector NPLs have bottomed out now. The trends indicate that the quantum of NPLs is likely to become lower going forward. That's what the trends are indicating.

Profile: Sultan Ali Allana

Currently working as the Chairman of Habib Bank Ltd, Allana has been with the bank since it was privatized in February 2004. Prior to this position, he was the Chief Operating Officer of NIB Bank and a Director and founder member of Global Securities Pakistan Ltd.

Allana, who has over 25 years of experience in the finance and banking industry, also serves as a Director on the board of the Aga Khan Fund for Economic Development (AKFED) and is the Head of the Financial Services Group, which oversees AKFED's holdings in banks, non-banking financial institutions and insurance companies in South Asia, Central Asia and Africa.

Since 1997, Allana has served as a Director of the Tourism Promotion Services Pakistan Limited, the owners and the operators of the Serena Hotels in Pakistan and has served as the Chairman of the First Micro Finance Bank until 2006.

He holds undergraduate and postgraduate degrees from McGill University and the University of Wisconsin in Engineering and Management.

Good things come in **small packages**

Manal Iqbal

The financial industry has experienced tremendous growth over the past few decades. On one hand, complex financial products are to be blamed for the recent global economic disorder; but on the other, simple financial products to enable socio-economic development and poverty reduction have been found missing. If there is any 'specialised branch of finance' that has the potential to improve the industry's image in these turbulent economic times, it is microfinance.

Evidence from various microfinance projects and programmes around the world are sufficient proofs that access to financial services not only facilitates poor people in increasing their earning, but also helps to establish small businesses, promote education and improve health.

A study conducted by the Kashf Foundation to assess the impact of microfinance on clients who have been with the Foundation for more than 4 years documented an increase in saving of two-third of its clients over the past one year, while 34 percent of their clients reported an improvement in economic situation during the same period.

The existence of microfinance is not very old in Pakistan. Various support programmes and pilot projects came into foray between the 1960s and 1980s. But, in essence, microfinance gained realisation in 1996, when the Aga Khan Rural Support Programme separated its microfinance operation into separate units.

The same year, the state-owned National Rural Support Programme launched the Urban Poverty Alleviation Programme while the country's first specialised NGO, Kashf Foundation, made its debut. Further progress was made after the formation of Pakistan Microfinance Network and formulation of Microfinance Ordinance in 2001.

With nearly one third of the population living below poverty line and more than 75 percent of the adult population deprived of basic banking facilities, the microfinance sector has witnessed tremendous growth in the space of few years.

At present, there are 29 microfinance service providers including eight microfinance banks. Of the 21 non-bank microfinance service providers, four cater to the rural support programme, nine are specialised entities, and eight represent social development organisations that have microfinance products in their service portfolio.

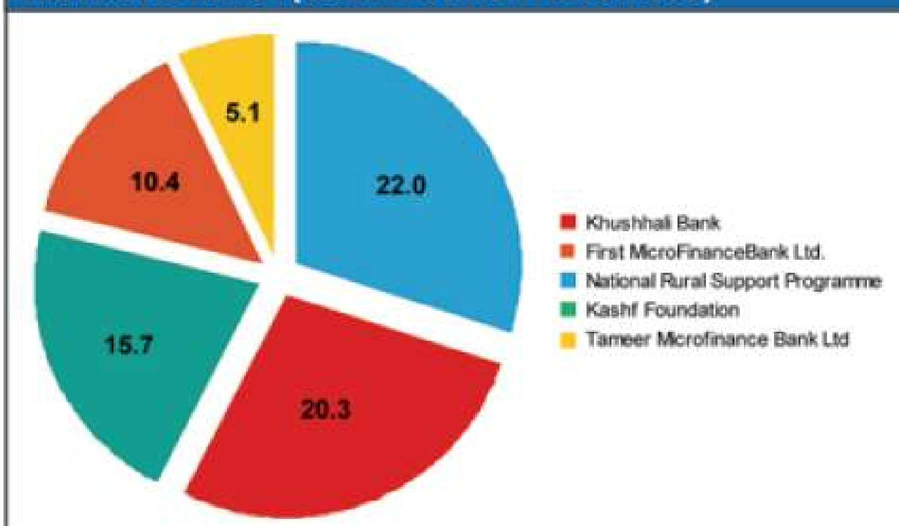
These organisations have launched a slew of microfinance products spanning four major areas, credit, savings, insurance and money transfer services.

Microfinance has come a long way in the last few years, but compared to the size of economy, its penetration is still very low.

First Microfinance Bank, Khushali Bank and Kashf Foundation are considered as the major contributors to the development of microfinance product basket in Pakistan.

The growing microfinance industry reached a major milestone last year when Tameer Microfinance Bank launched 'easypaisa' that provides banking services outside bank branches. It was hailed as a watershed moment in the development story of the microfinance industry in Pakistan. It is hoped that the availability of a branchless banking network would pave way for the expansion of banking facilities to un-served, rural areas at low cost.

Market Share (% of Active Borrowers)



Source: Pakistan Microfinance Network

	Return on Asset	Return on Equity	Operational Self-Sufficiency ratio
Africa	-0.2	2.3	100.5
Asia	1.8	11.2	111.4
ECA	1.1	3	109.8
MENA	3.4	10.2	123.5
Pakistan	-5.6	-23	94.1

Source: Microfinance Information Exchange
ECA: Eastern Europe and Central Asia

At present, the National Rural Support Programme holds a dominant position in all three key microfinance segments, capturing 22 percent, 51 percent and 46 percent market share in the micro-credit, micro-saving and micro insurance segment, respectively. The second slot has been taken by Khushali Bank in the micro-credit market, Kashf in micro-insurance and Punjab Rural Support Programme in micro-saving, according to the last available data released by Pakistan Microfinance Network.

On the growth front, of all three major segments, micro-insurance segment saw the highest growth in the past few years. This is evident from the fact that the industry was serving 3.2 million active insurance policies by September 2010, up from just 0.3 million at the start of 2007. At the same time, the size of the micro-insurance portfolio (sum insured) reached Rs44 billion from Rs5 billion.

Similarly, saving products have also gained attraction over the course of years; active savers more-than-doubled to 2.9 million and the size of saving portfolio nearly quadrupled to Rs9.7 billion at the end of September compared to the first quarter of CY07.

The high appetite for loans supported the demand for micro credit products,

Microfinance industry reached a major milestone last year when Tameer Microfinance Bank launched 'easypaisa' that provides banking services outside bank branches.

which are the most-loved product in developing countries, helping micro-lenders to expand outreach to 2 million borrowers from 1.1 million borrowers in the start of 2007.

Microfinance has come a long way in the last few years, but compared to the size of economy, its penetration is still very low.

This can be gauged from the fact that microfinance institutions have just around 20 deposit accounts per thousand adults compared to 229 accounts per thousand adults with commercial banks, according to the Financial Access Report 2010.

The main culprit behind low penetration is poor outreach. In Pakistan, there are 1.92 microfinance branches per thousand km compared to 20 branches per thousand km in Bangladesh.

Realising the fact that there is a large portion of population that is un-served - with some estimates suggest more than 27 million potential clients - microfinance in Pakistan has to go a long way, implying the need for more specialised banks to enter into this market.

ROLE OF SBP & CHALLENGES AHEAD

Positive developments in the microfinance sector, to some extent, have been attributed to a supportive regulatory environment as evident from the microfinance business ranking, released recently by the Economic Intelligence Unit.

Out of 54 countries, Pakistan got the 5th place in the microfinance business environment ranking, ascribed mainly to better regulatory framework, in which Pakistan, along with Cambodia and Philippines, was ranked first. Apart from aforesaid, Pakistan was also ranked 20th in investment climate and 12th in institutional development.

Lately, the State Bank of Pakistan has taken some constructive steps in the form of relaxation in certain conditions and lifted regulation that previously prevented microfinance banks from accepting foreign currency loans from international lenders.

Despite market potential, there are some challenges that have been making investors reluctant to setup microfinance institutions. The biggest impediment is high operating cost, as microfinance service providers offer small loans and deposit facilities, which makes it a very labour intensive industry. According to the last released data by Microfinance Information Exchange - a Washington-based NGO - the average cost per borrower per GNI per capita was 4.7 percent in Pakistan in 2008 compared to average 2.9 percent in Asia.

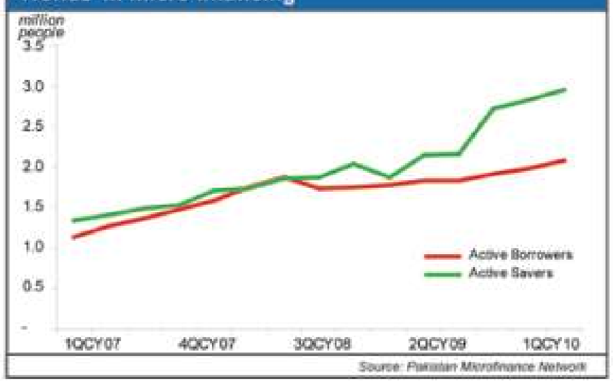
Another major challenge is the low saving rate among Pakistan's lower middle class families. Since individuals with small income are more inclined towards borrowing than saving, microfinance banks have to offer high interest rates on deposits than what commercial banks offer, in order to build volumes. At present, the size of micro saving account is Rs9 billion compared to total micro-credit of Rs26 billion.

Consequently, microfinance banks need to charge a higher lending rate to remain sustainable and profitable, which, in turn, hampers the ability of small micro banks to scale up. Therefore, the profitability of microfinance institutions in Pakistan remains weak. The industry's ROE in Pakistan is negative 23 percent, compared to an average of 11.2 percent in Asia.

The biggest impediment is high operating cost, as microfinance service providers offer small loans and deposit facilities.

But the good part is that local microfinance players have witnessed considerable improvement in the Operational Self Sufficiency (OSS) ratio. The ratio shows the ability of a microfinance institution to cover costs of operations, which includes financial and non-financial expenses with internally generated income. The OSS ration in Pakistan rose to 94 percent in 2009 from 80.8 percent the year before.

Trends in micro-financing



Source: Pakistan Microfinance Network

However, it is still low compared to the average OSS of 109 percent of 1136 microfinance institutions around the world

Amid high operating costs, the advent of branchless banking is good news for the microfinance industry. In a country where around 65 percent of the people live in rural areas with little infrastructure, branchless banking will hopefully bring scale to the microfinance industry.

It is also expected to provide financial services to poor individuals at low cost. A CGAP analysis with the Tameer Microfinance Bank discovered that the capital and operating costs for a branchless agent are 76 times less than its microfinance branch in the first year, and 89 times cheaper over a span of five years.

In some developing countries, banks have already started providing microfinance services using branchless banking networks. For instance, in Kenya, the Equity Bank, a leading microfinance bank in partnership with Safaricom (a telecom firm), launched M-Kesho earlier this year. The service will give their customers access to mobile micro-savings, micro-insurance and other banking products via mobile phones.

Given the size of Pakistan's economy and a large untapped market, microfinance is the way forward to bring economic prosperity to millions of people. And to achieve that, the government needs to attract more experienced international microfinance players to Pakistan.

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Faster foreclosure system must to foster banking

An interview with Atif R. Bokhari, President & CEO, United Bank Limited

Ali Khizar & Sohaib Jamali

This interview takes the reader through a conversation with Atif Bokhari, President and CEO of UBL Pakistan. The CEO speaks about the much-pondered issue of financing of long-term projects, and that of the SME sector. He also discusses in detail the rise and fall of consumer banking in Pakistan and the reasons thereof, and speaks of UBL's far-reaching presence in branchless banking.

BR Research: DFIs haven't been venturing into long-term financing, whereas banks' deposits are skewed towards short-term; in such a scenario do you think that long-term projects would suffer from lack of financing?

Atif Bokhari: The space left by DFIs was taken up by commercial banks completely. Agreed that in the last 15 years, the liability structure of banks has been skewed towards the short side, but irrespective of that when you look at the late 1990s and the early 2000s, long-term projects were being financed easily.

The entire power projects were financed by commercial banks; we are looking at 15-20 years of repayments. Fatima Fertiliser and other mega projects came in and banks financed them. So the mismatch on the balance sheet has never precluded commercial banks to go for long-term financing; it is just that you need to come up with viable long-term projects.

BRR: What in your view is keeping the private sector at bay from big projects?

AB: Monetary Policy is currently very tight -- though I don't disagree with it.

But when you are talking about financing a blue chip company, I won't be able to do anything less than 2-2.5 percent over KIBOR, whereas at 16.5-17 percent long-term viability is difficult to sustain for the private sector. Couple that with the prevailing political risk and uncertainty, and the private sector will naturally shy away.

BRR: Banks tend to focus on big ticket corporates whereas they should be focussing on the SME sector?

AB: To a degree, there is an element of name lending in this market. However between 1998 and 2003, there was substantial growth in terms of new names and large exposure being taken in what you call second tier borrowers. And I tell you that a majority of those were wrong calls by banks, because second tier was not adequately capitalised to sustain an economic downturn.

There is an element in this country where people have the ability to pay back but they lack the will to repay. People are very short sighted especially on the SME side. They would rather save a penny by not paying up banks' principal and interest, but would not think of the pound they lose by destroying their credit rating.

BRR: But don't banks have any recourse to law?

AB: Today the defaulters choose to fight in courts, where it takes on average 15 years to get a decree and an execution, and for 15 years they get free use of banks' money. So getting into litigation is actually the best thing for the borrower, because he doesn't have to service anything during that time. If there were sufficient laws on bankruptcy, you wouldn't see these things happening.

If somebody has defaulted, and he does not have ability to repay, it does not mean that bankers want them to be in put in jail. We just want that person to hand over the assets to us so we can sell them to somebody who can run the business better.

BRR: Does that mean that UBL has shied away from the SME segment?

AB: No, I am a firm believer that if we don't focus on and develop the SME sector, the economy will never grow. You will never grow through the 15-20 large groups, which are the largest manufacturers.

But at the same time you have to look at the track record of SMEs. SME portfolios of nearly all the banks have a default rate of more than 25 percent. You can't survive as a bank with 25 percent default rate.

Still, at UBL we continue to service the SME as well as the consumer segment. We can't just walk away from a particular sector in the economy, because we feel that we have a certain responsibility to this country.

> **The banking industry got blackmailed by people who were in fact mostly salesmen rather than true consumer bankers.**

BRR: Have the banks taken up this issue with relevant authorities?

AB: Yes, these issues have been taken up at various forums and all we seek is early resolution on court cases.

BRR: What are the lessons to be learnt from the consumer asset boom?

AB: You see Pakistani bankers were mostly corporate bankers; consumer banking was not their forte. There was only one international institution that had launched consumer banking, and a large majority associated with consumer banking in any bank in Pakistan had been trained by that institution.

So they all had one fixed business model and implemented the same model without knowing it fully well and how it would pan out. We just started following one model blindfolded.

BRR: What was exactly wrong was the model?

AB: The model was based on direct sales, which made sense for a bank with a limited branch network and hence needed a large direct sales force. Unfortunately, we did that too, because all consumer bank heads said that 'no other model will work'.

In hindsight, why should I have a direct sales force of 5,000 people when I have 1,100 branches? It is logical now, but at that time it wasn't.

BRR: So the KYC model would have been much better?

AB: The problem with the direct sales model is that salesmen are only bothered about commissions; a lot of these salesmen weren't actually bank employees, so they carried applications of 5 or 6 banks, and would sell any one of the banks' products depending upon what the customer wanted. They had no loyalty.

BRR: How did this herd mindset affect the industry's costs?

AB: The banks started competing so aggressively that the cost structure just went haywire; an officer of Rs50,000 salary per month would demand double that salary within the first three months -- saying that if you don't double it, then I will go to XYZ bank.

Suddenly, young officers with just 2-3 years of experience started demanding the title of Vice Presidents and a salary of Rs500,000 per month. So, we got blackmailed by people who were in fact mostly salesmen rather than true consumer bankers.

Secondly, product wise, everyone got into the game of who is going to make more sales. They started a competition; if one bank sold 5,000 cars a month, the sales heads of other banks would say we must beat that target; so quality was ignored and it totally became a sales driven exercise.

BRR: How do you see the consumer segment growing over the next 5 years and what model would you follow now?

AB: When we started downsizing our consumer business, we did an exercise called Proxima, which was basically reengineering and reorganising of our branch network.

Our acquisition numbers in consumer are down, but whatever we are acquiring is very good quality. We are looking at a default rate of less than 5 percent on our new portfolio. I would rather have a reduction in acquisition rates than see my default rates go up.

BRR: But at the end of the day, isn't it the credit policy wing that is responsible, whether you follow the direct sales model or the branch model?

AB: We follow a scorecard system of analysing applications; we used to do that in the direct sales model and we will continue to do so in the relationship model or branch model.

In the branch model, the relationship manager is responsible for bringing in quality customers, so if tomorrow the loan goes bad he is responsible. It may be not be UBL's client, but at least the relationship manager knows the client.

> **Unfortunately when we gave out banking licences, it was on the model of the big 5 commercial banks, which doesn't work for everybody.**

BRR: What makes you believe that the branch model will work?

AB: Well, the jury is still out whether this model will work in the long-term, because you have to have a certain amount of acquisitions a month to at least break even on the business. But again, at UBL, even if our consumer asset segment ends up as a loss leader for the next 10 years, we will still continue doing it. We are not going to walk away from it.

BRR: How would you re-strategise your commercial business as regards SME lending?

AB: The problem was that as banks moved directly from corporate to consumer; we missed the commercial and SME sectors in between.

But now at UBL we are going to increase our workforce in commercial lending by somewhere around 100 percent in 2011.

A relationship manager on the SME side handling around 30 or 40 relationships cannot have healthy interaction with so many clients. So we are going back deeper into the relationship model, because only that will work; we will rationalise the number of relationships that a person should be managing. Ideally it should be around 15-25 depending upon the size of the portfolio.

BRR: How do you plan to make good use of your branch network?

AB: We are moving towards what we call retail banking, which encompasses practically everything. It is inclusive of the branch network, commercial assets, consumer assets, insurance, mutual funds and so forth.

Our biggest strength is our branch network; and so everything should flow through it. We have also added around 15-17 Islamic banking windows within our conventional branches.

BRR: Isn't Islamic banking a separate business?

AB: It may be a separate segment, but it comes within the retail segment, I don't want to add Islamic banking branches in every city when we can offer Islamic windows in existing branches. This was all part of our Proxima exercise three years back.

We understand that today our most marginal branch is making money, because low cost deposits are placed in high yielding government securities. But, if and when interest rates ease to 6-7 percent, a lot of branches will start making losses. So we need to ensure that our branches don't just act as liability gatherers but also as revenue centres.

BRR: Farming economy has

seen a boom of late. Why don't banks, especially the big banks, venture aggressively into agri lending?**

AB: Most of the agri lending is in Punjab; banks don't tend to go to Sindh because of lack of documentation. Since Sindh has not been able to computerise its land records, bankers can't go about lending to farmers, even if the relationship manager knows that a certain person owns certain land.

The second issue is that we need to set up warehousing facilities; if you are a small farmer, you sell your crop to the 'aartis', who buy crop futures at substantially lower rates than market price.

If you have warehousing capacity, banks will increase agri lending because we will have a sense of security on the back of warehousing receipts.

Agriculture can be better promoted through private sector regional banks with limited geography. Unfortunately when we gave out banking licences, it was on the model of the big 5 commercial banks, which doesn't work for everybody.

BRR: Why don't banks provide banking services to the 'aartis'?

AB: 'Aartis' don't want to deal with banks; they are totally undocumented. About 60 percent of the currency-in-circulation is in the agricultural sector - and almost all of it is undocumented.

BRR: UBL is the first commercial bank to start branchless banking. What are your growth plans, and how successful has been the experience?

AB: Today we have something like 2,000 agents, we will ramp it to 20-30 thousand agents in the next 12-18 months.

For UBL the project has been quite successful; who could have ever imagined that IDPs of Swat, who had no exposure to banks, would start using debit cards and point of sales terminals. We did about 0.4 million cards in a space of 45-50 days. We did the World Food Programme and now we have done the Watan Card. A total of 1.3 million cards have been issued in the Watan scheme, of which UBL has issued 1.0 million.

We are planning to increase our presence in Africa, where in one particular country we should get permission by June 2011.

BRR: What is the secret behind the success of branchless banking - especially in terms of disaster management?

AB: Branchless banking is the cheapest form of distributing aid. For any aid agency, the cost of delivering aid to the needy is something around 15-30 percent. It's the international norm without any corruption.

On the other hand, the cost of delivering aid through these cards is less than 5 percent whereas in the case of IDP, it was less than 1.5 percent. The cost of Watan Card is around 3 percent.

Secondly, ours is a home-grown technology, whereas other banks opted for technology from international vendors, which costs a lot. Basically, we started working on this product called UBL Orion about 5 years ago; the project wasn't very successful, but the learning gave us a head start.

Having seen our success, a couple of private equity funds want to buy our technology for regional implementation.

BRR: Would you sell the technology?

AB: Absolutely.

BRR: Any plans to acquire a small bank?

AB: No. The acquisition has to add value and I don't see any small bank adding value. Small banks don't have any strength to bring to the table.

BRR: So what should small banks do to survive?

AB: They should merge. If they continue to do traditional banking they will always be caught up in the catch-up game to get to the right size, increase their branch network and so forth. And for that the shareholders will have to keep pumping money.

Instead the small banks need to develop specialisations, like trade, agriculture, SMEs, investment banking and so forth.

BRR: Do you think that MCR is a good measure or the capital adequacy ratio?

AB: There has to be a right mix of MCR and CAR.

BRR: What's your view on NPLs?

AB: The major area that I am concerned about is the value added sector. But I don't see any significant impact on the NPLs. The worst is behind us.

BRR: What's your interest rate outlook?

AB: The way things are going inertest rate will likely remain high throughout 2011.

BRR: UBL recently did a transaction in Yemen; can you share its details?

AB: It was our first offshore syndication transaction - a 5-year $20 million syndicated Term Finance Facility for Hadramout Investment Power Company to part-finance a 75 MW power plant in Hadramout Region in Yemen.

The project will supply power to Yemen's national electricity transmission and distribution company as well as the sponsors' steel plant. UBL acted as Investment Agent of the transaction in addition to being the exclusive Financial Advisor and Arranger to the client.

The transaction marks the first ever funded syndicated facility in Yemen with participation from 5 local and foreign banks including UBL, Tadhamon International Islamic Bank, Cooperative & Agricultural Credit Bank, Arab Bank and International Bank of Yemen.

BRR: Are you looking to increase your presence in foreign countries?

AB: Yes; we want to work with our strength that is the Middle East. Previously, we used to work on the Pakistan trade model. Now that we have a presence in all of Pakistan's major trade partners, we are looking at the Middle East trade model because that offers larger tickets. We are also planning to increase our presence in Africa, where in one particular country, we should get permission by June 2011.

Profile: Atif R. Bokhari

Mr. Bokhari was appointed as President and CEO of UBL in May 2004, subsequent to privatization in October 2002. Bokhari has 28 years of work experience, and prior to UBL, he worked for ICI Pakistan Limited, Bank of America and Habib Bank. He also serves on the Boards of United Executors and Trustees, United Bank AG Zurich, United National Bank, First Women Bank, Institute of Bankers Pakistan and Karachi School for Business and Leadership.

Islamic banking in search of a direction

Zuhair Abbasi

"I shall watch with keenness the work of your organisation...compatible with Islamic ideas of social and economic life. We must work...and present to the world an economic system based on true Islamic concept of equality of manhood and social justice," so addressed Mohammad Ali Jinnah at the inauguration of the State Bank of Pakistan in 1948.

A hindrance to Islamic banks' profitability is the lack of Shariah compliant investment avenues which causes short-term liquidity issues.

Yet, despite the fact that Islamic banking was inevitable in an Islamic republic, Pakistan was a late entrant to the practical model of Islamic banking. However, the past few years have seen Islamic banking getting due recognition, although the journey has just begun and there is a long way to go before it becomes huge in terms of size and impact on the overall financial industry.

During Zia's era, the regulator brought about sweeping changes in the financial system in the quest of 'Islamisation of the economy', which resulted in a countrywide roll out of Islamic banking. However, critics argue that the change was sudden and without adequate preparation, which led to confusion and, therefore, Islamic

A large majority still believes the current Islamic banking not to be in compliance with Shariah

banking could not really kick off in its true spirit.

The lessons learnt from the unsuccessful attempt in the 1980s led to a more realistic approach in re-launching of Islamic banking in the 1990s. The SBP issued licenses, formulated Shariah compliant guidelines, and introduced various investing and financing tools for the Islamic banks, gradually, by virtue of which, Pakistan today has five full fledged Islamic banks along with more than a dozen conventional banks that run Islamic operations on the sidelines.

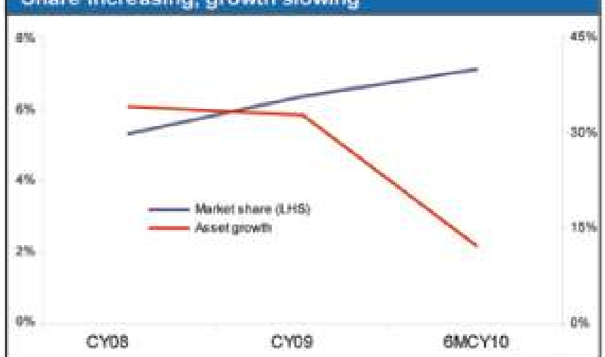
The growth of Islamic banks in Pakistan was massive during CY07-CY09 despite the global recession and unfavourable financial environment. The massive 34 percent and 33 percent growth in Islamic banks' asset size during CY07 and CY08 respectively speaks volumes of the relative immunity that the system enjoys over conventional banks. This is because the very nature of Islamic banks' deposits and advances does not hamper growth a great deal.

Conventional banking during the same period grew at a much slower pace, understandably though, as the financial system faced the impact of a weakening economy. The base effect and the developed stage at which the conventional banking system stands also explained the slower growth rate in relation to the relatively infant stage of the Islamic banking industry.

The Islamic banks' asset growth, however, considerably slowed down during the first six months of CY10, which many industry watchers say is not a good sign. Experts argue that the industry should instead continue to grow for another 5-6 years in ideal circumstances. It seems that Islamic banks have reached the consolidation phase a bit too early which reflects the hurdles that the Islamic banking system faces in Pakistan.

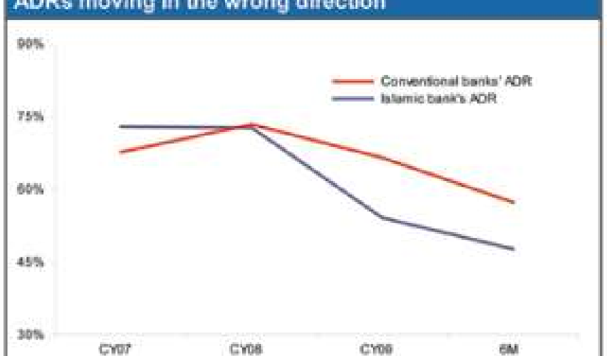
Islamic banks have shown

Share increasing, growth slowing



Source: SBP

ADRs moving in the wrong direction



Source: SBP

steady progress in deposit growth at a much better pace than conventional banks, managing to increase the deposit market share from nearly 4 percent in CY07 to nearly 7 percent by June 2010. These numbers have made the experts believe that the market is very much there to be tapped; it is just a matter of effectiveness and being competitive.

Advances growth, on the other hand, has been lacklustre, which is reflective of the fact that Islamic banks lack ample avenues for financing. The advance-to-deposit ratio, resultantly, shows a dismal picture when compared to that of the conventional banks. The ADR has worsened gradually from CY07, from the high of 73 percent in CY07, it has touched the lows of 48 percent as on June 2010.

"Islamic banks' ADR generally are comparable with that of conventional banks across the world, therefore, the poor ADR in Pakistan's case is a reflection of the cautious approach that the Islamic banks adopt and also the lack of enough financing tools and opportunities available in the Shariah system in Pakistan," said a seasoned Islamic banker associated with Meezan Bank.

Another hindrance to Islamic banks' profitability is the lack of Shariah compliant investment avenues which causes short-term liquidity issues. That is why Islamic banks usually carry higher cash balances than conventional banks and, in turn, yield lower returns on their investments.

There have been efforts to develop the derivates market for Islamic banks and other investment tools, but progress has been painfully slow and has yielded little fruit. The Sukuk market does exist, but is not liquid enough as it is not frequently traded in the secondary markets due to demand-supply issues.

Islamic banks eagerly await the State Bank to finally approve the Islamic T-bills, which could help a great deal in addressing the industry's problems of lack of investment tools. That said, enough still needs to be done towards the development of Shariah compliant investment tools, where a good lead can be taken from Malaysia which has plenty of Islamic investment instruments including swaps, T-bills etc.

Islamic banks rely on asset based financing to generate return for depositors. The fixed rate based products face heavy criticism due to their apparent resemblance with conventional tools. Entrepreneurs are also reluctant to share profits with the financiers in low risk ventures. Lack of documentation makes it difficult to work with real business ventures.

Malaysia and other regional countries have relaxed regulatory tools and taxation parameters for Shariah banks. Islamic bankers are of the view that since Islamic banking is new in the country, it demands relaxation in taxation because in Islamic banks the depositors are partners and share the actual profit and loss unlike traditional banks

The lessons learnt from the unsuccessful attempt in the 1980s led to a more realistic approach in re-launching of Islamic banking in the 1990s.

where depositors are creditors and their principal is protected.

Moreover, because of the differing nature of depositors, the percentage of SLR and CRR should be relaxed keeping in view the risk profile to create a level playing field and to reflect the risk-sharing nature of shariah banking deposits. The industry demands the central bank to treat Islamic banks from a different yardstick than the one used for commercial banks.

Availability of quality human capital is also a big issue - business schools, banks and other bodies have to work hard to produce more scholars on the subject, because the opportunity on offer is huge and the human resources required to tap that are few and far between.

Last, but not the least, there is a trust deficit amongst the consumers, both potential and the existing ones. A large majority still believes the current Islamic banking not to be in compliance with Shariah and perceives it as just a change in nomenclature.

That can only be done when all the scholars sit together and define what exactly is Islamic banking and the regulator should facilitate them by providing sufficient tools to operate in the current environment, like a different benchmark rate than Kibor for the Islamic banks because it makes the Islamic banks look every bit like conventional banks.

In the final analysis, there is indeed great potential in Islamic banking; it is just that the banks and the regulator need to align the concept more strictly with the Islamic teachings.

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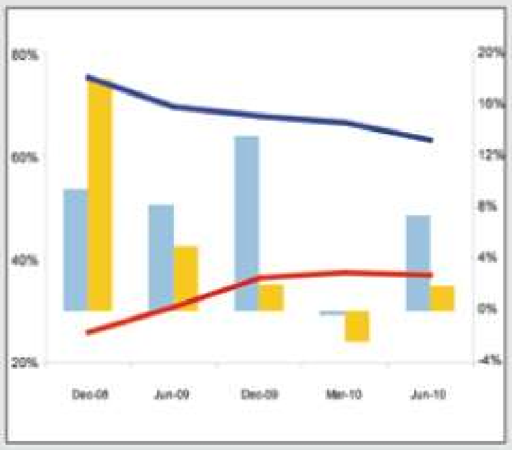
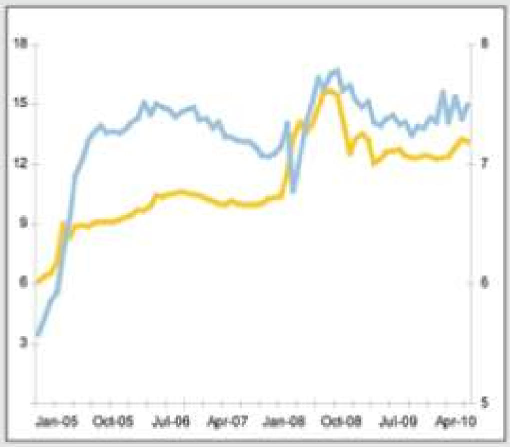
Deposit Mobilisation



Key Balance Sheet Items

Rs(bn)		CY05	CY06	CY07	CY08	CY09	9MCY10
Assets	Investments (net)	800	833	1,276	1,087	1,737	1,803
	Advances	1,991	2,428	2,688	3,173	3,240	3,739
	Lending to FIs	212	210	191	188	240	*NA
Funding	Equity	292	402	544	563	660	585
	Deposits	2,832	3,255	3,854	4,218	4,786	4,818
	Borrowing from FIs	351	438	452	459	659	*NA

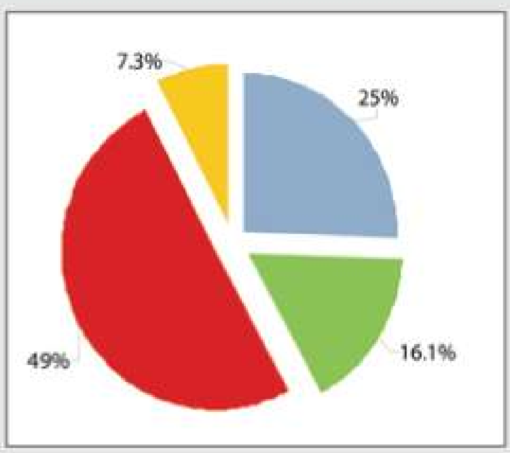
Bankers' Spread



Profit and Loss

Rs(bn)	CY05	CY06	CY07	CY08	CY09	9MCY10
Interest Income	170.4	272.6	361.7	477.1	566.3	372.1
Interest Expense	14.5	23.0	171.5	244.7	304.6	200.6
Net Interest Income	155.9	249.6	190.2	232.3	261.8	171.5
Provisions	2.9	3.1	53.2	102.2	94.0	38.8
Other Income	11.1	15.5	84.8	85.1	94.1	51.8
Operating Income	12.5	179.4	275.0	317.5	355.9	184.5
Profit after Tax	15.4	21.2	23.6	41.7	57.1	38.9

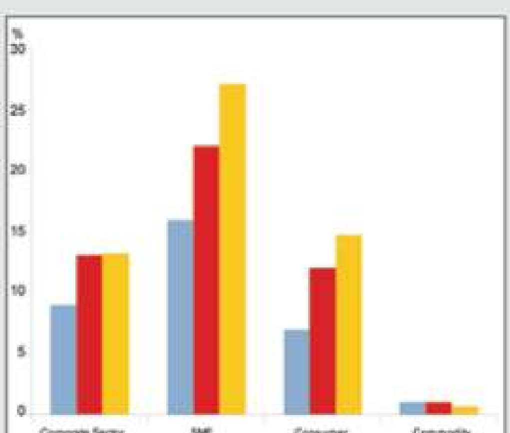
Advances by end use



Segment-wise Advances

Rs(bn)	Dec-07	Dec-08	Jun-09	Dec-09	Mar-10	Jun-10
Commodity	148	235	399	419	364	484
Consumer	371	332	300	269	262	246
Agriculture	151	155	151	156	160	164
SMEs	437	375	335	348	326	318
Corporate	1,520	2,016	1,953	2,065	2,090	2,046

Segment wise NPLs

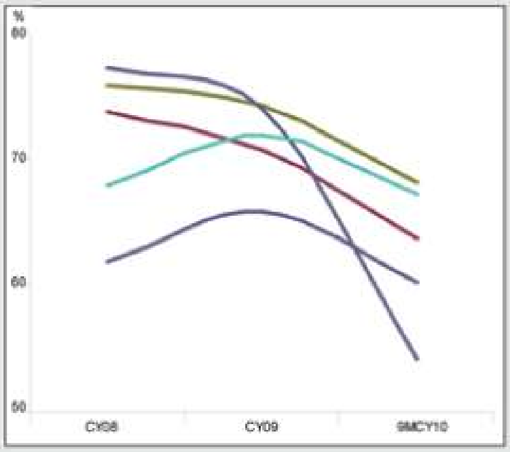


Asset Quality Indicators

As at Jun-10 (%)	Top 5	Top 6to10	Top 11to20	Top 21to29	All 29 Banks*	FBs
Infection Ratio	11.2	13.1	16.1	14.4	12.6	8.6
Net Infection Ratio	2.3	4.9	5.9	6.7	3.7	2.0
Provision Coverage	81.6	65.8	67.3	57.4	73.6	78.7
Net NPLs to Capital	10.6	30.7	26.3	19.4	17.7	4.5
Fixed Investment	12.7	13.9	13	14	14.8	14.6
Working Capital	8.7	11.5	13	12	13	12.8
Trade Finance	7.2	10.6	12	10	11.5	10.7

* All commercial banks

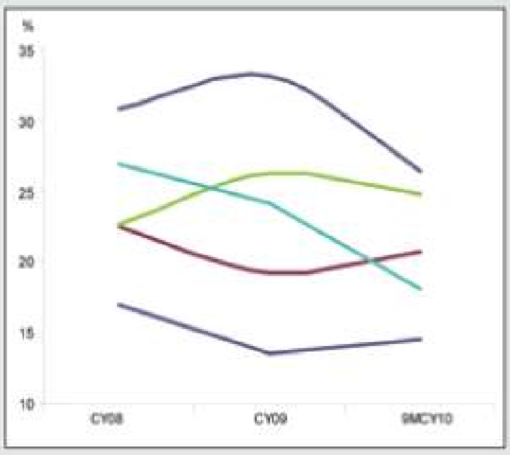
Trends in ADR



Revenue

Rs(bn)	Net-interest Income			Non-interest Income		
	CY08	CY09	9MCY10	CY08	CY09	9MCY10
NBP	37.1	38.5	31.7	16.4	19	11.4
HBL	35.6	41.7	33.6	10.3	9.9	7.9
UBL	27.9	32.7	25.1	10.7	11.7	7.3
MCB	28.5	35.8	27.0	5.8	5.6	4.6
ABL	13.3	18.7	16.6	4.9	6	3.7
BAFL	10.5	10.9	9.9	4.8	5.2	3.4
SCB	16.4	16.3	12.7	6.6	6.9	4.4

Non-interest Income Ratio

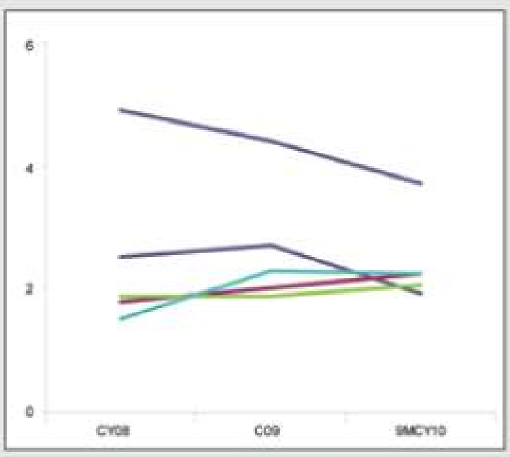


Costs*

%	Cost of Funds			Intermediation Cost		
	CY08	CY09	9MCY10	CY08	CY09	9MCY10
NBP	3.80	5.50	5.70	2.90	3.10	3.17
HBL	4.30	5.00	4.68	3.40	3.30	3.17
UBL	4.90	5.30	4.62	3.10	3.10	4.23
MCB	3.40	4.10	3.93	2.20	2.60	2.77
ABL	5.60	6.50	6.35	2.70	2.70	2.79
BAFL	6.70	7.50	7.30	3.20	3.30	3.30
SCB	3.80	5.10	4.44	6.80	6.00	5.42

9M numbers annualised

Return on Deposit

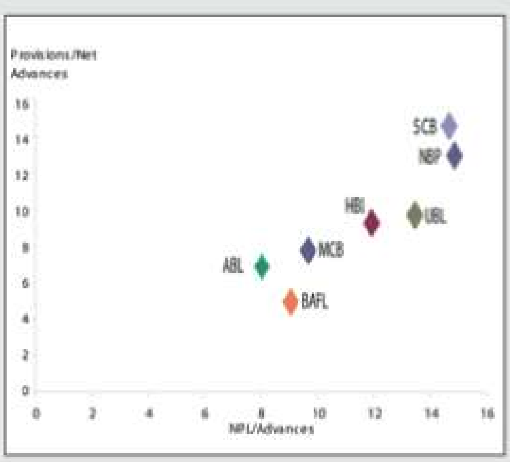


Returns*

%	Return on Equity			Return on Asset		
	CY08	CY09	9MCY10	CY08	CY09	9MCY10
NBP	20.5	20.7	14.8	2	2.1	1.5
HBL	17.9	18.6	19.8	1.5	1.6	1.8
UBL	21.9	19.5	18.4	1.5	1.5	1.6
MCB	31.5	27.3	24.4	3.6	3.3	3.0
ABL	21.2	30.5	26.7	1.2	1.8	1.8
BAFL	9.2	5.2	9.4	0.4	0.2	0.5
SCB	1.6	1.5	5.1	0.3	0.2	0.7

9M numbers annualised

Coverage for Toxic Assets



on Sep-30,2010

Profits

%	Net Profit Margin			Rs(bn) Profit after Tax		
	CY08	CY09	9MCY10	CY08	CY09	9MCY10
NBP	28.9	31.7	26.4	15.5	18.2	11.4
HBL	21.8	23.8	31.3	10.0	12.3	11.3
UBL	21.6	20.7	39.2	8.3	9.2	8.1
MCB	44.9	37.4	39.6	15.4	15.5	12.5
ABL	22.8	28.9	28.9	4.2	7.1	5.8
BAFL	8.5	5.6	11.3	1.3	0.9	1.5
SCB	2.9	2.9	11.2	0.7	0.7	1.9

Sources: SBP, NBP Bulletin Company Accounts, BR Research

Faysal eyeing further expansion

An interview with Naved A. Khan, President & CEO, Faysal Bank Limited
Haider Nawab

Naved A. Khan has his hands full; and from the look of things, he is set to have a busy schedule in the coming years. Talking to BR Research, Khan shares his plans to continue shopping for medium and small banks, while investing in technology to streamline his existing business and to expand his market presence. The following are edited transcripts.

BR Research: The only bank on sale for the past year is now with you; does this mean you are done shopping?

Naved Khan: I've not stopped yet; we are looking for more banks to buy or to merge with. My vision is clear, I want to scale up and I am hungry to do business. I am committed to Pakistan, and I believe that 180 million people are not going into the sea.

We can have bad politicians, a poor economy, horrible governance but all of it has to eventually evolve into a stronger structure. I have very strong principals who believe in Pakistan. And at Faysal Bank, we believe that there is tremendous opportunity to do business in this market.

BRR: But merging with a mid-sized could be a painful proposition?

NK: No, it all depends on how the equation works. Mergers are based on book value or discounted cash flows. For market values there is no benchmark in the market. So you go towards discounted cash flows, based on your estimate of potential earnings. I've done it twice before and I know how it can be managed properly.

BRR: When do you plan to get back in M&A action?

NK: I will look for more partners once I have stabilized. I am scoping right now and my troops are going through battle fatigue so let them settle down and we'll be up and running again very soon. I am not interested in carrying a very small entity; it doesn't make sense to me. So it has to be in the mid tier.

BRR: Are you looking to become a top 5 bank in the near future?

NK: I don't know if top five would be my target. I'll need to eat up a lot of mid sized banks before I can get to that level.

I think I would like to be on the top end of the medium size banks. And that is a goal that I can achieve, because I am not very far from it. I'm standing at about Rs270 billion in assets, so that puts me fairly close.

> **We are trying to create an outreach program of branchless banking.**

Considering that we've now got RBS, our scale changes. From being in the 12th or 13th position, we are now moving into the top ten. And within that range, we are a wafer away from 7 to 10, because the difference is not much. If I start playing my balance sheet, I can outstrip all of them.

But my strategy is to be profitable. In the last two years, we have been working towards stabilizing our core business and reduce dependence on equity capital markets as a source of earning.

> **We are working on a Customer Relationship Management system that will automate all of our front end customer touch points...we are also developing a platform for derivatives.**

BRR: Are you looking for an Islamic bank?

BR: I can. But my situation is that I will have 40 Islamic branches after the merger and I am not closing any branches. I will either relocate branches or convert them into Islamic ones. As long as I can find the market appetite, I will convert branches.

BRR: How were you able to negotiate such a good price for RBS?

NK: I think we dissected the portfolio really well. I still remember when I went into negotiations and my people started to present, I saw a lot of jaws drop. And I asked them to refute any numbers if they disagree. I had a very good understanding of the portfolio; I had built that bank.

I knew they wanted to exit the market and were debating who would be willing and able to buy it. They knew I had the capacity to close the deal and I think that is what made it happen.

BRR: What were the things you were looking for in RBS?

NK: Retail was definitely a focal point. If I was to setup cards and scale it up, it would have taken me two years. Now we get a portfolio of 150,000 cards. So that's an instant plug.

Then I get ADCs (alternate delivery channels) which are far more established than mine. FABL has a 25-30 seat call centre; RBS has much larger infrastructure. Thirdly I think best practices can be gained and system capacity will be greatly enhanced.

We will also benefit from technology platforms that they are running, though some of which are the same at FABL. I am also trying to consolidate the number of systems RBS was using. They were using way too many, and making things unnecessarily complex.

Lastly, we are also looking at inducting the high skilled human capital that RBS has to offer. Most of those that left RBS came to Faysal, so the flight of human capital pre-sale isn't a problem for me. I have lost people, but none that are regrettable. As far as I am concerned, those people paid for their jobs.

BR: Being a foreign bank many multinationals had accounts with RBS, would they like to work with Faysal as well?

NK: The foreign entities that wanted to exit did that about two years ago when RBS announced that it wanted to sell its operations here.

There are customers who have stayed and have chosen to work with me. We have a great relationship with them. I don't see any entities exiting the business right now.

BR: There were some off balance sheet derivative items in RBS; how are you handling them?

NK: All derivative transactions are hedged back to back and the risk is completely mitigated. So the question you might want to ask is, are you going to do it again? And the answer is, absolutely!

We are building capacity at the moment. The systems are in place and that to me is the product of my future, by the way.

BRR: What projects and new businesses are you working on?

NK: In the past two years, I have been a heavy investor in technology. This bank, when I took over in 2008, had just moved to a new platform. It had a core system but there were many chokes in it. So we started to fix that and incorporated peripheral systems with it.

> **The integration of my asset management with wealth management is definitely on my radar for the next year.**

Now, we are working on a Customer Relationship Management system that will automate all of our front end customer touch points. On top of that, we are now developing a platform for derivatives. In addition to all of that we are trying to create an outreach programme of branchless banking. We are in the phase of testing right now; hopefully next year sometime, we will go live with it.

With a client base of over 290,000 and with RBS adding with another over 150,000 we are looking at a healthy outreach and alternate distribution channels.

The areas that we were looking at, as far as FABL is concerned, was that we wanted to come into the cards business, branchless banking and deepening alternate distribution channels. So with the acquisition of RBS, we've got cards and a fairly large consumer portfolio. As a result, we've got a complete suite of products from high end investment banking to retail focussed products.

With a consolidated view, we should have 220 branches, whereas our target is 250. And we should have a fairly large size of Islamic Banking as well. The vision is to have about 40 Islamic branches, operating independently.

BR: What do you plan to do with the investment banking business?

NK: We have reached a stage such that there is no transaction in Pakistan to which FABL does not get invited to.

We have rescaled ourselves in the last two years. Deploying resources and creating value is what I think of innovation. We were able to buy RBS without raising equity from our sponsors.

Right now, I don't have the time to integrate my asset management with wealth management. I have a fairly large opportunity when I combine RBS's preferred banking and my Solitaire. For now, I don't have the time to do that, but it's definitely on my radar for the next year.

BANKING & ECONOMY

BRR: What's your view on small banks?

NK: If you are not among the top ten, then you are marginalized. I don't think the industry is going to let the small banks survive. So it is going to go into consolidation. It has been part of the strategy for the banking sector for the last ten years.

BRR: What if small banks can't find partners?

NK: Then they must become regional banks and specialize. The problem is that many of the sponsors' egos are too large to accept that their banks will operate in a regional spectrum. Many of them now are looking to merge with others but can't find partners. There is a realization that scale is very important but not very much is being witnessed on ground.

At the same time, you have to break the monopoly of the larger banks -- that itself is the next challenge for the central bank. History tells us that super banks are not healthy.

BRR: What is the problem with having super banks?

NK: Competition is not efficient because banks are divided into blocks. The large banks elbow out the medium sized ones. Efficiency has to come from a more vertical distribution of business and that I think is where the regulator is having a challenge to plug that gap.

We've made the paradigm shift from public sector to private, but what have we done. We still have those large banks and they distort the equation of the banking sector. Everybody talks about high spreads, but it is only in those big five banks.

BRR: What's your view on agricultural banking or banking in the rural economy?

NK: For me to open up a branch in rural areas means that my costs - of connectivity, of technology and of running operations - will be phenomenally high. At what level of deposit can I break even, so it will be a drag. Therefore, we have to find ways to create financial inclusion which are cost efficient and that's where I feel the next set of reforms will be.

BRR: How do think we can boost agri financing?

NK: You see we still have not been able to get rid of the 'arthi' - the middle man -- who continues to be the biggest supplier of funds to farmers. He is also the biggest hoarder. Sadly, we have not been able to fully establish the commodities exchange and haven't been able to integrate it to agriculture. As a result, you don't have warehousing, and in turn warehousing documents are not negotiable instruments. Hence, you need to vertically integrate; futures can play a key role here. You also need to eliminate the middleman - who doesn't want to work with a bank - by setting up warehouses.

BRR: You were chairman of the banking association when MCR was raised. What role did you play?

NK: It was the tail end of when I was chairing it. You know, there are two things where the central bank doesn't consult the market; one is monetary policy and the other is capital adequacy. These are dictated down.

At the time, we reacted against it. But the governor's thinking was very simple. Banks had excess liquidity so they could shore up their positions to become more resilient to absorb shocks. It was a smart strategy at the time and I think it has worked fairly well.

With a consolidated view, we should have 220 branches, whereas our target is 250.

I think it has changed for the right reasons and the Rs10 billion cap is fine. Very low capital requirements bring in very small players that create inefficiency in the system.

BR: Do you think CAR is a better measure of capital adequacy than MCR?

NK: There's no question about it. CAR is better. But there are many other problems that need to be addressed as well. SBP used to allow lower capital requirements for rated entities. When we improved our capital adequacy by encouraging ratings; the central bank said that unless the rating is public, we will not get the benefit. So, consistency in policy is very important.

BR: What is your sense of where NPLs are going in the upcoming months?

NK: If interest rates continue to rise, your NPLs are going to grow. They are absolutely correlated. And it is a case of default not by desire but by circumstances. The other thing is that the energy crisis stokes the NPLs. And neither of those things seems to be nearing resolution, so NPLs are going to rise.

BR: What is your view of the future direction of interest rates?

NK: I think they are going to go up. If inflation persists, which seems likely, it will negatively affect your economy. Moreover, without energy, growth in the economy is nearly impossible.

Profile: Naved A. Khan

Naved A. Khan has over twenty-four years of work experience, particularly in Corporate and Investment banking. Former CEO, ABN AMRO Bank, and an MBA holder from the Butler University, USA, Khan had also been associated with senior management positions at the Bank of America, Pakistan, and had been the President of Pakistan Banks Association.

He holds key posts at the Institute of Bankers, Pakistan, ECH Task Force, State Bank of Pakistan, and the Overseas Investor's Chambers of Commerce and Industry (OICCI).

State of **anti-money laundering** laws in Pakistan

Mona Khan

Post 9/11 counter-terrorism efforts, and an increasing global desire to eliminate financing opportunities for sponsoring acts of terrorism, has made it crucial for countries across the globe through a centralized database, to keep track of any suspicious transfers of money.

The promulgation of an anti-money laundering law has been an agenda item at most government level meetings and Pakistan has been under tremendous pressure for the approval of this law from western governments, international financial institutions and other international forums such as the Financial Action Task Force (FATF) and the Asia Pacific Group (APG).

The United Nations Security Council Resolution 1617, passed under Chapter VII of the UN Charter binds all member countries, and has been 'Strongly urging all Member States to implement the comprehensive, international standards embodied in the FATF Forty Recommendations on Money Laundering and the FATF Nine Special Recommendations on Terrorist Financing'.

In the absence of legislation around this area in Pakistan, the main law enforcement bodies involved have been the State Bank of Pakistan (SBP), the Securities and Exchange Commission of Pakistan (SECP), the National Accountability Bureau (NAB), the Anti Narcotics Force (ANF), the Federal Investigative Agency (FIA), and the Customs Authorities. Their enforcement initiatives have necessitated the cooperation of financial institutions and most banks have already developed compliance departments with specific Anti-Money Laundering (AML) contact points within their compliance and risk departments.

Their main initiatives have included the enforcement of a detailed Know Your Customer (KYC) policy by the SBP and instructions on how banks should identify high risk customers. The SBP has also developed a structure of monitoring and reporting, whereby banks are required to have in place systems to highlight suspicious transactions, manned by individuals trained in AML, to the SBP which in turn refers such cases to NAB for necessary action.

Although many banks in Pakistan have begun to implement AML software which is integrated with their core banking systems, there is a need for this to be more pervasive.

Correspondent banks have been put under greater scrutiny and banks in Pakistan have been precluded from entering into transactions with shell banks and those highlighted under the "watch list" as commonly used for money laundering and terrorist financing operations.

A comprehensive AML law instituting an AML corporate governance structure within Pakistan, bringing together all relevant law proponents and enforcers has finally been promulgated earlier this year, in the form of the Anti-Money Laundering Act of 2010. The main objectives of this Act are to enforce proper legislation to ensure proper investigating, criminalizing and prosecuting of money laundering offences.

Creating a centralized database for flagging suspicious transactions will entail operational, technical and completeness challenges.

The Act pulls together necessary elements within the Pakistani legal structure, who were previously working, to a great extent, in isolation, to prevent money laundering in the country. The creation of the National Executive Committee has been a big step in the right direction, encouraging the meeting of representatives from the Ministry of Finance, the Ministry of Foreign Affairs, the SBP, and NAB, all key stakeholders in protecting Pakistan against money laundering and terrorist financing activities. The Act has also for the first time, created the framework for a centralized database for suspicious persons and transactions as a ready point of reference for flagging future activities.

LEGAL ANOMALIES

There are however, some anomalies that need to be considered before regulation is created for the enforcement of this Act.

The FATF Forty Recommendations on Money Laundering do not require setting up special anti-money laundering courts nor do other countries enforcing similar laws encourage this. There does not appear to be any need for Pakistan to set up a parallel judicial system for prosecuting AML offences.

Charges against individuals potentially involved in money laundering should be tried either in the current courts that try similar offences or in general courts as a stand-alone charge. Under international requirements, money laundering is prosecutable as an individual crime without first convicting an offender for the predicate offence. The proposed law does not comply with this obligation.

The nature and role of the Financial Monitoring Units (FMU) created under the Act are perhaps wider than necessary. They are in essence authorized to receive reports on suspicious transactions from banks in Pakistan as well as summon records if they see fit, along with carrying out preliminary investigations. This is a conflict of role and may have implications for banks and financial institutions in Pakistan from compliance and monitoring perspectives. Investigative powers should remain solely with NAB.

Investigative powers should remain solely with NAB.

In a global market moving more and more towards paperless money, countries have become highly dependent on systems and a global information technology structure has evolved. Money laundering and terrorist financing activities have integrated with this system. The prevention of these transactions from entering normal financial activities requires the implementation of counter technology.

Although many banks in Pakistan have begun to implement AML software which is integrated with their core banking systems, such as Mantas, Norkom and Eudox, there is a need for this to be more pervasive. Not only does this act as a deterrent to potential activities, but gathering of data and monitoring becomes all the more efficient. Regulation around this Act will need to take this aspect into consideration.

Another aspect that will require mention while formulating regulation enforcing this Act is the benami transaction or hawala, which forms a sizable part of Pakistan's economic system. Although the primary reason for hawala transactions is cost effectiveness and efficiency, motives also include the lack of a paper trail and tax evasion.

Money derived from criminal activities may be introduced into the financial system. In many money laundering schemes, the biggest risk is handling cash. Current law in Pakistan precludes the exporting of cash greater that $10,000 and attempting to circumvent such reporting requirements by making smaller transactions is an offense.

Though the Act is a step in the right direction, the regulation being developed for enforcing this law needs to be carefully considered and formulated keeping local and international nuances in mind. The Asian Development Bank (ADB) is currently working closely with the SBP to create a structure and devise regulation for effective AML enforcement in Pakistan. The World Bank has recently completed a phase with the SECP on strengthening the AML environment in Pakistan.

Once regulation around this Act is formulated, challenges faced by implementers, regulators and operational stakeholders will be many and will need to be dealt with appropriately. These include a lack of training in the newly formulated regulation and awareness about the subject itself, both at a regulator and operational levels. Training and awareness sessions will become a must. Creating a centralized database for flagging suspicious transactions will entail operational, technical and completeness challenges, which will need to be managed carefully and proactively. Profiling of old customers not captured under the KYC regime which was only implemented in 2001, will especially be an arduous task. The cost to banks for setting up robust AML structures in line with regulation will need to be considered.

Initiatives such as the Act are very much needed in an environment of increasing potential of high risk terrorist activities, the brunt of which is being borne by Pakistan. We can only await formulation of the regulation around the Act and prepare for the challenges faced at the time of implementation.

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East to be growth centre for HSBC

An interview with Lloyd Maddock, Chief Executive Officer, HSBC Pakistan

BR Research

Lloyd Maddock has recently taken the helm of HSBC's operations in Pakistan. He believes demand for credit is expected to revive in the upcoming year and that the global focus of HSBC is on emerging markets. Maddock shared with BR Research developments on the launch of HSBC's Islamic banking operations in Pakistan.

BR Research: Banks play a role in the long-term economic development of countries. Why then are commercial banks focusing on short term and relatively risk free investments, rather than long-term infrastructure projects?

Lloyd Maddock: My observation is that this reflects a lack of infrastructure finance opportunities versus any particular reluctance on the part of the banks. Generally, banks would support long-term infrastructure via syndicated finance or project finance.

We are actively in the expansion mode, and looking to increase our asset book in Pakistan.

Given the requirements for substantial investments in, for example, power and water, I would expect to see generic bank funding being complemented by export credit backed finance and hopefully bond issuances, either conventional or Sukuk. We should expect to see developments in these areas in the near term.

BRR: Companies are largely dependent on bank lending to raise funds because of the under-development of capital markets; what roles can commercial banks play in this regard?

LM: My understanding is that the State Bank and the banking sector do want to progress the development of a corporate bond market, and this will certainly transpire. The benefit to larger corporates is that bond issuance will open their potential funding options to diversified international investors. The rarity value of initial issuances should provide for good investor appetite.

Let's not forget that large markets such as Saudi Arabia only facilitated the introduction of debt capital markets in recent years. Ahead of this, it would certainly be useful for a Pakistan sovereign issue to take place to provide a benchmark against which corporates and their advisors could price risk.

BRR: When do you see a revival in private sector credit demand?

LM: This is a question which not only applies to Pakistan but to the wider region. From 3Q 2008 corporates and banks have actively de-risked (i.e. de-leveraged) balance sheets, and corporates have generally needed to rely more on equity rather than bank finance.

My observation is that the banking sector in Pakistan has fared comparatively better than many other countries, due to prudential governance by the State Bank and, in particular, the robust capital adequacy requirements. For example, we have seen no bank failures in Pakistan, unlike other countries in the emerging and developed world.

The banking sector in Pakistan is liquid, with certain banks maintaining asset to deposit ratios of 50 percent and below. Through the downturn, banks have clearly favoured shorter-term exposures, with the public sector accounting for increased funding. Yields on T-Bills are certainly an attractive asset class currently. However, going forward, banks will need to increase lending to the private sector, in order to maintain revenue trajectories.

It is fair to say that having worked through substantial levels of NPLs, banks will be more judicious in lending, and will favour companies that are well capitalised with sound business models. Such companies should be well placed to avail bank finance, although disclosure requirements in terms of audited financial statements and business forecasts will be enhanced.

The private sector has been justifiably cautious in terms of business expansion, but expansion cannot be put on hold indefinitely. So, in summary, I would be surprised if we did not see some resumption of private sector credit demand over the coming year.

BRR: By the end of the year 2009, HSBC was performing much better compared to its peers in regards to NPLs, what segments has the bank focused on -- fixed investment, working capital etc -- and what are its priorities going forward?

LM: We are a full service bank in Pakistan supporting our corporate client's requirements in trade finance, cash management, treasury and working capital finance. We also have the leading investment banking capabilities of the HSBC Group to call upon, when required. In consumer, our primary focus is upon our global "Premier" and "Advance" propositions, which support the needs of our middle to high income clients both in Pakistan and globally. With HSBC being the world's third largest private bank, we are also active in this sector.

BRR: Your bank's focus is on trade finance business - especially cash management products - but there is significant competition from Standard Chartered and Barclays. What is HSBC doing to distinguish itself?

LM: There are only a very few truly global banks; and with our presence in 76 countries, we have an excellent platform to support an end to end service for our Pakistan based corporates, in whichever markets they trade. Competition is a fact of life in every sector, but we have gained success by building long-term strategic relationships with our clients, backed by the highest level of customer service, product suite and geographical reach.

BRR: Compared to other banks, HSBC's portfolio size is much smaller, restricting lending to a niche clientele, how has that changed in the recent past?

LM: In recent years, we have expanded from two branches to twelve. We consider this to be a satisfactory pan-Pakistan footprint in terms of geographical coverage. Backed by the HSBC Group balance sheet, we face no restrictions on the quantum of credit lines we are able to provide for any given borrower, subject to our usual credit criteria being met. I would add that we are actively in the expansion mode, and looking to increase our asset book in Pakistan.

BRR: Globally, HSBC Amanah is a leader in Islamic Banking. Pakistan presents a potential market in this area and the Islamic banks here have done well recently. Why has HSBC not entered this market?

LM: Currently the Islamic banking sector accounts for approximately 3 percent of the market. We expect this share to double within the next two years. Our plans are well advanced to launch Amanah in Pakistan in both the consumer and commercial sectors, and subject to regulatory approvals, we will launch the Amanah service very shortly.

BRR: HSBC had aggressively launched a consumer portfolio in Pakistan, its been downsized significantly since the international financial crash. What is the bank's view of the consumer market in the country?

LM: That is a fair comment, but equally applicable to the sector as a whole. Currently we are actively marketing our "Premier" and "Advance" propositions, and our consumer business is expanding. Banks cannot rely solely on liability (i.e. deposit) income. I think this speaks of our intentions going forward.

BRR: What is the strategy of HSBC Holdings Plc, where does it plan to drive its growth from?

LM: HSBC maintains a strong growth focus on emerging markets (within which we include the MENA and sub-continent regions) whilst continuing to invest in developed markets. The pendulum of global growth has swung from West to East and this drives our Group strategy.

Profile: Lloyd Maddock

Lloyd joined HSBC in 1991, and has worked in Europe, North America, Asia and the Middle East, primarily in corporate banking, strategy and credit. Prior to assuming the Country Manager role in Pakistan, Lloyd was the Country Manager in Kuwait. He holds a Bachelor of Engineering degree in Civil and Mining engineering.

SMEs in Pakistan: It's a catch-22

Sohaib Jamali

In the long list of dichotomies, anomalies and mismatches that exist in almost all the spheres of social and economic affairs of the country, the SME mismatch is surely amongst the top few.

The Small and Medium Enterprise sector constitutes nearly 90 percent of all the enterprises in Pakistan; it employs 80 percent of the non-agricultural labour force; and their share in the country's annual GDP is estimated to be around 40 percent, according to SMEDA. Yet, barely 10 percent of total advances given out by local banks find their way to the SME sector.

Are banks to be blamed for it? To an extent yes, but they cannot be blamed entirely.

By their very nature, SME businesses tend to be more susceptible to economic downturns than their larger counterparts; they are also widely dispersed, informal and undocumented, and lack sophistication of business.

According to the central bank data, total non-performing loans (NPLs) of the SME sector stood at Rs41.3 billion constituting 9.5 percent of total SME Finance at the end of December 2007; by the end of June 2010, the SME sector's NPLs stood at nearly 25 percent of total SME advances.

SMEs are widely dispersed, informal undocumented, and lack sophistication of business.

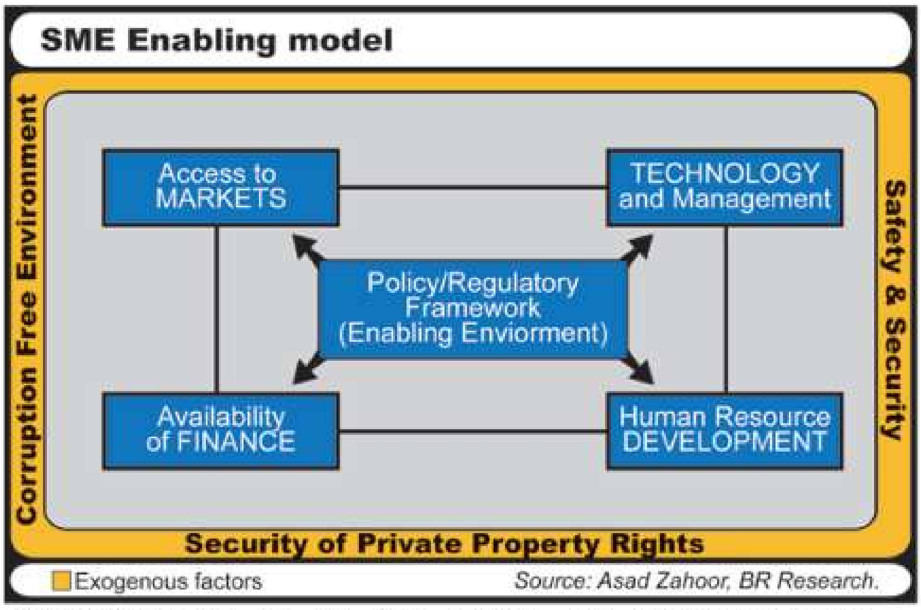
The jump in the quantum of SME bad loans can be attributed to higher cost of borrowing that tracked the hike in discount rate. At the same time, however, bad lending quality is also to be blamed, with the burden mostly falling on the borrower.

"Between 1998 and 2003, there was substantial growth in terms of new names and large exposure being taken in what is called second tier borrowers. And I tell you that a majority of those were wrong calls by banks, because second tier was not adequately capitalised to sustain an economic downturn," Atif Bokhari, President United Bank Limited told BR Research.

Bokhari argues that in Pakistan, people lack the will to repay, even if they have the ability to pay back the loans, owing to which the SME sector has become a dangerous segment to dole out loans to. "SME portfolios of nearly all the banks have a default rate of more than 25 percent. You can't survive as a bank with 25 percent default rate," says Bokhari.

Ordinarily, the deterrent comes in the form of strong laws that protect the lender. However, bankers argue that that recourse to the law is not available.

Sharing Bokhari's view, Sultan Allana, Chairman Habib Bank Limited said, "If processes and systems are strengthened to enable quick and timely enforcements, banks may be comfortable in lending". Citing different cases, bankers assert that delay in banking courts, which often take 15 years to give a decree, is essentially beneficial for defaulters as they can get 15 years of free use of banks' money.



Source: Asad Zahoor, BR Research.

LAZY BANKING

Bankers may be passing the bucket to the judiciary, but at the end of the day the failure to include the SME sector is also to be blamed in part to bankers themselves.

Industry sources say that over the course of years bankers lost the focus on relationship-based banking that weakened their KYC; while some banks had resorted to credit-score based lending to SME, others had too few relationship managers for the size of portfolio they were handing.

Some bankers highlight high transaction cost involved in SME sector lending. But this, in other words of State Bank governor Shahid Kardar, is called "lazy banking". Today banks are not even looking at corporate clients; all they are doing is filling the appetite of government. And once the economy revives, banks will have to revert again to the corporate sector again," Kardar pointed out in his interview with BR Research.

A quick glance at who lends to the SME sector confirms Kardar's view. Although the share of big 5 banks in SME lending has fallen between December 2006 to date, it still accounts for 39 percent, according to SBP last banking quarterly review released in June 2010. This implies that small and mid size banks have failed to find their niche in the SME segment, and instead have been involved in the catch up game with the big five ones.

When asked about SBP's plans regarding the SME sector, Kardar says, the SBP will create an "incentive structure for the banks that would entice them to target the SMEs". These include getting support from the International Finance Corporation and the Asian Development Bank as well as introducing SME specific Export Refinance Schemes and providing first loss guarantee to the banks.

Rising defaults in SME financing

Source: SBP Banking Quarterly Reviews

WILL SBP'S EFFORTS REAP FRUITS?

The answer to that might be, possibly yes, probably not. That's because at the end of day, a central bank can only use the monetary tools to breathe life into an economy or any of its particular sector. If the lungs are charred or damaged, even oxygen masks fail to help for long periods.

The bucket therefore falls on the government, where documentation of the economy holds foremost importance. Lack of adequate documentation of the SME sector, precludes bankers to provide loans to the sector.

Agreed, that in less developed countries like Pakistan, SME enterprises wish to remain in the informal sector, and so may remain unbankable, because of the complex regulatory obstacles to formalisation.

But these exactly are the areas, where the government must step up its efforts, set up institutions to document, evaluate, and also direct the SME businessmen in their ventures.

In this context, while SMEDA's role has to be enhanced at one end, at the other, awareness must be created so that more and more businesses can brought into the formal sector - especially the agricultural sector where lack of infrastructure is also an impediment.

At the same time, in order to promote the culture of entrepreneurship in the country, the government must ensure a safe business environment and security of property rights.

Anecdotal evidence suggests that young businessmen from Karachi, who have ventured into dairy or poultry farming in suburban areas like Gadap, or have set up small factories in areas like Korangi, have been paying extortion money to unruly gangs in the area; failure to pay up the 'bhatha' often leads to kidnapping for ransom.

In such a scenario, monetary stimulus can do little; the real impetus needs to come from the government especially by focussing on increased documentation, faster judiciary, better governance, and higher level of awareness. Will the government be able to do it; your guess is as good as mine.

HOW IMPORTANT ARE THE SMEs

93% of firms

90% employment of private enterprises in industrial sector

80% of non-agricultural labor force

40% of GDP

25% of export earnings

35% of manufacturing value

Source: SMEDA & BNU presentions

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Small banks must bet on riskier assets

An interview with Mohsin Nathani, Chief Executive, Standard Chartered Bank

Sohaib Jamali

In this interview, focused on the overall banking climate in the country, Nathani speaks to BR Research about the challenges lying ahead, particularly for small banks. The high spread environment and high cost of funds, he believes, will keep small banks on their toes, which might favour prospective consolidations. Nathani is optimistic about NPLs and the outlook of the industry in general.

BR Research: What is your outlook on the banking industry?

Mohsin Nathani: Undoubtedly there are challenges in the industry but those are more linked with the state of the economy; the industry on its own is very well regulated.

There are silver linings across different sectors despite the prevailing challenges. If you look at the latter half of 2009, the outlook was far more challenging than it is today. There are large pockets in the industry which are showing good signs of recovery as well.

Ensuring profitability, finding good asset growth and growing NPLs are some of the challenges for the banking industry, but on the whole the industry is still doing quite well.

One more thing in the context of the industry is that we have seen and we will probably continue to see that some of the smaller banks will be looking more towards consolidation. That applies more to the local banks than the foreign ones.

BRR: How successful have the mergers and consolidations been?

MN: Mergers and consolidations are never that easy or successful anywhere in the world. Nevertheless, the journey has started. There will be challenges but that's the way the industry will move ahead.

BRR: How was that experience with the Union Bank?

MN: Union Bank predates me significantly; I was not around here then. But I think it was a pretty good move as it gave us the required scale to operate efficiently and deliver on improved customer proposition. So, it was a very important strategic move. It gave Standard Chartered a great positioning in the local Industry.

BRR: How did Standard Chartered cope up with the cultural difference between the two banks after the acquisition?

MN: People have unrealistic expectations with mergers; they expect everything to be on track without any differences in just six months. That does not happen anywhere in the world. I have seen many international mergers; a merger needs lot of hard work and time as there are lot of challenges.

In our case, the post-merger challenges were exacerbated by the fact that the economy took a nosedive; valuations were high, but markets came down. When you go for a merger of banks you don't take a two-year or three-year timeline, you look at much longer periods.

Union Bank gave us a lot of synergies and products - most of which we wanted. I am not saying we did not have a fair share of challenges, but those challenges were expected like in any merger.

> **It is obvious that the cost of funds will be high for smaller banks and the spread will be lower for them. The bigger banks have no motivation to keep the lending rate low.**

BRR: Do you think NPLs have peaked and are now coming down?

MN: I am a bit more optimistic about the NPLs than some of the people I have talked to. I see enough silver linings in the industry.

After the economy took a U-turn, interest rates moved upwards, all the major banks absorbed the write-offs rapidly in the last 3-4 years. So, the rate of increase in NPLs might slow down from now on.

Even on the corporate side and the SME side, there have been challenges because of the state of the economy. Having said that I don't think they are going to be significantly higher than what we have seen in the recent years.

But at the same time, they won't be declining significantly because there is the flood situation, and the resultant slower economic growth. I believe NPLs will be there but I don't see a significant rise.

BRR: When do you see that turnaround happening?

MN: It again depends on the state of the economy, the disposable income and the interest rates. Back in 2007 people used to get car loans at 7~8 percent; today the interest rate is 20 -26 percent. It's no rocket science that times are tough, so we have to be realistic.

> **The post-merger challenges were exacerbated by the fact that the economy took a nosedive; valuations were high, but markets came down.**

BRR: Any plans to be more aggressive in the SME segment within the retail sector?

MN: We have been focusing on the SME sector and will continue to do so.

BRR: Do you plan to venture into m-banking?

MN: There is nothing specific at this point in time. Though, it is not something that we rule out, but there is nothing at present.

BRR: Do you plan to expand your branch network?

MN: I think we have a good branch footprint at this stage. We want to be where customers want us and where we see opportunities.

BRR: SCB's operational effeciency indicators appear to be on the higher side. Your view on this?

MN: We have made significant investment in technology platforms, infrastructure improvement and capacity enhancement which results in higher depreciation charges. Those expenses will definitely come down with the passage of time.

BRR: Banking spreads are generally high in Pakistan. Why is that?

MN: It is obvious that the cost of funds will be high for smaller banks and the spread will be lower for them. The bigger banks have no motivation to keep the lending rate low. We all pretty much lend at similar prices. But the small banks may struggle to lend at that rate, so they have to go for the high yielding riskier assets.

The spread difference between the big and small banks is a scale function. Nobody is kicking anybody out.

Our regulatory environment today is a very supportive one, so anybody who wants can go and increase the size. This is what market competition is.

BRR: What is your concentration on the agri business?

MN: We have a very low presence in the agri sector. We do lend to bigger companies that are associated with agriculture, such as fertilizers, but not directly to small farmers.

BRR: How is the consumer segment progressing?

MN: Our strategy remains unchanged. Our overarching business opportunity is growing market share in chosen products and customer segments.

There has been momentum in deposit mobilisation. This is testimony of the strength of the Standard Chartered brand and our expanded geographical footprint.

BRR: What is your share in the remittances market?

MN: Our share is moderate, the simple reason being larger presence of the local banks spread well across the country, more importantly in the rural areas.

BRR: There seems to be huge potential in corporate farming in Pakistan? Do you think that local and foreign banks will go in?

MN: Yes, the potential very much looks there. But I think it will take time for the foreign banks to enter this area, because of the network and the limited presence in the rural areas.

Profile: Mohsin Nathani

Nathani, the Chief Executive of Standard Chartered Bank (SCB) Pakistan, is a seasoned corporate banker with over 20 years of local and international banking experience. He was the Country Head and Managing Director of Barclays Bank Pakistan prior to joining SCB. An MBA from Institute of Business Administration, Karachi, Nathani's experience spreads across corporate banking, fixed income markets and Islamic Banking.

The **evolution of banking** valuation in Pakistan

Khalid Iqbal Siddiqui

In the early part of the decade, there was little interest in banking stocks at the Karachi Stock Exchange; investors mostly focused on the more heavyweight scrips such as PTCL, HUBCO, PSO, FFC and the likes. This was the pre-privatisation timeframe and saw the listing of National Bank of Pakistan at the stock exchange through a 10 percent public offering.

It was generally accepted that banks could not be valued using free cash flows or price/earnings (P/E) multiples given the leveraged nature of the balance sheet and volatility in earnings due to hard-to-estimate intangibles.

Therefore, the best way to value banking stocks was generally assumed to be utilization of the banks' book value per share and attaching a particular multiple to that book value per share.

The major focus remained on arriving at a justified price/ book value (P/B) multiple based on peer analysis and comparing respective ROEs (return on equity) to generate a justified P/B multiple. For example, if one was valuing MCB, one would use two methods to arrive at a consensus fair value.

Firstly, one would look across the sector and see what sort of multiples are the rest of the banks in the sector trading at, take an average of that multiple and then apply it to XYZ bank's book value to arrive at a fair value.

Secondly, one would also take the expected RoE for the current year and divide it by the required rate of return (as per capital asset pricing model) to arrive at a multiple. For example, if MCB's ROE is 25 percent and the required rate of return is 20 percent, the P/B multiple would be calculated as 1.25x, and then multiplied with the bank's book value to arrive at the stock's fair value.

ADDING DIVIDENDS TO THE MIX

Banking sector profitability began to shoot up following the loosening of monetary policy by the State Bank of Pakistan (SBP) between 2003-2005. Decline in interest rates led to a period of sustained money supply growth well above 15 percent per annum, resulting from growth in private sector credit. Not only was the industrial sector borrowing to finance expansions, but the foundation for aggressive consumer lending was also laid in this time period.

As interest rates came down, banks not only increased their lending volumes, but also began to take advantage of increases in values of investments (bonds, T-bills, stocks, etc.) to record unrealised and realised capital gains.

Being newly, and highly profitable, the banking sector also began to be looked at as a dividend-paying investment alternative, especially as capital adequacy ratios of the listed banks began to improve and new banks (UBL and HBL) began to get listed as part of the privatisation programme.

Banks were now also valued using the much-coveted Dividend Discount Model (DDM). However, the one major criticism of this valuation methodology emanated from the little weight it assigned to dividends and its heavy dependence on a relatively arbitrary terminal value. Terminal value here means the value of the present value of all future dividends in perpetuity, calculated by growing the last estimated dividend on the forecast horizon at a terminal growth rate.

Sample DuPont Analysis Methodology

	UBL	MCB	NBP
Avg. IEA Yield	10.18%	11.45%	9.15%
Avg. IBL Cost	-5.17%	-4.04%	-5.42%
NIM (% of avg. IEA)	**5.47%**	**7.93%**	**4.52%**
IEA/Assets	97.6%	94.7%	96.6%
Margins (% of avg. Assets)	**5.34%**	**7.51%**	**4.37%**
Non-IR contribution	25.2%	12.0%	27.3%
of this - fees	13.5%	8.2%	16.9%
of this dealing	2.8%	0.8%	5.7%
of this other revenues	8.9%	2.9%	4.7%
Non-IR/Avg. Assets	1.80%	1.02%	1.64%
Revenue/Assets	**7.14%**	**8.53%**	**6.00%**
Cost/Income	39.0%	35.4%	43.3%
Cost/Assets	2.79%	3.02%	2.60%
Pre-Provision ROA	**4.35%**	**5.51%**	**3.41%**
LLP/Loans	-2.49%	-2.14%	-2.23%
Loan/Assets	63.1%	57.0%	56.1%
Other Income/Assets	-0.2%	0.6%	0.4%
Operating ROA	2.8%	4.3%	2.2%
Pre-Tax ROA	**2.53%**	**4.87%**	**2.53%**
Tax Rate	-34.5%	-33.1%	-18.3%
Return on RWA	**1.66%**	**3.26%**	**2.07%**
RWA	**2.12%**	**4.65%**	**3.12%**
Equity/Assets	8.6%	13.5%	12.6%
ROE	**19.4%**	**24.2%**	**16.4%**

LEGEND

IBL: Interest Bearing Liabilities
NIM: Net Interest Margin
IR: Interest Revenues
RWA: Risk-Weighted Assets
IEA: Interest Earning Assets
LLP: Loan Loss Provisions
ROA: Return on Assets
ROE: Return on Equity

Source: Company Reports 2009 results

FOREIGN INVESTORS' INTEREST & NORMALISED ROE

The year 2006 was the time when foreign portfolio investors began to take an interest in Pakistan's stock market. With an improving economy, which had grown 9 percent in the previous year, a stable exchange rate, and controlled inflation levels, Pakistan offered an attractive lower-priced alternative as an investment destination.

It was often quoted that the closest one can come to taking exposure to an economic growth story in terms of equity investment is through the banking sector, since it mirrors the trends prevalent in the economy.

As foreign investors arrived and began taking exposure in Pakistan's banking sector, especially the large listed banks such as MCB and NBP, it became apparent that there was a disconnect between the valuation methodologies used by local analysts and those put into practice by foreign fund managers and analysts.

It seemed as if foreign investors were more bullish on banking sector, with higher fair values, as compared to the local analyst community.

Since 2006-2007 to date, the valuation method favoured for banking stocks in Pakistan has been more in line with global and regional practice. The method basically recreates calculation of a justified P/B multiple, while also allowing contribution from the dividend discount model (DDM).

Taking the dividends for the forecast horizon and discounting them using the required rate of return gives one portion of a banking stock's value. However, the major portion of the stock's fair value is derived through a three-step process:

i) Determination of Normalized ROE level based on earnings forecasts. This is determined by breaking down the ROE into its sub-components via the DuPont method.

ii) Using the formula (ROE - g) / (k - g) to calculate a value for justified P/B multiple; where g = terminal growth rate and k = required rate of return on equity.

iii) Multiplying the calculated justified P/B number by the bank's book value to generate a terminal value.

This terminal value is then added to the present value of the dividend stream calculated earlier to arrive at a fair value for that particular banking stock.

CONCLUSION

It seems that as the market has got more sophisticated due to the influx of foreign investors, then so has the valuation methodology.

From the basic universal methods of P/E multiples and simple DDM, the market has graduated to more complex and detailed valuation models. The beauty of the normalised ROE calculation using DuPont method is that it isolates each sub-component and allows the analyst to trace any error that may have occurred, and even serves to explain the contribution of various key heads towards profitability.

It is also intuitively comprehensive in the way that it takes the required pieces from the profit & loss accounts and balance sheets of the banks.

There may be further evolution in the methodology used to value banking stocks going forward, as banks' balance sheets get more sophisticated with time (e.g. adding on assets/liabilities in the form of derivatives), in line with other developing economies.

However, at present Pakistan's banking sector remains heavily focused on higher spreads due to an 'unaware' depositor-base who is unable/unwilling to go through the hassle of demanding optimal return.

Therefore, it seems that since DuPont-led justified P/B calculation is relatively straight-forward, it will continue to be the method of choice for most analysts covering the banking sector in Pakistan.

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Small banks need to do a **SWOT analysis**

An interview with Arif Usmani, Managing Director & Citi Country Officer, Citibank N.A

Ali Khizar & Haider Nawab

In one of the most candid interviews, Usmani asserts why the consumer banking boom in Pakistan 'was a 'mistake' and how his bank has been moving away from the consumer business to focus more on its strength. Commenting on Pakistan's macroeconomic picture Usmani highlights the country's fiscal deficit woes, and how high interest rate would keep stoking the NPLs. The following are edited transcripts.

BR Research: Citibank has had such strong presence in Pakistan for the last 50 years, but it has been cutting down on its operations of late. Why is that so?

Arif Usmani: Businesses survive when they produce sustainable returns for their shareholders and those businesses which do not, need to be reviewed and fixed. Our consumer businesses since 2005 have been in the latter category.

Citi designated Pakistan as a consumer business country in 1992 and gradually became a steady contributor to our revenue in Pakistan - though it had its ups and downs during this period. Our credit card business which was a Citi first in Pakistan did quite well and was a market leader.

Post 2004, there was a change in strategy and new management that took over, decided to grow the business much faster than the capacity of the market. In my opinion that was a mistake. We simply pressed the accelerator too hard in 2005 and ultimately had an accident. We had to write-off and provide for over Rs5 billion in the consumer business over 2007 - 2009. Also, at that point the credit bureau was not established - it was like driving in pouring rain without wipers.

BRR: Was the change in strategy back in 2005 specific to Pakistan or was it a global strategy?

AU: It was specific to Pakistan and was driven by regional and local management. In my opinion, banking is a long term business which needs to be built carefully. Also, you need scale in the consumer business and compared to the large domestic banks, we are very small. That is why, we are gradually moving out of the consumer segment - we just don't have the competitive advantage to deliver value to our clients.

Pakistan's budget deficit is not 5-6 percent, it is much higher....our 'should-be' deficit is probably over 20 percent.

BRR: Why don't you target cities other than Karachi, Lahore and Islamabad more aggressively?

AU: We were in Faisalabad, Multan, Sialkot, Gujranwala and Hyderabad but our business model was not right. It was asset driven and given the poor quality of loans we sourced, the costs killed this small city initiative and we had to get out.

BRR: Do you have any plans to come back to the consumer business in the next four five years?

Aggressive consumer financing without credit bureau was like driving in pouring rain without wipers.

AU: Pakistan is a bankable consumer environment and we provide best-in-class consumer deposit services supplemented by our state-of-the art on-line platform. So we are in consumer but not in consumer lending.

Today with interest rates so high, it is difficult to design credit products for consumers. For example, a mortgage at commercial rates with Kibor at 14 percent would probably be priced at 20 percent per annum. That is difficult to service for the salaried segment. For example, if I give you a Rs5 million for mortgage on 20 percent p.a., you will have to pay at least Rs85,000 per month on interest and principal payments for 20 years. Basically, there is a very limited target market for consumer credit here.

BRR: What is Citi's strategy in Pakistan going forward?

AU: One needs to look at one's strengths and competitive advantages and make business plans accordingly. Our strength is our globality and the products that we can bring for our clients - there is no other bank in the world that is present in more than 100 countries.

Our basic business is providing banking services to the top tier companies operating in Pakistan particularly the various multinational clients who work with us in multiple countries. We do everything for the multinationals irrespective of the size because in some other countries, they are very customers of Citi. Other international banks are not as focused globally on this business and are trying to replicate Citi's processes but this will take time. We are cognizant of increasing competition and are ready to respond.

We are also focused on large local companies and in our target segments; there has not been a single corporate opportunity where we have not been involved. We are also, bankers-to-bankers i.e. our Financial Institutions business is strong and again our advantage comes from our global network..

I know we get criticized for working only with the large local companies. However, the reason is that we cannot meet the needs of the smaller companies. It is not our strength given our limited local distribution/network. The "Jodia Bazar" trader does not need us, we add no value to his business but we support him indirectly by working with his local banker.

BRR: What is your strategy regarding CASA?

AU: Just like all banks, we also want to increase the share of CASA in our deposit mix and lower our costs. But being a tiny bank, we need to be creative about this. Our strategy is to go after operating accounts of our consumers rather than their savings accounts by supplementing our offering with technology.

We have two consumer operating account products - one is called Citi-at-Home and the other is called Citi-at-Work. We do not want the consumers to ever have to come to the bank. We encourage online transactions as technology is our key strength. We will even work with internet providers and facilitate internet connectivity if you don't have one. However, online banking is not the final frontier; the final frontier is mobile-phone banking. Citi-in-your-pocket is ultimately where we see this going.

BRR: What is your view on Pakistan's macroeconomic picture?

AU: One view is that Pakistan's economy is simple to analyse. Our economic fate depends on the price of energy. If oil prices are higher than $90 a barrel for a while, we will be hit hard. If oil prices come down, we have less pressure on our reserves. Basically, our poor energy policy has really hit us hard and has made our entire economy vulnerable in many ways. If we get this right, we will fix a lot of our problems.

The final frontier is mobile-phone banking; Citi-in-your-pocket is ultimately where we see this going.

In my view the budget deficit of Pakistan is not 5-6 percent, it is much higher! The ~5 percent is because we don't have the funds to build infrastructure e.g. dams, schools or roads. I think, our 'should-be' deficit is probably over 20 percent. I think this is an exercise we should work on - set ourselves some medium-term developmental goals (e.g. the millennium development goals) and make a theoretical budget against these. We will then see the real gap - it is a scary thought as it has significant social implications.

BRR: What is your view on the NPLs? Do you see them further accelerating?

AU: The high interest rate scenario is a problem for the corporate sector. One simple view is to consider the debt-to-sales ratio of the various sectors. This is a key parameter in this interest rate environment, if your debt/sales ratio is more than 50 percent, you have a problem - unless your EBIT margins are high enough to allow such leverage. NPLs are bound to rise in this environment.

BRR: What is your word on the future of small banks in Pakistan?

AU: They are in trouble and have to find an alternative business model. I guess they should do a SWOT analysis and devise a strategy to address their weaknesses. If you don't bring value to your customers, very soon you will not have customers. It is as simple as that.

One way out could be for the small banks to focus on the SME sector and develop solutions for such companies. This is not easy given the credit quality of our SMEs. Small banks have to create a niche in order to survive - an activity or a service that they can do best - otherwise I am afraid they will not be around for long.

Sharia-compliant banking?

Dr. Khalid Zaheer

The present-day Islamic Banking is, in my opinion, fifty percent Islamic if viewed from a legal point of view. It is even less from the standpoint of the true spirit of Islamic teachings.

As someone whose doctoral dissertation was a critique of Islamic banking that had emerged until the time it was presented (in 1994), I believe the experience of the banking that emerged in the name of Islam subsequent to the writing of that thesis was an improvement upon what it was during the initial stages of the experiment.

However, a lot needs to be done to reach a closer-to-ideal version. The bankers and the Shari'ah scholars involved in Islamic banking will need to be more tolerant, flexible, and open-minded if they are to realise that goal.

By pleading for open-mindedness, I am not suggesting that they should give up Shari'ah principles to accommodate more liberal views on Islam. Instead, what I am asking is that they should not hesitate in reviewing their principles in order to bring them in conformity with the original teachings of their faith.

We don't want unbridled liberalism that would deface Islam beyond its true picture nor do we want unreasonably rigid attachment to traditions that would disallow ideas on understanding the true Islam; other than what the majority of the traditional scholars understand. The idea should be to appreciate and practice Islam honestly the way it is and not to promote one brand of Islamic teachings over another.

Two products dominate the balance sheets of Islamic Banks these days: Leasing and Murabaha. While in principle, leasing is in line with Islamic rules of doing business, Murabaha isn't. There is a debate whether only operating lease is permissible in Islam or finance lease is allowed too.

However, the fact is while in principle leasing is permissible in all forms, some forms of leasing contracts are closer to the spirit of Islam while others are not. Most certainly, exorbitant rentals, much higher than the market commercial rates of interest are undesirable.

However, so long as we are asking for a fixed charge for the services extracted from an asset that doesn't deplete on being utilized, we are within the allowable territory of Islam. The trouble emerges when we are asking for a fixed return on the assets that depletes or is exhausted upon being used. If a fixed return is demanded for their use, the charge shall not be in the category of legitimate rental but prohibited Riba. This latter arrangement is Murabaha and seems to be the mainstay of Islamic banking.

We don't want unbridled liberalism that would deface Islam beyond its true picture nor do we want unreasonably rigid attachment to traditions that would disallow ideas on understanding the true Islam.

No matter how much one sympathetically attempts to understand the point of view of the scholars that justify Murabaha one would never be convinced that inflated price on credit sales of perishable goods (Murabaha) is acceptable in Islam. The reasoning of our conventional scholars on this issue, as indeed in many other issues on Islam, could be understood either by giving technical or philosophical arguments.

Technical arguments to show the validity of Murabaha should positively present reasons from Qur'an and Sunnah to prove that despite the apparent similarity of it with Riba, the former has been allowed in Islam. From what I have heard and read in the literature of the scholars who consider it Islamically legitimate, there is no technical argument in their armoury to make that claim.

The Council of Islamic Ideology allowed Murabaha as a way of doing financial business only as a second best alternative. One can see a definite lack of conviction in their statement while proposing Murabaha. The Report says '...it needs to be pointed out that these alternatives [i.e. Murabaha etc.] ... are no more than a second best solution from the viewpoint of an ideal Islamic system.'

An official of the State Bank's Islamic banking wing, presented the defense of Murabaha in a discussion forum on Islamic Banking on the following lines:

Many disbelievers did not agree with the difference between riba and trading (Bay' Murabaha) at the time of revelation, like some so-called enlightened people do today. The Holy Quran responded to their objections in these words: 'Those who devour riba will not stand except as stands one whom the evil one by his touch has driven to madness. That is because they say: 'Trade is like riba, but Allah has permitted trade and forbidden riba.'

Those who desist after receiving direction from their Lord shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the fire: they shall abide therein (forever).'

The Council of Islamic Ideology says that alternatives like Murabaha are no more than a second best solution from the viewpoint of an ideal Islamic system.

The important condition in Murabaha is that the banks should conform to the principles of trading prescribed by Shari'ah. If an ordinary person can earn profit from selling goods in cash, he is entitled to earn profit on deferred payment sales as well. And the same goes for banks.

The difficulty in understanding this argument is that when we mention Murabaha in the original, classical sense, we find no mention of any delayed payment in it. It used to be transparent sales transaction in which the seller gave an honest picture of his product to his prospective buyer including his profit margin (ribh) .

There is neither a mention of any credit deal in it nor inflated prices due to delayed payment. Ba'y Mu'ajjal was another transaction practiced in the earlier period which was a simple credit sale in the classical understanding with no mention of inflated price due to delay in payment. The present-day Murabaha practiced by Islamic Banks is a clever hybrid of the two.

Most certainly, no sane trader would ever give a commodity on sale without adding a mark-up (ribh) on it. But adding mark-up as profit margin is one thing and adding it because of delay in payment is quite another.

What I called clever is the attempt to combine the two in which mark-up has been allowed to be added because the buyer is not in a position to pay cash immediately: His inability to pay cash has been exploited to force him to pay more at a later date. If this is not riba what is? It is demanding forced extra amount for delaying the payment, whether the payer (borrower) is capable of doing so or not.

It is interesting that whenever this illegitimate hybrid of Murabaha and Ba'y Mu'ajjal is condemned by someone as un-Islamic, the Qur'anic verse 2:275 is presented in defence of the arrangement, even though the verse has nothing to do with the permissibility of Murabaha in its modern, illegitimate form.

The fact is that the verse is condemning the understanding of some people who believed that trade and riba were similar. It is not defining what riba is. Had that argument been correct, then all trade should have been permissible in Islam because, according to the argument built upon the Qur'anic verse above, no trade could be riba. How can Riba al-Fadl which is exchange of identical commodities be Riba when whatever comes within the category of trade cannot be Riba?

Even in the case of the present form of Murabahah, some believe that although mark-up for delayed payment is allowed, mark-up on mark-up is not allowed. Why, one might ask, is it not allowed? Obviously, because, according to them, mark-up on mark-up is Riba.

My question is: How could it be Riba when it is being charged on trade? The obvious answer is that it is not the question whether a certain transaction is trade or not that decides whether there is Riba in it or not. It is the question whether the arrangement, trade or otherwise, forces the borrower to pay a definite amount in addition to the principal after a delayed time that makes it Riba-ridden.

We have to look into the reason why Riba has been prohibited in Islam and find out whether Murabaha fares any better in that respect.

From the point of view of philosophical understanding of Murabaha's acceptability, we have to look into the reason why Riba has been prohibited in Islam and find out whether Murabaha fares any better in that respect. The apparent reason why the Almighty has prohibited Riba is that the lender demands from the borrower, payment of the principal amount plus a pre-determined interest, even when he is in no position to repay it.

This is quite clearly showing the lender's complete lack of concern for the plight of the borrower. If during the period of the loan, the borrower goes bankrupt, the lender would still demand not just the principal but interest as well. A humane soul would be hesitant in going into that kind of a financial arrangement. Islam has, therefore, prohibited it.

In view of the above, when we look at the Murabaha arrangement, it appears to be completely the same as Riba: The borrower, euphemistically the buyer, acquires an asset from the lender, the seller. Because the borrower/buyer cannot afford to purchase the asset on cash, he goes for a credit arrangement with inflated price.

Call them by whatever name, the buyers/borrowers are exactly in the same state of helplessness if the relevant asset gets destroyed. The lender/seller would demand from him the original spot price (principal) plus the mark up (interest/Riba). His plight, like in the case of Riba-based loan arrangement, would fall to deaf ears, because the 'pious' lender in this case has used the right terminology to believe that he has not given a Riba-based loan but has entered into an 'Islamically legitimate' Murabaha transaction. It is simply a stratagem (Hila) devised to declare an otherwise prohibited arrangement as Halal.

The supporters of Murabaha present two conditions in it which they think distinguishes it, to them quite clearly, from Riba. One of them is that unlike the case of Riba where cash or cash-like circulating assets are involved, in Murabaha the subject matter is a real commodity. The other condition is that while in Murabaha they don't allow mark-up on mark-up, they believe, in Riba, interest on interest is also charged.

As for the condition of real asset, it really is inconsequential whether the commodity is real or unreal. The important thing is that if the commodity in question is destroyed while the borrower/buyer hasn't paid the amount, who is going to be responsible for the loss? The answer is obviously that it would be the borrower. How then is it any different from Riba? What difference has the physical presentation of the commodity caused to the transaction? What relief has been offered to the borrower/buyer?

On the point that in Murabaha, mark-up is charged only once and no further even when the borrower/buyer defaults, I would say that not committing a double sin doesn't make a single sin valid. Would the pleaders for the legitimacy of Murabaha accept interest too as valid if it was decided that compound interest shall not be charged?

Furthermore, the policy of not charging mark-up on default is not even being practiced by the institutions claiming to be pursuing Islamic banking. They charge additional mark-up from the defaulters but don't add it to the revenues of their banks. Instead, they distribute it in charity. In other words, they do charge what they themselves consider to be haram. However, instead of utilising that haram money for their own benefit, they give it to somebody else. How could that be justified?

If the religious experts engaged in the promotion of Islamic banking were prepared to accept Islamically valid, new ideas, they would do well to take into consideration the concept of principal-guaranteed profits. Unfortunately as yet, the understanding amongst the Shari'ah experts, Islamic bankers and economists is that the only acceptable alternative to Riba-based banking is the model of profit-and-loss-sharing banking.

Unfortunately, the understanding amongst the Shari'ah experts is that the only acceptable alternative to Riba-based banking is the model of profit-and-loss-sharing banking.

That model has never seen a world beyond the realm of the books where it is mentioned. The unfortunate reality is that the understanding that PLS banking is the only acceptable model in Islam is as flawed as it is well known. It is based on a Hadith which is not saying what has been made to appear.

The Prophet (pbuh), decided an issue that arose between two individuals who were in dispute on the question whether the amount earned by a slave belonged to his de jure or de facto master. He settled the dispute by stating: "There is no benefit allowed where no risk is taken." In other words since the de facto owner was not bearing the risk of the slave in case something untoward would have happened to him, he did not deserve to enjoy the benefit of his earning. It was only the de jure master, the real risk taker, who deserved to pocket the revenues earned by the slave.

Islamic jurisprudence is replete with many such examples wherein a decision incidental to a situation during the prophet's time was made into a sacrosanct, inviolable Shari'ah principle. If one looks at the rationale of the decision in the context of the situation it was taken, it makes a lot of sense.

However, if it is generalised into a Shari'ah principle, it defeats the very purpose and spirit of Shari'ah. The condition of not allowing purchasing in the agreement of hiring is another example. Likewise is the case where our Shari'ah experts do not allow sale of an item whose possession has not been taken by the seller. Once a verdict of a situation-specific ruling is declared Shari'ah, no debate is allowed by the diligent followers of it.

Thus many 'Islamic rules' are forcibly included in the list of the God-given Shari'ah even though they have little to do with His message. The Islamic banking practitioners, the bankers that is, take whatever their scholars tell them as the ultimate verdict of their faith. Thus perpetuates the practice of Islamic banking with a confident label of Islam on its face even though some of what is practiced in it may actually have nothing to do with Islam.

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Consumer boom was a disservice to society

An interview with Sirajuddin Aziz, CEO, Bank Alfalah Limited

Sohaib Jamali

In his conversation with BR Research, Aziz laments the consumer-led economic boom of the yesteryears and stresses on the need to make sacrifices to ensure long term growth in the country. Sharing his growth strategies for the bank he leads, Aziz talks about his focus areas, and his plans to increase presence by expanding branch network as well as by venturing into branchless banking. Below are the edited transcripts.

BR Research: What do you reflect when you look back on the consumer boom that saw a hard landing in 2008?

Sirajuddin Aziz: During the economic boom, the growth in consumer banking was out of step with incomes that largely remained stagnant.

Households that did not have air conditioners started buying split units and other luxury items. So the boom in consumer banking, on hindsight can be referred as a disservice to society. Though the model that Pakistan followed had been successfully implemented earlier in much of South and North East Asia but Pakistan's case was different.

We believed that if we start selling Rs1 billion worth of mobile phones, or for that matter automobiles industry, other peripheral industries would prop up to support the main industry. But the development of industry to support that growth didn't occur. As a result, we continued importing the goods, to the impairment of the economy.

And coupled with that there were many unscrupulous elements in the society that benefited from the fact that the economy was not fully documented. We did not even have a proper credit information bureau at the time, and as a result many people borrowed much beyond their repayment capacity.

Today we have scaled down the business to about one-tenth the size it was in 2005-2006.

BRR: How did it affect Bank Alfalah's business and what's your strategy going forward?

SA: In 1997, Bank Alfalah was the 38th bank of the 42 banks. Our strategy was

At the start of this year we had 321 branches, we are going to close this year at 386 branches.

to grow organically to become a leading player in the market. Our sponsors supported us, and now we have become the 6th largest bank in the country. And the intention is to remain within the top 5 banks in the next five years.

We initiated consumer banking with focussed attention. The segment suffered greatly between 2007 and 2009. But that was a result of shrinking disposable income in the market.

We are the market leader in the credit card business. We were the first to introduce no joining or annual fees, so we became the

The default rate on credit cards, according to Visa, is about 23 percent, in Pakistan it's about 16.5 percent and ours is about 13 percent.

obvious choice of the market. But our portfolio has now scaled down from Rs9 billion to Rs7 billion.

The default rate on credit cards, according to Visa, is about 23 percent, and in Pakistan it's about 16.5 percent. And in comparison to the rest of the market, we are doing about 13 percent. We do not see the same growth as we saw in previous years; issuance is far and few, and our concentration is on recovery and rescheduling.

Similarly, mortgage lending is stagnant; we haven't seen any growth in this product in 2010. At the most, fresh advances are no more than the inflows that are coming in from repayments. Overall, at the peak in 2007, we had 23 percent assets in the consumer segment of our loan book and it has now fallen to 17-18 percent.

BRR: What steps can be taken to develop the industrial base that was supposed to be created by the credit led growth?

SA: My personal recipe is of a different kind, one that will be unpalatable for politicians and the people alike, because it begins with sacrifice. No country moves forward without it. At least one generation will have to sacrifice. Two generations of China didn't know where the world was, and now the country is reaping its rewards.

From a practical stand point, an economic vision for the country must be established that is shared by all political parties and is representative of the people's wishes. Organizations grow because there are small milestones along the way that are achieved.

There was a point in time when all economists believed that only countries endowed with natural resources will succeed. That theory is out of the window now. You are looking at knowledge economies now. Now, countries that are progressing are the ones that have a focus on education and knowledge.

BRR: What are you growth strategies in this environment?

SA: We will continue to focus on the consumer segment, however, consumer was never and nor it is now our bread and better. Our mainstay is corporate banking and lending to the SME sector.

And then we are looking towards trade finance, not just domestic but also foreign trade. We undertake consortium financing of infrastructure projects. We can't do that alone, and I believe that no bank other than state-owned banks have the muscle to finance development projects on a stand-alone basis.

BRR: How do you define SME; do you feel focussing on the S of the SME is a good idea?

SA: That's a good strategy for the nation, but for financial institutions a blanket statement may not be appropriate. For example, I don't think Bank Alfalah can go anywhere below the small sector. Matters of documentation are critical to doing business with small businesses.

For us small businesses are entities above Rs2 million revenue and medium sized enterprises are Rs50 million plus. Anything below Rs1 million lending, from a commercial bank's perspective, would be microfinance, and we have specialized institutions for that in Pakistan.

BRR: BAFL has a significant presence in the Islamic Banking space, what are your plans in that area?

SA: We are the second largest Islamic banking window in the country. And we had every intention to convert our Islamic window into a full fledged bank. In fact, we engaged SBP on this, and got permission to do so.

But market conditions have changed so much that we want to wait until the economy is better. We feel we can get a better return on it then.

In the current quarter, we are launching full fledged branchless banking, with our sister concern, Warid Telecom.

BRR: Can we expect BAFL to become aggressive in the agri sector?

SA: I don't think we'll become aggressive in the agri sector but only more cautiously because our experience has not been very positive; default rates are very high in rural areas.

Agri sector in Pakistan is a difficult sector - difficult to lend because there is very little documentation. Again, if you look at private banks, we have lending of about Rs6.5 billion on the agri side. So in our peer group, medium sized banks, we are in the lead as far as agricultural lending in concerned.

BRR: What do you think needs to be done to document the rural sector, so that banks can lend to the farming industry?

SA: Tax agricultural income. It will become documented and banks will be able to lend. Eventually corporate farming will take a hold and lending to the agricultural economy will flow.

BRR: How will the country finance long term infrastructure projects, now that DFIs are slowly reducing in significance?

SA: Commercial banks by their definition of doing business should not be involved in long term financing. The problem is that DFIs have entered the domain of commercial banks, whereas, since they are backed by government funds which are long term in nature, they should invest in infrastructure and development projects.

The regulators must step in and enforce the role of each institution. Unless that is done, commercial banks will find themselves financing long term projects, which in my view is suicidal because it is based on short term deposits.

We must use institutions for the purposes they were created for. Public sector banks that are the beneficiaries of government funds should be investing in long term projects. But if market participants expect private sector commercial banks to take a lead in this area, I think it is a bit unfair.

At the same time the government should be using the money raised from treasury bills and PIBs, to build irrigation systems, roads and dams, etc.

BRR: Your operating expenses are on the higher end compared to other banks, is there a strategy in place for that?

SA: We are definitely on the high side, and I have a plausible explanation for it. We are in the growth phase, and are still opening branches. At the start of this year we had 321 branches, we are going to close this year at 386 branches. Now adding about 65 branches and hiring people to man them, will obviously mean higher costs.

Our sponsors would like us to grow to an optimum number and then take a pause. And we hope to achieve that within the next 2 years. Our next focus is the semi-urban space, where we believe the low cost resources are untapped.

BRR: What should be done to raise the savings rate of the country and what can banks do to facilitate this?

SA: I think banks have a social responsibility to create products that induce savings. And our shareholders' view is in alignment with mine. Our Founder Chairman, H.H. Sheikh Nahayan Mabarak Al Nahayan and our current Chairman, H.H. Sheikh Hamdan Bin Mubarak Al Nahayan are positively inclined to the social and economic well-being of Pakistanis.

We are coming up with saver focussed products and have already launched some products targeted towards pensioners.

Likewise, the society must respond as well. We as a nation, for the last so many years, have spent more than what we earned. The psyche must change.

BR: What is view on MCR?

SA: I think it's not the best way to measure a bank's sustainability. From the PBA platform we have made our opinions known to the regulator as well. If you look at the Basel III requirements, it mentions risk weighted capital adequacy ratio; times have changed and banks must now look at the risk-asset base. CAR will prove to be more effective, than just MCR.

BR: But since MCR is what's being applied today, what should the small banks do? Is BAFL looking to acquire one?

SA: They should either merge together to become profitable or inject capital.

Bank Alfalah at the moment is not looking to acquire any banks. However, if we do find a deal that adds value to our business and if offered at a good price, we may have a look at it, although traditionally it is organic growth that we subscribe to.

BR: How many banks do you think there should be in Pakistan?

SA: The number of banks in Pakistan is still below what the country's capacity is. Semi-urban cities have just a few branches. If more banks prop up competition will flow even to smaller cities and consumers will benefit.

BR: What is your view on mobile or branchless banking?

SA: We are already in that space; in the Watan Card scheme we were the only bank apart from UBL. The wallet is there now, and now we have to start introducing products for it. In the current quarter, we are launching full fledged branchless banking, with our sister concern, Warid Telecom.

The technology handshake between the two organizations will be a key challenge. Raseen is one of our group companies that is likely to provide the architecture to enable the bank and the telco to talk to each other, technologically speaking.

We are introducing products and services for various types of transactions, remittances, and possible access to accounts across the country. It will serve two purposes; one it will allow greater reach out to the economy and at the same time will also document the economy.

The potential for mobile banking is anywhere between 60 to 80 million new clients in Pakistan, looking at the basic telecom subscribers.

Profile: Sirajuddin Aziz

Sirajuddin Aziz has been the Chief Executive Officer of Bank Alfalah Limited, for over three years. Prior to this, the Banking and Finance MBA-degree holder had over 33 years of experience in the banking sector, both locally and internationally.

His foreign experiences include that in China, Hong Kong, U.K, Nigeria and the U.A.E, where he has often represented banks in their meetings with the officials of the Asian Development Bank. Aziz is also fond of public speaking and writing and has a book 'In Quest of Mirage' to his credit.

The Bank of Khyber - **RAAST Islamic Banking**

Bilal Mustafa is the Managing Director of The Bank of Khyber with over 38 years banking experience. He took over the charge on March 05, 2008. He started his banking career with Habib Bank and subsequently joined Allied Bank. In addition to being the Manager of various branches, Zonal Chief, Circle Executive, Area Regional Chief, Provincial Chief (Balochistan, NWFP, AJK and Punjab). He has also worked as Chief of Audit and Inspection/Group Chief Human Resources and as the overseeing executive of various divisions of Central Office, Karachi. He also worked as Chairman /Director First Allied

Bank Modarabah. He retired from ABL as SEVP in June 2007. Having graduated in 1965, he completed M.A (Economics) in 1967 from Punjab University. His professional qualifications also include DAIBP. He has attended various foreign and national level trainings / courses during his career.

The Bank of Khyber (BoK) was established in 1991 through Act passed by the Provincial Legislative Assembly of the Khyber Pakhtoonkhwa Province of Pakistan. It was awarded status of a scheduled bank in September 1994. The Bank of Khyber enjoys a unique position and stands out amidst the other banks operating in Pakistan. It has the privilege of being bracketed amongst the only three government banks operating in the country. The Bank of Khyber started Islamic Banking by converting all assets and liabilities of Hayatabad Branch Peshawar on November 22, 2003 (27th Ramadan) with an aim to gradually convert the Bank into a full fledged Islamic bank as per Rules and Regulations of the State Bank of Pakistan.

The BoK has named its Islamic banking 'Raast Islamic Banking', which is gaining popularity among the public, especially the business community. Out of a total 54 branches all over the country, 21 offer

Islamic banking. The bank established 9 branches in 2009 and 11 branches in 2010. Presently there are four branches in Lahore out of which 2 are Islamic Shariah compliant. However every branch has an Islamic banking counter.

Islamic Banking in Bank of Khyber:

In December 2002, BOK decided to initiate Islamic Banking Services for customers. As per policy of the Bank, BOK is perusing Islamic & Conventional Banking side by side. We are opening new Islamic full service branches as per demand of the customers and are also extending Islamic Banking facilities through dedicated Islamic Desks in all conventional banking branches. The Government of Khyber Pakhtunkhwa constituted a Shariah Supervisory Board (SSB), subsequently renamed as SSC, to guide and supervise the Bank's Islamic operations presently comprising of the following scholars:

1. Syed Muhammad Abbas
2. Mufti Muhammad Zahid
3. Dr. Dost Muhammad
4. Mr. Shahzad Iqbal Sham
5. Mr. Muhammad Ayub,

Today In Islamic Banking Industry, Islamic Banking Group (IBG) of The Bank of Khyber (BOK) is providing Islamic banking services almost in all big cities of Pakistan through 19 full-fledged branches, 4 sub-branches and Islamic counters.

Products & Services

Islamic banking of BOK is offering the following Products and Services.

Deposit:

1. Current Accounts
2. Interest Free PLS Saving Accounts
3. Riba Free Certificates
4. Call Deposits
5. Riba Free Special Deposit. Pool Deposits/Certificate

- These two are also accepted on the same principles as applicable to PLS Financing

1. Ijarah
2. Murabaha
3. Diminishing Musharakah
4. Musharakah
5. Mudarabah
6. Wakala
7. Share Purchase
8. Import Export under Islamic Banking
9. Foreign Currency (FCY) Transactions
10. Discounting of Bills
11. Export Refinance Scheme

Bilal Mustafa
Managing Director & CEO

FUTURE PLAN

1. Further expansion in Islamic branches network through the country.
2. Launching of liability & asset innovative products
3. Active participation in Islamic Financing for Commodity Operation of Punjab Government, Investments in SUKUKs and other Shariah Compliant Investment products.
4. To enhance professional knowledge of the Islamic Banking Staff, enable them to provide quality services to the customers.

Going Branchless: Paving way for financial inclusion

Rais Mahaned Ahmed

The concept of 'financial inclusion' is now widely acknowledged by many economists as an imperative growth strategy in developing economies. It may be defined as a durable solution, aimed at creating expansive livelihood opportunities through enhanced financial access for the lower income and marginalized strata of the society.

According to a World Bank survey in 2010, around 2.7 billion people do not have access to formal financial services. The State Bank suggests that only 14 percent of the rural population is banked in Pakistan, even though 67 percent of the total population resides in rural areas. Furthermore, on average, there is one bank branch per 20,000 people.

One of the earliest serving of the unbanked in Pakistan started when United Bank Limited launched its 'mobile banking' in 2007. Although very simplistic, the beta version of the branchless banking service was the first-of-its-kind payments solution that enabled customers with GSM mobile connections to carry out simple financial transactions using their mobile phones. Combined with customer insights and the central bank's robust regulatory framework in place, the opportunity to introduce a transformational branchless banking service came in 2010.

DIFFERENCE BETWEEN BRANCHLESS & MOBILE BANKING

Now deemed synonymous with 'financial inclusion', branchless banking may be defined as the delivery of financial services outside the conventional bank branches using communications and information technologies and non-bank retail agents. It may be distinguished into two categories:

1) The 'bank-led' model constitutes a licensed financial institution that delivers financial services through a third party agent or merchant, that can facilitate account opening, payments, cash services and other banking services, usually using a mobile phone or point of sale terminal. The customer account is maintained with the bank but operated through the agent or via other non-branch channels, such as, mobile phone or ATM.

2) In the 'non bank-led' model, a firm such as a telecom operator, or other non-bank entities such as Post Offices, make use of their retail network in conjunction with third party agents to offer customers basic banking services.

Globally, CGAP estimates that as many as 364 million unbanked individuals could be tapped by agent-networked banking through mobile phones

Inherent to branchless banking, mobile banking (m-banking) was initially started as a high-tech solution to abate dependence on the traditional branch banking system. The reasons for taking this trajectory are the myriad of costs involved in branch banking and its propensity to financially 'exclude' the larger part of the population.

According to the Consultative Group to Assist the Poor (CGAP), the number of m-banking service deployments has escalated considerably since 2007. Globally, CGAP estimates there will be 1.7 billion people with a mobile phone and as many as 364 million unbanked individuals could be tapped by agent-networked banking through mobile phones. In Pakistan, the State Bank figures suggest that there are only 26 million bank accounts in comparison with the 95 million mobile phone users.

THE UBL OMNI MODEL

UBL Omni is an innovative banking lifestyle for the masses that does not require stringent KYC requirements of the State Bank for account opening. The minimum requirements for opening an account with UBL Omni are the customer's mobile number and CNIC number.

The establishment of a wide network of Dukaans/agents is expected to increase the outreach of financial services at much lower costs compared to a branch.

Non-account holders or 'walk-in' customers are also entertained at a UBL Omni Dukaan where they are eligible to make utility bill payments, send or receive money, purchase mobile card vouchers and make postpaid mobile bill payments. This can help convert the non-bank-account-holders into regular bank-account holders and incorporate them within the fold of the documented economy.

Unlike other branchless banking models, a factor that is unique to UBL Omni's functioning is that it is 'Telco-Agnostic', meaning that it does not discriminate against customers based on the type of mobile network they belong to.

The value proposition for customers is the ease and efficiency of the service in terms of time saving and conveniently located Dukaans for availing transactions. The agent system is available both on a PC as well as on a mobile phone. The incentive from a Dukaan/agent's perspective is the probability of increased foot traffic and the ability to offer additional and differentiated services to existing or new customers.

UBL Omni is 'Telco-Agnostic', meaning that it does not discriminate against customers based on the type of mobile network they belong to.

COMPARISONS WITH GLOBAL TRENDS

Like Pakistan, internationally, branchless banking is largely prevalent in developing nations, akin to the market vacuum left by the 'financially excluded' rural strata.

In Kenya and Tanzania, Safaricom's M-Pesa is considered to be the torchbearer of the branchless/m-banking world. Its staggering growth and success has made Kenya a focal point of growing international interest in mobile commerce.

The initial concept involved creating a service which allowed microfinance borrowers to easily receive and repay loans using the network of Safaricom. M-Pesa was later re-launched with a different value proposition; i.e. sending remittances and making payments across the country.

As with UBL Omni, the mass appeal of M-Pesa is partly the ease and simplicity of its account opening. Safaricom subscribers can register for the M-Pesa service by filling up a simple form and presenting any legitimate identification proof.

Unlike UBL Omni, which supports the use of any mobile network, Safaricom replaces the customer's SIM with an M-Pesa enabled one. M-Pesa's success is evident from the 8.6 million users it possesses out of which more than 90 percent believe their money is safe. Furthermore, 81 percent of the users find M-Pesa very easy to use. Analysts posit that one of the significant reasons for M-Pesa's success is the care with which agents were selected. Similarly, UBL Omni also adopts a strict agent selection process.

BRANCHLESS BANKING IN DISASTER MANAGEMENT

The ubiquity of the 2010 Flood Crisis prompted the banking sector to appropriate their resources to help victims. UBL, having been successful in previous aid disbursement assignments, collaborated once again in tandem with the Government of Pakistan and NADRA to make electronic payments to approximately 1.3 million affected households.

Making branchless banking their primary avenue of disbursement, UBL is using the Omni accounts and distributing cards, so that respective recipients can withdraw their cash at ATMs. To ensure efficiency in the disbursement process, local resources were hired according to regions for Sind, Punjab, Khyber Pakhtunkhwa and Azad Kashmir under the supervision of UBL staff.

Additionally, UBL also hired staff with local language skills to work at the call centres to guide and assist flood affected people with their queries. Moreover, UBL built its own infrastructure to guarantee consistent online connectivity to the NADRA verification system while mapping individuals to Watan cards.

The first installment of Rs20,000 each, has been distributed among 1 million flood affected people through UBL Watan cards. This has taken overall disbursement, thus far, to around 20 billion which has been funded equally by the Federal and Provincial governments.

OUTLOOK

Branchless banking has revolutionized the very meaning of the 'financial sector' by augmenting it to welcome the unbanked into the financial world.

It is there to help that segment of society who feel compelled to hide their cash in odd places in fear of theft; who feel the need to conceal their value to prevent other people from incessantly borrowing; who adopt difficult channels of sending money to their loved ones across the country. From the factory worker in Rohri to the milk shop owner in Sahiwal, branchless banking aims to reach out to those for whom the world of banking seems daunting and beyond their access.

Pakistan's advent into the world of branchless banking is still nascent, however, the experience of the international players, thus far, demonstrate it to be a promising endeavor.

A survey, by CGAP's Mark Pickens in 2010, conducted to assess whether branchless banking is really catering to lower income groups, found that each of the high profile pioneers brought 1.39 million people into the formal financial system.

The survey, which analyzed the operations of Banco Postal (Brazil), FINO (India), GCash & Smart Money (Philippines), WIZZIT (South Africa), WING (Cambodia) and of course M-Pesa (Kenya & Tanzania), also found that 37 percent of their active clients were previously unbanked.

It was also found that branchless banking serves more previously unbanked individuals in comparison to the largest Micro Finance Institutions (MFI), who also target the unbanked market. It, therefore, took only three years for branchless banking services to surpass the outreach of even the largest MFI.

It is indeed evident that branchless banking is serving its purpose by reaching out to the un-banked. While it may be too early to declare it as an imminent success, a service like branchless banking, whether bank-led or telecom-led, has created the much-needed inroads towards financial inclusion. And before we know it, solid evidence of the positive effects of branchless banking on the economy will hopefully start emerging.

The writer is currently working as Product Analyst for UBL Omni and holds a Bachelors degree in Economics with Development Studies from SOAS, University of London. He can be reached at kci.ecom38@ubl.com.pk.

Concentrating on **trade finance**

An interview with Husain Lawai, President & CEO, Summit Bank

Haider Nawab

Juggling with the varied portfolio of Arif Habib Bank, Atlas Bank and My Bank, Lawai is busy reorganising and restructuring the entity he runs. Sharing his thoughts with BR Research, Lawai discusses his planned business niche, the number of branches he eyes, and the strategies he intends to adopt to stand out from the rest.

BR Research: Small banks are finding it hard to stay afloat. What in your view should be the small banks' strategy to show good presence?

Husain Lawai: Each bank has to have its own business strategy. In the last 8 to 10 years, small banks initially tried to create specializations like Arif Habib and JS Bank, they wanted to focus on the capital market, but unfortunately, many other banks were not clear about their plans and were confused.

The second mistake that the small banks committed was that they relied on interbank to fund their asset acquisition. And the third mistake was that they never kept an eye on the cost of operations, because unless you keep an eye on your operational costs, you can never be successful.

BRR: What are your plans regarding Summit?

HL: When we acquired the bank, we had a very clear mission in our mind as to what we want to do. We cannot behave and do the business like the big banks; there is no competition and match between us and them. Primarily our focus is on trade finance, but if anything else comes out of the relationship, like consumer banking, investment banking, advisory etc, we will do it.

We offer better rates of return to the society segment that lives around our branch network, as a result our core deposit have increased to Rs33 billion from Rs6-7 billion when we took over the bank. Similarly, when I joined the bank, there were 12 people per branch; there was no need for such staff, and you do not need more than 5 persons for a branch.

BRR: Since there are other medium sized banks that have larger presence in trade finance, don't you think there is a need to create a niche?

HL: I believe there is still a lot of room in the trade finance business. Secondly, the large banks have the inherent disadvantage of the management layer that takes 10-12 weeks in the entire procedure. Our advantage on which we pride ourselves is that we turn the proposal around in one week's time at the maximum. So, time is our niche.

We have a defined strategy. We have listed a number of customers, and the list is circulated to the branch managers about whom to contact and whom not to, so it is like a pre-approved list which saves processing time. The approval of credit amounts is obviously not pre-approved; we follow the normal procedures in this regard.

We may look at some bank with 100 odd branches to complete our acquisition process.

BRR: Would you try to create a niche in the capital market business?

HL: We have to diversify our portfolio; we cannot solely rely on one sector. It is our strategy that we will not have more than 20 percent exposure in one sector. When I took this portfolio, the capital market share was 80 percent, so we are gradually reducing it to the desired level of 20 percent.

We will have 160 branches by the end of next month. Next year, we plan to relocate 26 branches; the year after, we will be opening 50 new branches.

BRR: Do you think that the 80 branches you have at present are enough or you would like to expand the network?

HL: By virtue of acquiring My Bank, we will have 160 branches by the end of next month. Next year, we plan to relocate 26 branches to reduce duplication and ensure presence in other areas. The year after, we will be opening 50 new branches, because we have to have at least 250 branches by then.

BRR: Given that all the three banks that form Summit had similar structure and similar problems - what was the idea behind the merger? What were the synergies in combining three horizontal entities?

HL: We initially desired to buy RBS but the SWOT analysis told us that it had a couple of very serious challenges; it was not our cup of tea.

The banks we acquired were available and the major charm was their branch network and stable core deposits. Other parameters were the deposit mix and the cost of funds.

We were not entirely happy with the deposit mix of Atlas Bank but its good SME portfolio was very attractive for us. The amount was good, but we never realised that they have such a serious problem in SMEs as well, we realised it subsequent to the takeover. So the programme-based consumer lending model did not work.

I believe that the customer is not that bad except for a few black sheep. If you engage with them well, it will work, we have been very successful in the past three months and our recovery rate has gone up.

BRR: How did you deal with the challenges of merging different cultures and the employees' behaviour, technological changes etc?

HL: Merging is no doubt a very challenging exercise, but I had had the experience of mergers before which I applied here. We formed various core teams consisting of all the three banks; they were assigned with the job to choose one technological system that will suit the bank best. Then we studied the HR policy and the operational side of things, to come with a strategy that is suitable for the bank.

We took the staff into confidence and brought about the changes gradually. That experience has been very rewarding; we did not see any glitches in implementing whatever changes we wanted to.

BRR: What is the present state of NPLs?

HL: We have provided for about 65 percent of all the NPLs. I expect some more increase in Atlas' NPLs; I am ok with Summit and My Bank. We have a separate department to deal with the NPL issues, but our judicial system takes very long for the cases to settle, so we have to look at case to case while analyzing the NPLs.

BRR: What is your combined cost of funds and what is your target?

HL: After the merger of all the three banks, it would be around 8.5 percent. Bringing it down is not an easy task and will take some time. When you open a branch, it takes at least two years to attract and retain the customers and to attain loyalty. Our strategy will be based on building long term relationships and we aim to bring the cost of funds down to 7.5 percent gradually.

I cannot disclose the strategy right now, but I can assure you that it will really create ripples in the market. Other than the commission and fee income, we will also focus on our debit card business, we have started distributing this but we will announce a major initiative in this segment soon. We will offer 5 percent cash back on every purchase; no other bank is doing that.

BRR: What is your view on the NPLs of the overall industry?

HL: There are three problems in this area. We, in Pakistan want to keep the problem to ourselves. If the global banks detect a problem account, they just pick it and resolve it. But our legal system is so pathetic that we have to keep those bad loans on our books for decades.

Second reason is that we don't have good bankruptcy laws; otherwise we could take the companies and declare them bankrupt. Finally, our economy is going through a lean patch, unless that bad patch is over, the problem will persist.

BRR: Do you have plans to venture into more M&A activities considering that a few banks are still out there to be merged or acquired?

HL: We may look at some bank with 100 odd branches which can complete our acquisition.

BRR: What is your view on the ongoing debate of CAR being a better measure than the MCR?

HL: My view is that we can have some better criteria than the existing ones. The State Bank should put its foot down so that the banks act like banks. They have to come with some sort of solution to it.

BRR: Are you eying to tap the agri sector?

HL: We are doing our research on agri business financing. I have assigned the task to my team and hopefully we will come up with something on this.

BRR: What are your plans for the m-banking and branchless banking given that these are tipped to be the future?

HL: We are working on a few products and some deals with the telcos are in the pipeline too. But unless we are a merged entity, I cannot say much on this.

BRR: How do you see mobile banking transforming the banking experience in the next five to ten years?

HL: The secret of telcos success was that they were very user friendly; this is why they have managed to tap such a huge market. Secondly, they made it comparatively cheaper than the other alternative that is the landline. We are trying to do the same thing, but human resource is the problem. That is the biggest impediment in the way.

Quality of education at the universities is also a problem, with the exception of three to four institutes, others are not procuring quality products, the right attitude is not there, which means added pressure on their training. There is a need to eradicate the disconnect between the industry and the educational institutions.

Profile: Husain Lawai

Husain Lawai started his banking career in 1971 with the Muslim Commercial Bank, after which, he was involved in senior positions at various local banks and international financial institutions.

Currently sitting as the President and CEO, Summit Bank Limited, Lawai has been a board member at several notable local and international organisations. He's particularly fond of sports and has several regional and corporate-level tournaments to his credit.

FIRST WOMEN BANK LTD.
Giving women the power to succeed

First Women Bank Ltd., a scheduled commercial bank and DFI designed, managed and run by women, for women, was set up in 1989 by the Islamic world's first woman Prime Minister Mohtarma Benazir Bhutto (Shaheed) who envisioned a bank that would meet the special needs of women. Currently, the Bank is headed by Mrs. Shafqat Sultana, who took over as President in May 2009.

The FWBL model caters to women at all levels of economic activity - micro, small, medium and corporate. Most importantly, the Bank provides women with the support services required to navigate the obstacles to the development of business. By doing so, FWBL is helping them emerge as key players in the national and global economy.

The Bank has always looked at its micro-finance borrowers as potential SME and Corporate clients. The Bank's unique credit policies promote asset ownership for women, by:

Financing to business entity:

- Where women have 50% shareholding or
- Where a woman is the Managing Director or
- Where women employees are 50% or more

However, the Bank seeks deposits from and provides services to both genders. It is the only bank in Pakistan offering women single and joint accounts without any minimum balance requirements and penalties on low balances. The Bank offers Online Banking Facility to its customers at branches all over Pakistan. The ATM Card customers can access their Savings and Current account through all ATM's in Pakistan. The bank is also live on SWIFT to transfer funds internationally. At present, the Bank has a network of 38 branches (23 cities) and have presence in rural areas of the country through its strategic partners.

FWBL was the first Commercial Bank to launch Micro Credit in Pakistan. In 1992, an ILO Geneva Study recognized First Women Bank Ltd. as a major innovation in Pakistan, along with Edhi Trust and Lahore University of Management Sciences (LUMS). In 1994, Euro money awarded FWBL the Best Bank in Pakistan for its low administrative cost.

In 2001, Women's World Banking in its Global Directory profiled FWBL for Banking Innovation in Microfinance, and acknowledged that FWBL features among the world's micro finance leaders.

To combat child labor in the carpet weaving industry, FWBL collaborated with ILO and directly financed women micro-borrowers in rural areas. Asian Banking Award 2005 awarded FWBL / ILO - IPEC Micro Credit Program as Runners-Up in its Micro-Finance Program category. Under this project, one of the borrowers received the Global Micro Entrepreneurship Award (Runners-up) organized by the UN Capital Development Fund in collaboration with CITI Group Foundation, Harvard Business School and Pakistan Poverty Alleviation Fund.

The ministry of women development collaborated with First Women Bank Ltd., for economic empowerment of rural women. The major objective of the project was to enable the poorest of the poor women in rural areas to supplement their livelihood by supporting micro enterprise development, through strong linkage between micro-credit and skill development, thus leading to their economic empowerment. Under this project one of the borrowers won two Citi PPAF Micro-Entrepreneurship Awards.

Realizing the fact that only access to credit is not the solution to economically empower women, First Women Bank Ltd. developed Computer Literacy and Business Centers, which have played a very important role in developing computer and business skills in women who were not very well educated, lacked technical skills and belonged to lower middle income group.

Recently First Women Bank Ltd. has become the strategic partner of United Nations Industrial Development Organization (UNIDO) for the implementation of Women Entrepreneurship Development Program (WED).

The bank has so far disbursed Rs. 28 billion with outreach to 47,453 borrowers, of which Rs. 16.1 billion has been disbursed to women, which constitute 57% financing to women

In Pakistan, when compared with other countries of the world, female entrepreneurship is amongst the lowest in the world. With very low female participation in the economy of the country, the percentage of female employers is even less than one percent. The issues stems from the statistical invisibility of women. There's very little research on the market itself, primarily because women are just not considered a market worth tapping into on their own.

Even at the macro level, there are very few people working to empower women as a special interest group. This is mainly because no extensive research or study has been done so far on women's economic role. Realizing the importance of research, FWBL commissioned SPDC to conduct a Market Assessment Study for First Women Bank. The study gave surprising results and revealed that Credit demand of women in five big cities of the country ranged between Rs. 261 Billion to Rs. 285 Billion.

Since inception, FWBL has contributed substantially in raising a sizeable body of women entrepreneurs and banking professionals in the country. For example, the total proportion of women bankers in the commercial banks is around 6% of the total bankers, which was less than 1% around twenty one years ago.

FWBL's successful model has been replicated in Tanzania and Iran.

FWBL was formed with shareholdings from all the large public sectors banks. Over time, these banks were privatized; however, their shares in FWBL were not transferred to the public sector. A majority of the shares of FWBL are currently with the private sector banks - HBL, MCB, ABL and UBL. Only National Bank of Pakistan and the Ministry of Women Development are the public sector shareholder of the Bank.

Shafqat Sultana
President and CEO

Recently, the Government of Pakistan has decided to keep First Women Bank Ltd. (FWBL) in the public sector by purchasing the shares of private shareholder banks i.e. MCB, HBL, ABL and UBL through State Bank of Pakistan.

Today, FWBL's mission for empowering women, remains unmatched.

"To transform the status of women from passive beneficiaries of social services to dynamic agents of change."

Agent network is the key to branchless banking

An interview with Syed Irfan Ali, Director Banking Policy & Regulations Department, State Bank of Pakistan

Manal Iqbal

In this interview Irfan talks about the future of branchless and m-banking industry in Pakistan and the lessons to be drawn from experiences in other countries. He also shares his views on the profitability of this growing banking genre, the challenges it faces, and how the State Bank plans to deal with that in coordination with Pakistan Telecommunication Authority. The following is the edited transcript.

BR Research: What does branchless banking constitute of; what kind of products and services does it cover?

Irfan Ali: The objective of branchless banking is to go outside the ambit of branch banking itself.

At present, we have 40 commercial banks, including Islamic banks and 8 developmental financial institutions. As we are a country of 180 million people, with at least 100 million adult people, so technically speaking we are providing banking service to around 25 percent of adult population. But various studies show that banking penetration in Pakistan is less than that; only 12-15 percent of the population is properly banked.

So, we thought that we should explore other ways and means outside the ambit of branch operations to address the unbanked sector and to promote financial inclusion. Hence we came up with branchless banking regulation.

When we talk about branchless banking sky is the limit, as these services can be provided through post offices, retail stores, departmental stores, mobile network operators, petrol pumps & CNG stations etc. It is the beauty of the branchless banking that it leverages state of the art smart technologies and we can carry out financial and non-financial transaction using cellular phones, GPRS, internet, Point of Sale machines, plastic cards etc.

Our main objective is to promote basic banking facilities, such as an opening of bank account, remittances transfers, cash withdrawal, deposits, payment of utility bill, through a distinct registered network of agent all over Pakistan.

Habib Bank is undergoing negotiations with Ufone; Bank Alfalah is talking to Warid.....Dubai Islamic Bank also plans to pilot launch their branchless banking by early next year 2011.

The basic banking services allowed by State Bank in Regulations include:

- Opening and maintaining a BB Account
- Account-to-account Fund transfer
- Person-to-person Fund Transfers
- Cash-in and Cash-out
- Bill Payments & mobile phones easy loads
- Merchant Payments
- Loan Disbursement / Repayment
- Remittances

BRR: In making the regulations for branchless banking, the State Bank has chosen the bank-led mode as against the telecom-led model. What were the reasons behind this decision?

IA: We chose the bank-led model specifically to protect depositors. Under this model, any bank that enters into branchless banking model needs to have Agency Agreement with agents and that Agreement authorizes SBP to inspect the books and accounts of agents also.

This enables SBP to have an appropriate level of control over operations and supervise payment and clearing system since banks are custodians of the depositors' money and SBP is the regulator of all banks.

If somebody else on the streets starts providing banking facility, then the State Bank would not have a check on that. So the SBP provided the best through its regulation to protect depositors and at the same time to facilitate banking transaction outside branches.

BRR: Does that mean that telecom companies cannot roll out mobile banking service?

IA: They can enter into an agreement with an authorized bank to launch a mobile banking service, just like what Telenor did, as they can not come out with their own model. What they did was to partner with a bank i.e. Tameer Microfinance Bank and started rolling out the mobile banking services by performing as Super Agent of the bank.

BRR: What has been the response of bankers so far?

IA: We have got a very good response from the banking community. Initially, the banks were not forthcoming; they were a bit apprehensive.

However, branchless banking regulations were formed through a very elaborate consultative process, not only members of the State Bank gave their input, but members from Ministry of Information and Technology and bankers from the banking community also participated in development of regulations.

And we came with regulations which were very well drafted; when the draft was displayed on our website the CGAP, the International Finance Corporation, the Asian Development Bank, DFID - all gave positive comments on it. Moreover, our branchless banking model & regulations have been literally copied by other countries.

We are currently working with the PTA on developing inter-operability model, to enable banks and telecom firms to conduct business transactions through third party service provider.

BRR: Aside from UBL and the Telenor-Tameer venture, which other banks are looking forward to launch branchless banking services?

IA: Habib Bank is undergoing negotiations with Ufone while Bank Alfalah is talking to Warid. Habib Bank & Ufone have our approval to offer mobile banking services to Habib Bank's existing customers. HBL's branchless banking arrangement with Ufone is at initial stage. As negotiations are in the initial phase, I anticipate that they will launch branchless banking services by the mid of the next year.

Dubai Islamic Bank has also SBP's approval to pilot launch their branchless banking deployment. The bank will launch their services early next year 2011.

MCB Bank is also offering mobile banking services to its existing customers as additional delivery channel since one and a half year.

Lately Askari bank also contacted us. Then we have organizations such as TCS who are talking to us to setup microfinance institution, with an object to provide branchless banking services. At this moment in time, we are talking to at least three new players who want to enter the market.

BRR: How successful UBL Omni and Easypaisa have been in providing banking services to underserved areas?

IA: The most important achievement as far as Telenor Pakistan and Tameer Microfinance Bank is concerned is that they are providing branchless banking services through around 12,000 branchless banking agents across Pakistan. But, the potential is far more than this, since each telecom company has 150,000 agents all across Pakistan, who provide package of telecommunication services. This means that the telecom industry can have a total of approximately 500,000 agents.

It may be difficult to connect all those 500,000 agents into the network of branchless banking agents, but within three to five years I do anticipate that agent network for branchless banking will grow to 50,000 agents.

The challenge, basically, lies in developing network of agents. Once agent gets into network, then the real challenge is to retain him, keep him happy, to train him and at the end of day agent should be able to make some money out of it. He should be motivated & be profitable; otherwise he wouldn't provide banking service or would lose inclination.

BRR: What kinds of challenges exist in dealing with agents and what is the future?

IA: The development of agent network is the key to successful branchless banking. Since operator's main target is to reach customers that will not be possible without setting up agents' network.

But sometimes customer doesn't want to go to bank; it is too far, he wants facilities at his door steps or nearby. The agents do not provide services at door step but may be 50 yards away. But ultimately the number of banking services will soon be available at doorstep, once the public starts using m-banking facilities.

BRR: Can you give an example of a successful branchless banking model around the world?

IA: There are so many of them, among them famous is M-PESA in Kenya and GCASH in the Philippines. And there are some operatives in Mexico, who have done a wonderful job, and also Brazil. These two countries are quite comparable to Pakistan; they have huge land mass, like ours, somewhat similar population structure but with better literacy rate and higher per capita income.

A large number of migratory workers in these countries and in Pakistan work in urban areas with their dependent families living in the rural areas. They have the needs for banking services for their families and the solutions are mobile phones.

BRR: There is an impression in certain quarters that banks might not like to enter into m-banking, because it might be less profitable in terms of margins per customer. What is your view?

IA: It's not easy to provide banking services through branchless banking. But any bank that develops infrastructure and takes lead will set the market.

This reminds me of one story; some 200-300 years ago two foreign shoemaking companies sent their representatives to the sub-continent. The representative of one company went back and said that there is no market since nobody wears shoes there. While the representative of second company went back and said that there is huge market, because nobody wears shoes. So a lot depends on your view and your will.

It is not possible for every bank to provide branchless banking model. But, I am very hopeful that more branchless banking services providers will come into market. Each bank that jumps into this business has to find its own niche and the potential is huge since we are a country of 180 million people with majority of unbanked.

BRR: Is branchless banking profitable; how long will it take to reach the breakeven?

IA: On per transaction basis it is profitable. But since infrastructure cost is very high, operators will start making profit when the volume of transaction will grow.

But banks are not providing one service; they have a basket of products. There might be few products that are not making profit, but, branchless banking gives them outreach and helps them the regulatory target of financial inclusion.

BRR: If bank branch and the bank's retail agent are present in one village, don't you think that customer will go to branch?

IA: It is the customer's personal decision, but going to the branch will likely require higher transportation cost because of the higher number of branchless agents. If it cost me Rs50 to go to bank branch and Rs20 to a branchless agent, I will go to agent. We cannot control prices; our objective is to provide services. It is now up to the customer. More importantly, it is customers' psychological mindset that they feel it more convenient to go to retail shop as compared to decorative bank branch.

BRR: Since branchless banking deals with the least sophisticated and uneducated customers, what steps have been taken to balance consumer protection regulation with financial inclusion?

IA: The regulation has made it mandatory for any bank that wants to set-up branchless banking framework to have a consumer protection mechanism in place. Consumer disagreement and complains have to be addressed by bank instantaneously. Banking service provider will be given no relaxation as far as consumer protection is considered.

However, to educate customers, we have embarked on a training programme in unbanked areas to educate the customer through stage show; presentation etc, as customer literacy and awareness are the prime issues. But, we have not achieved a lot, as we are in initial phases.

BRR: What sort of branchless banking products are coming in the market?

IA: So far it is the usual ones -- remittance products, utility bill payment facility and account opening, mobile phone top ups. Initially there will be very basic services. But if say for example tomorrow Tameer decides that they want branchless banking model to lend money they can easily launch loan products with SBP's approvals. However, the industry is at nascent stage, it may take one or two years for loan products to come in market.

BRR: What are you currently working on?

IA: We are currently working on developing inter-operability model. In this regard, we are working with the Pakistan Telecommunication Authority. This will provide a medium to banks and telecom companies to conduct business transaction with each other through third party service provider.

It will develop technical platform that will act as a hub to facilitate & route financial transactions, which is not available at the moment. For instance, if you have an account with UBL then you will be able to transfer money to a person who has an account with HBL. Moreover, if you have an account with UBL Omni's retail agent then you will be do transaction with Easypaisa's retail agent.

BRR: What are prospects of using mobile to deliver financial services to unbanked customers?

IA: We are very optimistic because there are 100 million SIMs floating around. Everybody has a mobile phone. So that's the ultimate target and we want people to use mobile to conduct financial transactions.

If people get educated and understand mobile transaction they would develop confidence in this medium. Mobile will be one of the main tools to provide banking service. It is the main foundation, as there are 12,000 post offices, 10,100 bank branches, 500,000 agents, but there are as many as 100 million mobile phone subscribers.

Profile: Syed Irfan Ali

Currently working as the Director Banking Policy & Regulations Department (BP&RD) State Bank of Pakistan Irfan oversees the implementation of the existing policies & regulations in the banking industry of Pakistan.

Irfan has vast experience in wide range of policy & regulatory issues pertaining to financial institutions. He has also been involved in issuing Branchless Banking Regulations for Financial Institutions in Pakistan, and is leading the State Bank of Pakistan's team on Branchless Banking.

Irfan, who received his MBA degree from Lahore University of Management Sciences, also holds a Masters degree in Banking & Finance from University of Wales.

How Pakistani banks are aggravating **income inequalities**

Ashraf Janjua

It is well known that income distribution in Pakistan is highly skewed. Nearly 40 percent of the people (about 70 million) are living below the poverty line.

While healthy developments, such as a dramatic increase in home remittances during the past decade are making a dent on poverty in many ways, the country's financial system comprising of nine categories of financial institutions and financial markets, dealing with resource mobilisation and resource allocation, are, by and large, serving the interests of population other than the disadvantaged class.

This article takes a look at how the principal components of the financial system, namely commercial banks, are aggravating the income inequalities in the country.

It needs to be understood that the banking sector in Pakistan is characterised by a lack of both breadth and depth. In a population of 175 million, the number of account holders in banks is 25.23 million or about 14.5 percent of the population, and borrowers are only 4.25 million or 17 percent of account holders and 2.4 percent of the country's population.

Total bank deposits, at Rs. 4,352.7 billion, are about 29 percent of the GDP. The number of bank-cheques issued everyday is about 30,000 as against 96,000 in Sri Lanka, a comparatively small economy. In this situation, the benefits of banking services are largely going to the well-off urban classes.

Corporations in Pakistan have the advantage of relatively easy access to bank borrowing, which can be rescheduled under difficult conditions and not infrequently written off.

Aggravation of inequalities through the banking industry is reflected in the structure of deposits and advances (loans) as well as such aspects as loan write offs and non-performing loans etc.

STRUCTURE OF DEPOSITS

Take a look at the Figure 1, which indicates the structure of deposits in the country as of December 2009. The table shows that:

1. Deposits in the individual accounts of Rs5,000 or less, totalling around Rs5.62 billion, are held by 2.14 million account holders or 8.4 percent of total account holders.
2. Those holding deposits worth Rs100,000 or less are about 19.05 million or 75.57 percent of the total deposit holders. Their share in total deposits is 15.88 percent.
3. Holders of deposits at Rs0.5 million or less account for 38.93 percent of total deposits and their number is 24.45 million or 96.9 percent of total deposit holders.
4. Those holding deposits worth Rs10 million or above are only 0.107 percent of total depositors and account for 36.45 percent of total deposits.

Figure 1: Structure of Deposits

	Number of account holders		Deposits	
Size of Account	million	(% of total)	Rs (million)	(% of total)
Less than Rs5,000	2.143	8.40	5,626	0.13
Rs100,000 and less	19.05	75.50	691,458	15.88
Rs500,000 and less	24.45	96.90	1,694,887	38.93
Rs10 million or more	0.027126	0.107	1,586,439	36.45

The above deposit structure clearly shows that a fairly large chunk of bank deposits belongs to the relatively poor class who are getting a very small rate of interest. The average rate of return on deposits as of end December 2009 was 6.14 percent and highly negative in real terms.

STRUCTURE OF BANK ADVANCES

Figure 2 shows the structure of bank advances as of December 2009.

Figure 2: Structure of Bank Advances

	Number of Accounts		Advances	
Size of Account	units (in million)	(% of total)	Rs (in million)	(% of total)
Less than Rs5,000	0.097668	2.30	122	0.00
Rs50,000 or less	1.59	37.40	37,106	1.16
Rs100,000 or less	2.84	66.00	132,106	4.14
Rs0.5 million or less	4.013	94.20	353,497	11.07
Rs10 million or less	4.227	99.35	787,654	24.70
Rs10 million and above	0.027612	0.65	2,404,237	75.30

The above data are an unmistakable evidence of who is benefiting from the banking sector. It appears that the benefits of the banking sector are meant only for the privileged classes. More specifically, the latest available data shows that there are 4.255 million borrowers with total outstanding advances of Rs3.1 trillion.

No less than 75.3 percent of these advances were made to only 27612 borrowers, just about 0.65 percent of the total borrowers. Those borrowing five million or more are about 45133 or 1.06 percent of the total borrowers who account for 79.14 percent of total bank advances. Conversely, those borrowing Rs500,000 and less, equalling 94.2 percent of total borrowers, availed only 11.07 percent of bank credit.

While it is true that these big borrowers are making investments and generating production and employment, the fact that credit is concentrated around just 1 percent of borrowers who make use of nearly 80 percent of bank borrowing cannot be ignored.

At this point, a number of relevant factors need to be kept in view.

First of all, in Pakistan the corporate sector is virtually exclusively dependent on banks to finance their business activity. Unlike other countries, the corporate sector in Pakistan has hardly issued any bonds or debentures.

Corporations in Pakistan have the advantage of relatively easy access to bank borrowing, which can be rescheduled under difficult conditions and not infrequently written off. The burden of such borrowing is on depositors who get negative real rate of return on their savings.

The impact of non-performing loans is also on the depositors since provisioning for such loans is made out of bank profits which in principle should be distributed among depositors.

Similarly, the banking business is skewed against the small borrowers. According to central bank data, a total of Rs74.384 billion was written-off by the banks during 2008 and 2009. Of the amount written-off, those who had borrowed more than Rs0.5 million benefited to the extent of Rs4.4 million per borrower, whereas those who had borrowed less than Rs0.5 million benefited only to the extent of Rs81,000 per borrower.

Borrowers of Rs0.5 million plus had Rs4.4 million written off per borrower, whereas those who had borrowed less than Rs0.5 million benefited only to the extent of Rs81,000 per borrower.

The impact of non-performing loans is also on the depositors since provisioning for such loans is made out of bank profits which in principle should be distributed among depositors.

This then poses an important question: why are depositors keeping their savings in banks if the rate of return is negative in real terms. The answer is that nearly 80 percent of bank deposits (demand deposits and time deposits with maturity of six months or less) are placed with the banks not for profitability consideration but for liquidity consideration. And the banks are making full use of this consideration and exploiting depositors.

The writer is the former Deputy Governor (Policy), and Chief Economic Advisor of the State Bank of Pakistan. Among other research work, he is the author of History of the State Bank of Pakistan Volume-III (1977-88) and Volume-IV (1988-2003). He can be reached at ashraf.janjua@iobm.edu.pk


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