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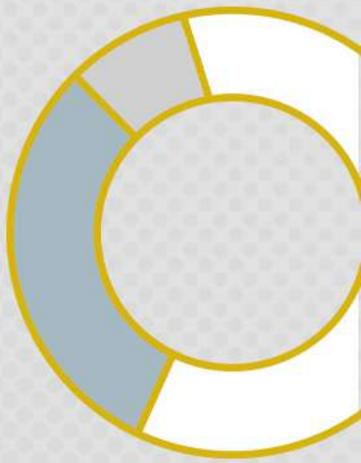
BANKING ON OUR BANKS

ALIGNING GROWTH WITH DEVELOPMENT



A. PAKISTAN BANK'S PRODUCTIVITY CHALLENGES

The banking sector in Pakistan employs a significant proportion of educated white-collar individuals, playing critical roles in capital formation, documentation, and digitization of the economy via automation of payments, remittance systems, and provision of liquidity. Banks serve as implementers of monetary policy; help improve national savings rates and facilitate international trade and private-sector credit. For any country in emerging, frontier, and developing markets, economic growth, and improvements in quality of life and standards of living, are not possible without an active, healthy, and growing banking sector, because the banking multiplier effect continues beyond money supply.[1] As a nation, we are only as competitive as our banking system.

Between 1992 and 2002, the banking sector in Pakistan went through an ownership transition transferring management control from the state to the private sector. In the first ten years after that transition, new ownership helped troubled banks become efficient. Banking profitability rebounded from historic lows as banks cut fat, restructured loans, refocused lending, and automated operations. By 2024 banking sector metrics for profitability, capital stock, branch networks, technology automation, service quality, branding, stability, and product range had improved dramatically, compared to early 2000 benchmarks. In 2024, we have same-day check clearing for checks above PKR 300,000, seventeen million mobile banking users, instant zero-cost IBFT transfers through the SBP RAAST network, digital bill and tax payments, tap and pay point of sale infrastructure, a nationwide network of ATMs and sixty million debit and individual payment card accounts.

Today, the banking sector in Pakistan faces a different set of challenges. It is not enough to look at how far we have come in twenty years. That benchmark is no longer relevant. Pakistan's economic profile has changed and will continue to change as our industrial base retools to become more competitive. The corporate and consumer client base has different needs and demands. There is a growing share of services and technology exports as a percentage of goods and services exports. Can the banking sector respond to these changes and demands?

As part of our recent work, we delved deeper into the following questions.

- How productive is the banking sector in Pakistan?
- How competitive are our banks when compared to regional benchmarks?
- Where are the largest gaps in the banking sector business model?
- How do we address these gaps?
- Is a change required in the role of the banking sector in Pakistan's economy?
- How would such a transition help economic growth at the national level?

1 Thaçi, L. (2023). Bank Loans Types and Economic Growth-Literature Review.

Banking remains the largest player within Pakistan's services sector. Productivity improvements within the banking sector have a multiplier effect across the economy.[2] Re-energizing banking and making the sector grow in real terms translates directly into real GDP growth for Pakistan.

ARE WE COMPETITIVE?

To examine productivity and competitiveness we looked at banks with two separate lenses. The first lens was local. We identified a pool of six leading banks in Pakistan. For each local bank, we evaluated contributions to the national economy, profile, growth, focus, network, and approach to executing the mandate of their banking license. We then picked one bank to represent this group of leaders.

For our second lens, the selected bank was compared to four regional peers from three similarly placed countries. The second lens provided a competitive benchmark across geographies; two banks from India, and one each from Bangladesh and Indonesia. The comparison mechanism was growth, profitability, productivity, and return on capital measured in USD terms. The dataset used was twenty years of published consolidated financial statements. We picked India, Bangladesh, and Indonesia because of our shared colonial pasts, demographic trends, cultural and social profiles, and economic challenges.

The representative bank selected from Pakistan was HBL.[3] One competitive benchmark from India was HDFC Bank. In 2004, HBL had **higher net advances** and comparable net assets and total assets when benchmarked against HDFC Bank. HBL's net advances in 2004 stood at USD **4.4 billion** compared to HDFC's USD **3.9 billion.** Net Assets for HBL stood at USD **548 million** to HDFC's USD **595 million.**

Eight years later in 2012, the difference between the two banks on these metrics had increased from 1x to 7x. In 2004 the two banks were comparable. In 2012 they were in two different leagues. In eight years HDFC grew at 7x the rate compared to HBL. In 2024 the two banks are no longer comparable.

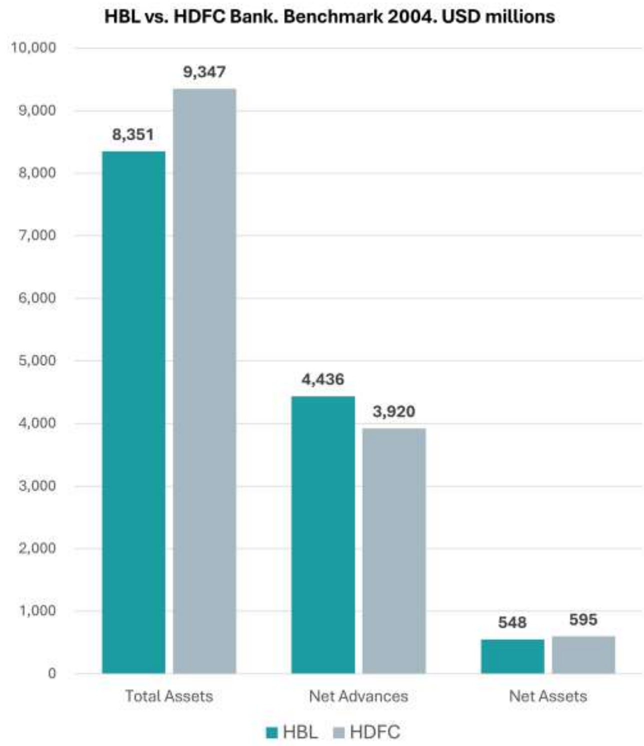


Figure 1 - HBL vs HDFC Bank. The 2004 benchmark comparison

In 2004, HDFC Bank contributed twice the amount in local taxes in USD terms compared to HBL. In 2023, HDFC to HBL's tax contributed multiple was 10x, 83% of the total tax contributed by the entire Pakistani banking sector.

HDFC's total assets in 2023 stood at 15x HBL's total assets. Net advances stood at 30x HBL's net advances. Eleven years earlier in 2012, this differential was 3.7x for total assets and 7x for net advances.

How did this happen? What could explain this dramatic difference in growth on the part of HDFC and the absence of the same growth for HBL?

2 Ismail and Masih (2015). Causality between financial development and economic growth, and the Islamic finance imperative: A case study of Indonesia. https://mpra.ub.uni-muenchen.de/65831/1/MPRA_paper_65831.pdf

3 HBL was the largest bank of the six banks selected for our study. It had the broadest exposure to all sectors of Pakistan's economy, a national branch network, a diverse credit portfolio, and a consumer-friendly focused approach compared to the other banks in our sample.

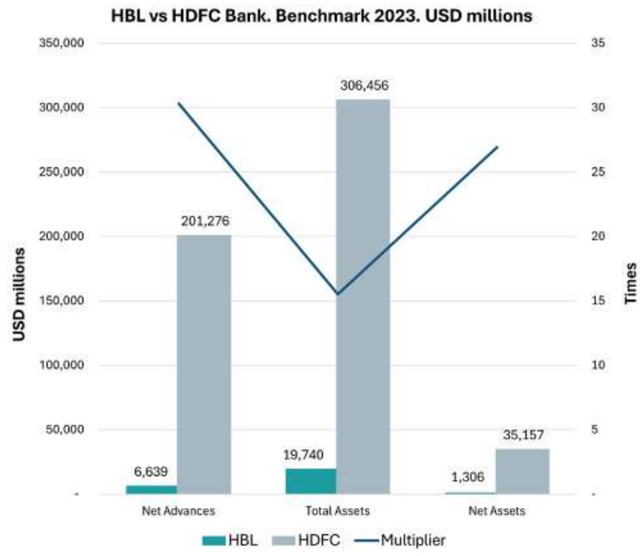


Figure 2 - HBL vs HDFC bank. The 2023 benchmark comparison

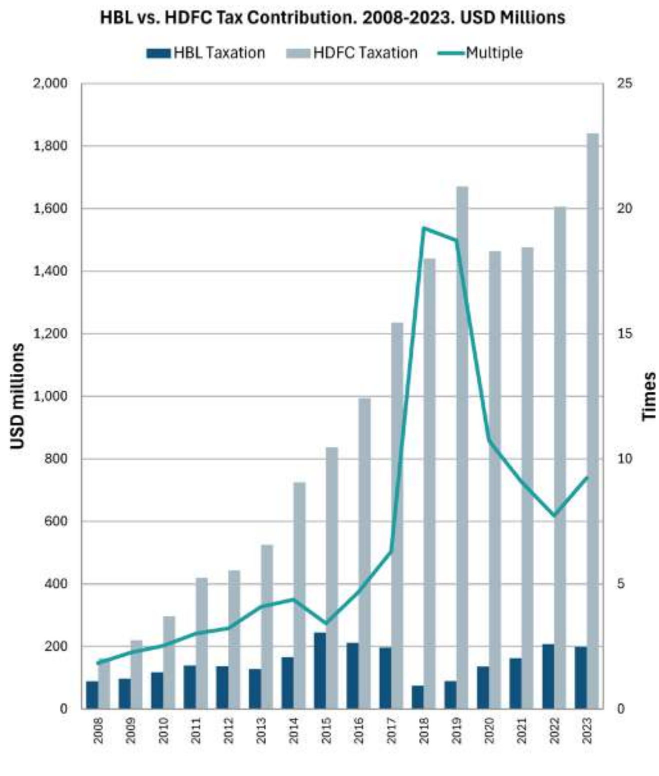


Figure 3 - HBL vs HDFC bank. 15 years of tax contributions in USD equivalent amount.

WAS IT TALENT?

HDFC's founding team and HBL's turnaround teams both came from Citibank.[4] The same banking network and franchise trained Aditya Puri, Shaukat Tareen, and Zakir Mahmood. They all spent time with Citi in Europe and APAC.[5] Both banks borrowed heavily from the talent pool of the region's Citibank and SCB.

WAS IT CAPITAL?

HBL was acquired by AKFED, the Aga Khan Foundation for Economic Development which has never been short on capital. In the same year as the HBL acquisition, they also acquired Commercial General Union Life's operations in Pakistan, a CGU insurance subsidiary.

There is a common argument on the relative size of the Indian economy, the depreciation of Pakistan's currency against USD in the period being examined, and the benefits of political stability provided by three consecutive terms of the BJP government in India. These factors themselves don't explain the growth differential between the two banks. The USD-PKR depreciation was 2.6x in quantum to the USD-INR depreciation over 20 years.[6] In 2004, Private sector banking assets in India were only 2x the size of Pakistani private sector banking assets.

Currency depreciation and devaluation do not sufficiently explain a 30x differential in 2023. Neither is the size of the Indian economy. Even when we adjust for both factors, HDFC still outperformed HBL by 6 times in terms of advances and 3 times in terms of total assets. ***One Indian Bank grew to be larger and more relevant than the entire banking sector in Pakistan.***

There is more to the growth equation than comparing a Pakistani bank with an Indian bank, especially HDFC. The same trends repeat when we extend our analysis to Bangladesh and Indonesia and compare HBL to BRAC Bank (Bangladesh) and Mandiri Bank (Indonesia). HBL's performance lags against all four regional competitors.

4 See, Keep it simple, McKinsey & Company, December 2020, https://www.mckinsey.com/industries/financial-services/our-insights/keep-it-simple-aditya-puri-on-hdfc-banks-path-to-market-leadership
5 Asia-Pacific
6 The cumulative depreciation factor, measured as the FX exchange rate for 2023 divided by the FX exchange rate for 2004, for USD-PKR was 4.80 times, whereas it was 1.82 times for USD-INR.

BRAC bank was **2%** the size of HBL's total advances in 2004. In 2023, BRAC's stands at **75%** of HBL's book. In 2004, Mandiri's net advances stood at **2x HBL.** In 2023, the number is **13x.**

What is holding our banks back? Domestic economic overhang, or a more deadly disease?

PAKISTAN'S HISTORICAL BAGGAGE?

Much is said about Pakistan's unique baggage when we draw regional comparisons. To be fair while Pakistan has had multiple challenges in the period under study, from a banking regulation perspective, the Pakistani central bank has been rated, perceived, and viewed as progressive, forward-looking, and better managed compared to the three regional central banks in India, Indonesia, and Bangladesh.

The Indian government executed a contentious de-monetization[7] program in 2016, ignoring the objections of the central bank governor and its chief economist. The move cut a full percentage point from Indian GDP growth in 2017. India was slow to adopt the Bank for International Settlements (BIS) risk capital and capital adequacy regulations when they were introduced in 1996. Less than robust lending standards led to rising non-performing loans and bank failures. In the ten years between 2010 and 2021, the Indian government injected over USD 57 billion into public sector banks to cover capital losses associated with fraudulent and nonperforming loans.[8]

Indonesia created Bank Mandiri from the ashes of the Asian Financial crisis in 1997. The country and the banking system executed a remarkable turnaround but the events leading up to the crisis weren't flattering for the banking sector's reputation or that of its regulator. In 2016, Bangladesh's Central Bank was the target of a billion-dollar SWIFT heist[9] by North Korean hackers that resulted in the resignation of the Governor of the Central Bank. Bangladesh like Indonesia and Pakistan is also no stranger to political instability, corruption, domestic terrorism, religious intolerance, and exchange rate depreciation.

Comparatively, retired Pakistani central bankers, Dr. Yaqub, Dr. Ishrat Hussain, Dr. Reza Baqir, and Dr. Murtaza Syed are respected within and outside the country for their roles during their tenures at the central bank. Pakistan's central bank's Covid response in 2020-21 was perceived as proactive and timely by local bankers, businesses, and consumers. Pakistan was also at the forefront of implementing BIS capital adequacy guidelines in emerging and frontier economies before the 2008 financial crisis, ahead of OECD members, like Saudi Arabian Monetary Agency (SAMA) and Asia-Pacific regulatory framework leader, Monetary Authority of Singapore (MAS). In 20 years, despite multiple and significant economic shocks to the system, no Pakistani bank has publicly failed or suffered a loss or a write-down of customer deposits.[10] Over thirty years, the State Bank of Pakistan (SBP) has acquired a hard-earned reputation of being a responsive consumer protection-focused central bank.

The exchange rate stability perspective is more ambiguous. From January 2003 – April 2008, in the backdrop of the US invasion of Afghanistan, Pakistan experienced ample liquidity, currency stability, economic growth, and the emergence of a thriving consumer finance business. Large-scale manufacturing grew as did foreign direct investment, international trade, and exports. While January 2013 – June 2018 was challenging from an economic policy perspective, Pakistan did experience currency stability in that window for 5 years. Combined with the earlier 2003-2008 era, half of the time frame under study, the USD-PKR exchange rate was relatively stable.

7 A year after India killed cash, Bhaskar Chakravorti, World Economic Forum and HBR, Nov 2017. https://www.weforum.org/agenda/2017/11/a-year-after-india-killed-cash-heres-what-we-can-learn/

8 Privatization of public sector banks in India, WP 141, Poonam Gupta, et. al, National Council of Applied Economic Research, August 2022.

9 The billion-dollar bank job, Joshua Hammer, 3 May 2018, New York Times, https://www.nytimes.com/interactive/2018/05/03/magazine/money-issue-bangladesh-billion-dollar-bank-heist.html

10 The benchmark Pakistani bank HBL used in this paper was fined USD 225 million dollars by the NY Department of Financial Services (NYFSD) for money laundering violations mainly on transfers to and from the Kingdom of Saudi Arabia. NYFSD fines HBL, Sep 2017. https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1709071

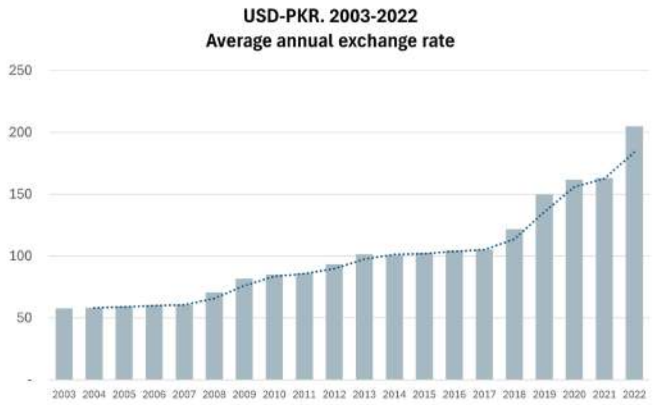


Figure 4 - USD-PKR exchange rate with moving average trend line. 2003 - 2022

The challenges Pakistan has faced over this time horizon are by no means unique when compared to India, Bangladesh, and Indonesia. It won't be unfair to say that Pakistani banks had significant advantages, especially in the earlier years of our comparison window. Banks from India, Bangladesh, and Indonesia grew at respectable rates despite their domestic operating environment. On a relative basis, Pakistani banks did not do as well, irrespective of the advantages they enjoyed over the same time frame.

Do we have any indication of why these growth and performance differentials exist?

THE DISEASE.

At the heart of the Pakistan banking sector productivity paradox is the mandate for the banking license. The objective of a banking license is to facilitate:

a. Financial intermediation by providing a safe harbor for deposits and savings,

b. Tackle informational asymmetry in credit allocation and lending business,

c. Apply underwriting and collection standards to allocate credit and reduce loan defaults,

d. Curate and direct credit to sectors and segments that are likely to pay it back,

e. Deploy private risk capital to provide a layer of first losses against loan defaults,

f. Provide services in payments, domestic transfers, remittances, trade, and international exchange of value.

When we compared operating models between Pakistani, Indian, Bangladeshi, and Indonesian banks, we found one key area with wide divergences - the **Advance to Deposits** ratio or **ADR.** The ADR of a bank is an indicative metric that shows what part of deposits have been used to finance loans. A higher and stable ADR along with low nonperforming loans is an indication of a healthy credit function. In the comparison period, ADR for Pakistani banks was significantly lower than the regional benchmark. Pakistani banks were taking customer deposits but were not lending to borrowers. This was true for all six banks reviewed for our research. For example, the leading foreign bank in Pakistan, i.e. SCB, had an average ADR ratio less than half the size of the average ADR of regional banks in our sample pool.[11]

Why is this a challenge? Rather than lend to risky creditors, if banks invest customer deposits in government securities or domestic debt guaranteed by the state, why should that decision impact long-term growth at these banks? Isn't government debt a safe bet?

Here is a five-part answer to this question.

I. Banks raise deposits from savers and lend them to borrowers to create value for customers, borrowers, and shareholders. If banks borrow money but don't lend, they shortchange the cycle. Of the banking mandate above, banks in Pakistan do (a) and (f) but don't do enough of (b), (c), (d) and (e). The benchmark banks in India, Bangladesh, and Indonesia do. Pakistani banks don't.

II. When banks don't engage and participate in the lending cycle, they don't just shortchange borrowers, they also short-circuit the growth equation both for the economy and themselves.

III. Private sector credit earns a higher spread compared to government lending. It allows banks to become specialists in specific industries and sectors, reducing their cost of acquiring, servicing, lending, and collecting from new customers. It makes them curators, advisors, partners, and guides for identifying and selecting "bankable ideas". Ideas where credit allocation

11 An average of 92% over 2012-2023 across the 4 regional benchmark banks versus an average of 38% over 2012-2023 for SCB (Pakistan) and 44% for HBL.

is likely to lead to value creation for business owners, society, and banks. They can do this well because over time they become aggregators and interpreters of private business information that is not publicly available or shared.

IV. Banks are no longer held hostage to what the state feels is a fair return on risk but use the market to better price and allocate risk capital. As convenient access to credit helps customer balance sheets grow, bank balance sheets grow with them as customers come back with larger financing needs. This is part of the growth equation because banks can now lend on their terms to the businesses and customers they understand.

V. On what is safer? Government debt or private sector credit? Ships are safe in harbors and ports. But that is not what ships are made for. The banking license mandate requires the facilitation of credit. When banks walk away from that responsibility, they devalue the banking license.

As Abbas, Christensen[12], concluded in their 2007 paper based on a 29-year study of 93 emerging, frontier, and low-income countries, domestic (government) debt contributes to economic growth and value when it bears positive real rates, is marketable, and is held outside the banking system. Banks holding more than **35% of bank deposits** in domestic debt crowd out private-sector lending, reduce banking efficiency, and undermine long-term growth.

How big is the ADR divergence between Pakistan's banks and our regional benchmarks?

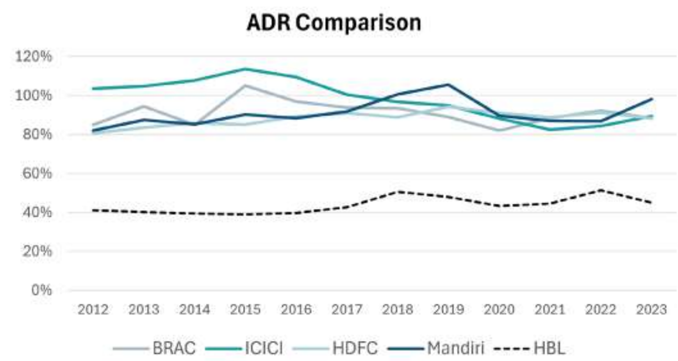


Figure 5 - ADR comparison between HBL and regional benchmarks

Where do Pakistani banks invest if they are not lending to creditors?

Pakistan's banks invest in safe government debt securities. In HBL's case across 11 years ADR averaged less than 45% while the ratio of investments in domestic debt over deposits averaged over 50%. But how do we know that this impacts banking productivity and efficiency? Do we have any evidence that suggests this?

One measure of banking efficiency is the cost-to-income (CTI) ratio. It compares non-interest expenses to a bank's net interest income and other income. A lower cost-to-income ratio is better. We see how HDFC leads all other banks in this dataset and how HBL has transitioned into a higher cost-to-income ratio rank without realizing the benefits of those additional expenses.

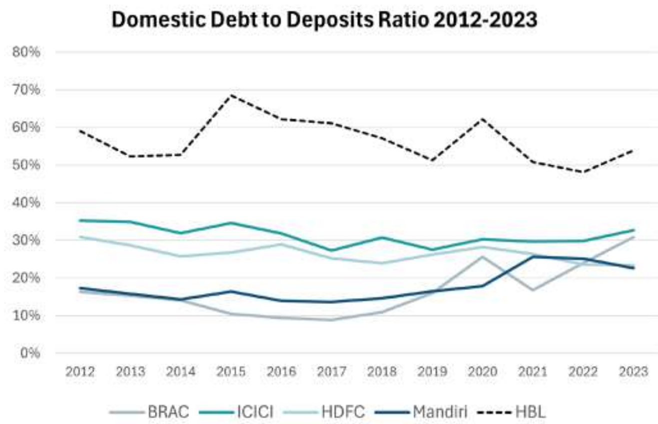


Figure 6 - Domestic debt to bank deposits. HBL vs regional benchmarks

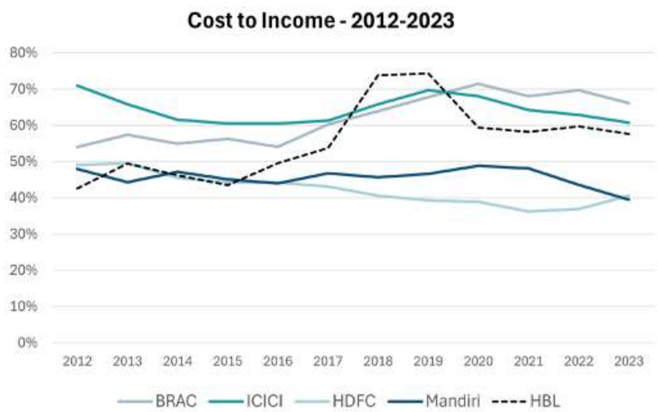


Figure 7 - Cost to Income ratios. HBL vs regional benchmarks

12 Abbas, Christensen (2007). The role of domestic debt markets in economic growth, IMF WP 07/127.

However, higher cost-to-income ratios could be attributed to higher expenses and lower income. We ran a similar analysis on employee productivity, branch productivity, fixed assets, and unit expense productivity and the plots remain dismal. Given the established context one may ignore metrics for advances-per-employee and advances-per-branch and instead focus on deposits-per-employee, or deposits-per-branch. Even with such a curated selection of metrics, HBL's performance lags behind its competitors. Younger, newer, and smaller banks like BRAC from economies like Bangladesh which have a smaller footprint than Pakistan lead HBL when it comes to simple metrics like average deposits per branch.

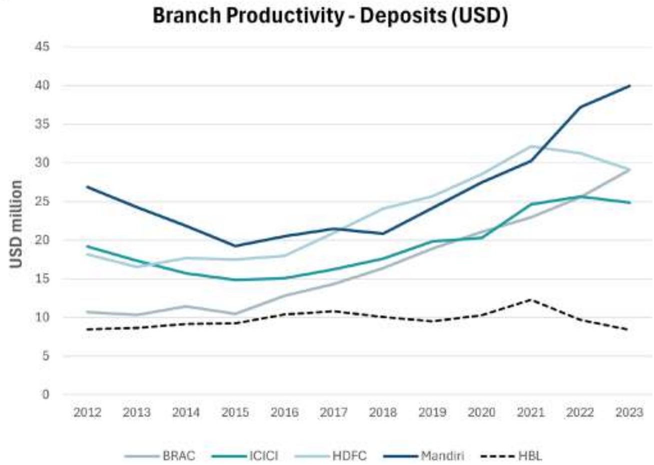


Figure 8 - Branch productivity. HBL vs regional benchmarks

Would it help if we switched banks? If we used a different bank than HBL for our comparisons? During our research, we looked at the best-performing Islamic Bank, the best-performing foreign bank, the best SME bank, the best Trade Finance Bank, and the nearest competitor of HBL. The metrics don't change. While HBL has its' challenges, within the pool of six banks, in overall performance, it remains a better-performing Pakistani bank. This suggests a not-so-positive conclusion. The disease is endemic and symptomatic of a much deeper malaise.

What do we mean by deeper malaise? There are two indicators of the banking sector's effectiveness. One is private sector credit. The other is cash in circulation as a percentage of GDP. When the banking sector plays its due role, private sector credit as a percentage of GDP should be a rising trend and cash in circulation should be flat or declining.

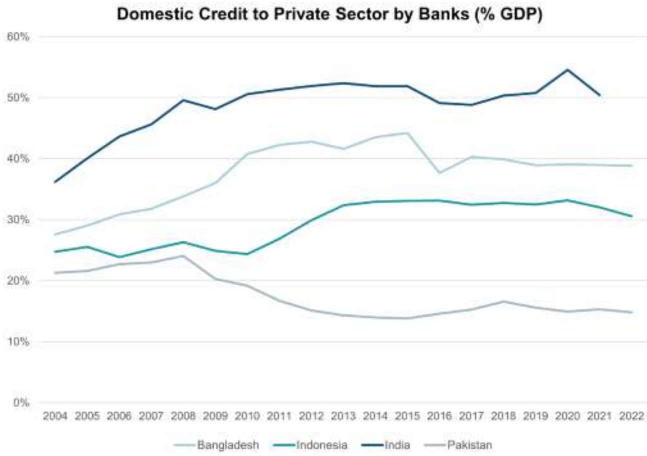


Figure 9 - Private sector credit. Pakistan. 2004 – 2022.
Source: World Bank Group

The plot above compares the trend in private sector credit for Pakistan, Bangladesh, Indonesia, and India. The plot below does the same for cash in circulation as a percentage of GDP. The trends are the opposite of what would be considered a healthy relationship or an effective banking sector. If Pakistan's banking sector effectiveness was a course at a business school, or measured against effectiveness OKRs[13], the sector would receive a failing grade.

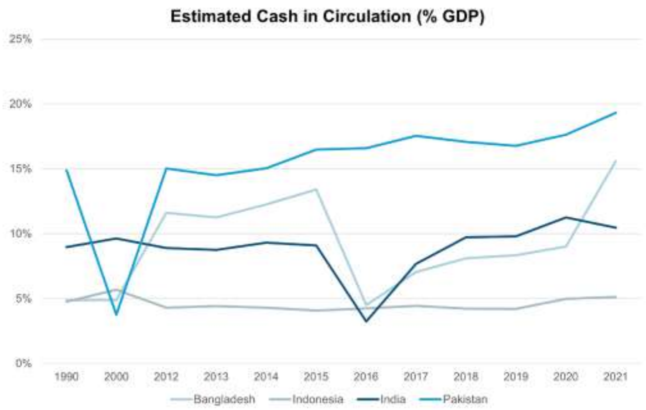


Figure 10 - Estimated cash in circulation as a percentage of GDP . 2000-2021. Source: World Bank Group

As is the case for complex economies, there are confounding factors that should be addressed. One is taxation rates and their inverse relationship with digitization and formalization efforts. India and

13 Objectives and Key results. A business framework for setting objectives and measuring progress by tracking effectiveness in achieving results.

Indonesia have had higher tax rates in place for 20 years. Pakistan has recently started to explore higher rates of taxation. Higher taxes aren't a factor in the period under review. There is a trade-off between tax rates and formalization. It is an incentive game. When incentives for being part of the formal economy outweigh the incentives of avoiding taxation the math works, as it does in Indonesia, India, and Bangladesh. It should work in Pakistan too.

The other is the state's debt burden. In 2003-4 awash with liquidity from USAID, exports to rebuild Afghanistan, and rising remittances, the central bank limited issuances of 10-, 15-, 20- and 30-year paper. Yields on the Pakistan 10-year bonds traded at 3.99%[14], lower than treasury yields on US 10-year bonds in September 2003.[15] There was no need or demand from the state for banks to invest in government paper. But that is exactly what banks did then, too.

PERFORMANCE IS A CHOICE.

Whether it is employee, branch, or capital productivity, HBL as a representative of Pakistan's banking sector flatlines when compared to regional competitors. Using a different bank for comparison would not change the results or conclusions we have reached.

Performance and competitiveness are a choice. One that is actively made and chased. It cannot be achieved on a passive basis. The analysis indicates that it is not the choice Pakistan's banks have made. There is no special national regulatory burden that has held us back. That is just an old excuse. The countries we have compared Pakistan to have had significantly harder challenges. Their banks still lead Pakistani banks despite these challenges.

What is Pakistan's challenge? We believe it is groupthink. When everyone is thinking the same thing, no one is thinking at all. Pakistani bankers argue that original thinking, innovation, and cutting-edge products or technologies are not a part of the banking mandate. The banking mandate is to safeguard depositor funds and invest them keeping safety in mind. If the machine is making money, is not at risk, and is not broken, why fix it?

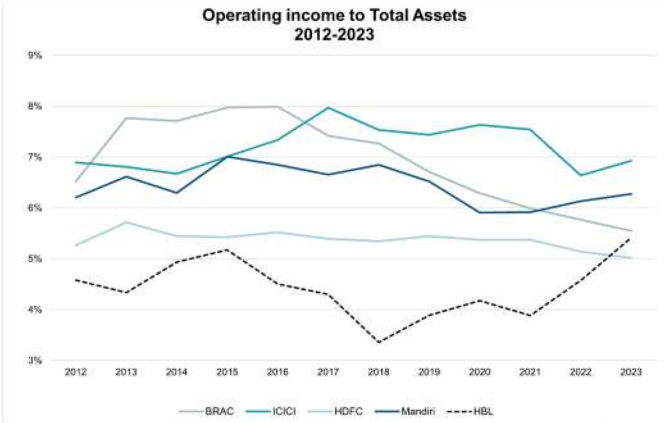


Figure 11 – Pakistan banking scorecard. HBL's operating income to total assets ratio against benchmark banks. 2013 - 2023

Banking profitability in PKR and USD terms is not our challenge. The challenge is relative performance. Pakistan is suffering from a banking mutation of the Dutch disease.[16] On an Operating Income to Total Assets[17] (RoA) basis HBL underperformed the best banks in our benchmark pool by **300 basis points** across eleven years. Operating Income to Total Assets is another measure of performance and banking effectiveness. Consider it a proxy for value creation or the size of the net banking spread. Now wear the shareholder value hat for a second. Given the size of net banking spreads, Pakistani banks left **50% of the value** of their banking franchise on the table by making **"safe"** choices.

We need to fix business models when they fail to uphold reasons for the existence of a banking license. We need to change our mindset when regional banks once the same size as our banks grow to be 30x larger while our banks barely move the needle. We need to evaluate new metrics and benchmarks to measure performance and growth because the old ones are no longer relevant or helping. Without banking playing the roles it needs to play, we will not find our path to productive growth as a nation.

14 https://tradingeconomics.com/pakistan/government-bond-yield
15 https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value=2003
16 Back to basics, Christine Ebrahim-Zada, IMF F&D, March 2003, Volume 40, Number 1, http://www.imf.org/external/pubs/ft/fandd/2003/03/ebra.htm
17 Defined as (Total net interest income + total non-interest income) / total assets.

B. RECOMMENDATIONS FOR PRODUCTIVE GROWTH

WHY NOW?

Why is now the right time to have this conversation?

On September 5, 2006, SCB Pakistan announced the acquisition of Union Bank for US$ 487 million. It was the transaction that opened the season on banking mergers in Pakistan culminating with NIB's acquisition of PICIC (2007), ABN Amro's acquisition of Prime Bank (2007), Sinthos Capital's purchase of Saudi Pak Bank (April 2008) and May Bank's strategic investment stake of 20% in MCB for US$ 900 million (2008) in two separate tranches.

The thesis behind the list of transactions? Banking spreads, rising profitability, attractive valuations, growing rupee liquidity, and the belief that a bank in Pakistan represented the opportunity to find an HDFC /ICICI Bank at cheaper multiples. There was a time in the not-too-distant past when Pakistani banks were considered attractive investments.

A year later NIB (PICIC) and Silk Bank (the renamed Saudi Pak Bank) were in trouble as credit spreads soared, the economy tanked, rupee liquidity disappeared, demand went south and fuel costs, electricity bills, overheads, and USD-PKR exchange rate all headed north. The cycle had turned, and the thesis soured.

Acquirers initially wrote off the goodwill booked on their acquisitions and then closed the books on their credit portfolios. With Union Bank, SCB had added 20,000 SME customers to its credit rolls. Nine years later the number was down to 40. ABN AMRO first became RBS and in less than three years was sold off to Faysal Bank for a quarter of the price (22% or USD 50 million) ABN AMRO paid for Prime Commercial Bank. NIB burned through $400 million of capital before running aground and being acquired by MCB. May Bank's strategic 20% shareholding in MCB which cost US$ 900 million was written down to $195 million in 2024. By the same measure, Fullerton Financial's $400 million investment in NIB was worth $50 million in 2024, 17 years from their original investment decision.

SCB, NIB, ABN Amro, Silk, and Maybank all bet on Pakistan's banking sector. The first four bets were bets on SME and retail customers. The 5th bet was a broader wager on banking's ability to make a dent. It is troubling that across 18 years the sector repeatedly humbled investors.

While the first part of our paper focused on banking profitability drivers for big banks, the historical context above reminds us that banking is not for the faint of heart. Especially in Pakistan and even more so for foreign investors, except for NIB and Silk Bank which were run by local executive teams. These were the stories from the other side of the table.

Also, the old joke. How do you become a millionaire? Become a billionaire first, then buy a bank in Pakistan - the easiest way to burn through a few billion dollars of investor capital.

Recommendations and strategies are easy. It is execution and implementation where SCB, ABN, Fullerton, May Bank, IFC, and Bank Muscat faltered. Not small names or new or inexperienced players. If they stumbled so badly what hope do others have in this market?

To some extent, these failures validated policy pillars that led us to where we are today - the desire to build and create safe banks. Big banks are safe banks. Manage risk by avoiding it or requiring excess capital to underwrite it. To value safety over experiments. Coupled with the post-2008 crisis mindset, capital preservation over the allocation of risk capital. Some of this was a result of the BIS Capital adequacy guidelines implemented in 2004 onwards. Others were an extension of the same mindset given the implosion of some of the largest banking acquisition transactions in our country's history.

Beyond validation, these transactions also help us understand where banking went wrong in the last two decades. SCB and NIB were scale and risk experiments that failed. Silk was a consumer banking model that succeeded but was shot down by an uncontrolled and unrealistic cost base. ABN Amro, Silk, and May bought stakes at peak valuations at a time when the original thesis was already faltering. We can't limit ourselves to studying and picking lessons up from HBL, UBL, and Meezan Bank. Core banking profitability at large banks often hides an underlying web of inefficiencies.

There is a second related trend that fed into the post-crisis mindset. It wasn't a banking model or timing issue. It was a policy directive.

In 2003, yields on Pakistan's 10-year domestic bond briefly dipped below 4%. In parallel with SCB's acquisition in December 2006, SBP auctioned the 30-year domestic Pakistan Investment Bond for the first time. The weighted average cut-off yield for the first auction was 11.68%. Two years earlier, in 2004, SBP had issued 20-year maturity debt at 8.7%. Imagine a world where we reprofiled a large portion of our domestic debt for 20 years at 8.7%. What would that sole decision have done to our fiscal profile and debt servicing costs?

But we didn't do it in 2004. The next window came around in 2015-2017. 10, 15, and 20-year yields once again dipped below 9%. We didn't do it then, too. The third window is starting to open now.

As the Government of Pakistan, the Ministry of Finance, and SBP work together to shrink the stock of outstanding domestic debt, they aim to lock in yields at the lower end of the long-term curve for 20 and 30 years.

The longer tenors are attractive for multiple reasons. Long-term debt, with its sensitivity to changes in interest rates, is not as attractive to banks as short-term paper. Long-term debt reduces the need to tap markets again and again. Regular issuance of long-term debt stabilizes the yield curve and reduces overall rate volatility. A stable yield curve serves as a benchmark for the Eurobond curve. If domestic paper is trading at 23%, at what rate would dollar-denominated debt trade in international markets? By over-emphasizing the shorter tenor, we have inadvertently fed the very cycle we were trying to fight. We have locked ourselves out of longer tenors in both the domestic and international debt markets.

The emphasis on short-term treasury bills for fiscal needs and a renewed focus on safety and avoidance of credit losses within the banking system created a reinforcing loop. Bigger was better. Safer was better. Compounding capital at the risk-free rate made more sense than risking it. In that world, all roads led to public finance, and the state willingly obliged by spending all it was lent.

We are not sure if this was a policy misstep, unintentional consequence, a collation of economic drivers, or a directed intervention. We don't currently have the data or insights to support a clear conclusion. What we do know are the consequences of these decisions.

WHAT WOULD YOU DO?

The comments we heard the most in our engagement with our friends in the banking sector were simple questions. Why don't you run the bank for a day? What would you do with the excess liquidity in our system and on our balance sheets? How would you put it to work? Where would you park it? Other than public debt?

In the first few months of Fiscal Year 2024-25, SBP bought back PKR 351 billion of treasury bills, while the Government of Pakistan (GoP) paid down PKR 1.09 trillion in SBP borrowing. The decline in interest rate by 700 basis points will reduce GoP debt servicing costs by PKR 1.3 trillion in the coming 12 months. The bulk of that PKR 1.3 trillion will come from the banking sector's bottom line as they refresh their government debt holdings.

Given the shift in interest rates and the public debt stance of the government, the "what will you do?" questions are no longer hypothetical questions. The answer to these questions will drive banking strategy for the next twenty years.

i. Digitalization and taxes.

By conservative estimates, formal frictional costs associated with the tax collection network of Pakistan amount to PKR 2 trillion every year. The PKR 2 trillion[18] represents an opportunity lost by keeping PKR 9 trillion in cash in circulation and PKR 6 trillion in current accounts outside the effective banking value chain. It does not include invisible, behind-the-scenes friction costs that we may not be able to measure with direct data. When we add these invisible frictional costs, the actual figure may be twice as high.

This is the incentive challenge digitalization must overcome. Does becoming part of the digital economy create PKR 2 trillion worth of value at the national level? For a small business to become a part of the formal economy the underlying incentive associated with being documented needs to be higher than the cost of reporting, compliance, and auditing by FBR and the provincial revenue authorities.

There is an inverse relationship between taxation and digitalization. The higher the tax rate, the higher the friction costs. The higher the friction costs, the higher the incentive to not play the game. Every time we revise the tax slabs or the tax rates for the documented sector, the undocumented sector has more converts.

Perhaps it is time to try a different, counter-intuitive strategy. One that reduces the tax rate, rather than raises it. To see if tax collection goes up or comes down when the rate is reduced. If we are serious about digitalization and documentation, we must rethink our national tax strategy and the design of our taxation model. Incentives are an economics game. We have been playing the accounting version for twenty years.

ii. Productivity metrics.

What gets measured, improves. What we had been measuring for twenty years has certainly improved. But are we measuring the right metrics? In a regional context, productivity matters. In a national context, peer group matters. From a strategic context, both matter. A higher benchmark leads to better performance. The effectiveness of a local-only benchmark can be seen by looking at how international branches of our local banks are perceived and have performed globally.

One recommendation on the productivity side is to not only compare national metrics at the board level but to identify and track comparative metrics in US dollar-denominated terms against regional players, to borrow and learn constructively from their playbooks. Run side-by-side comparisons every quarter. Use and report metrics that measure how banks fulfill their banking license mandate, e.g. Advances to Deposit ratio, Domestic Debt to Deposit ratio. Measure quarterly to reduce the manipulation[19] of year-end accounts or unexpected spikes and dips.

Then link board, management, and employee compensation to regional productivity metric targets.

Productivity also matters beyond banking performance. Ultimately the banking spread includes a charge for covering the cost of overheads. Lower overheads and productive infrastructure lead to lower costs and lower banking spreads. Customer use cases around maximum daily transfer limits, transfer confirmation, account reconciliation, time taken to reverse digital transactions, and support center turnaround inform customer choices, decisions, and actions.

We are only as competitive, at the national level, as our banks.

iii. Regulatory framework.

By limiting competition and focusing on well-capitalized balance sheets the regulator has successfully created a safe playing field. But it is a playing field with no incentives to take risks, bring about change, compete, or innovate.

Pakistan's challenge is the incentive and competitive structure in the banking industry. Like taxation and digitalization, we have been using an inorganic carrot-and-stick approach on the regulatory side. It is time we evaluate other organic models that rely on internal and intrinsic innovation versus external and reactive innovation.

18 With the new lower interest rate regime, the friction costs are estimated at PKR 1.8 – 2 trillion per year. Source, conversations with banking industry analysts in Karachi.

19 https://www.brecorder.com/news/40320576.

In the last three decades, innovations and technological shifts in the industry have happened because the regulator pushed for it. ATM networks, core banking upgrades, a national switching network, middleware, internet banking, branchless banking, mobile banking, and digital banking all came forth because of regulatory initiatives.

In 1998, amidst nuclear sanctions and a sector plagued by weak balance sheets, this may have been the most suitable approach. Twenty-six years later, in 2024, the approach is a key factor holding the industry back.

For instance, take preferred sectoral credit allocation. Pakistan's banks have historically prioritized credit lending to certain economic sectors: agriculture, manufacturing[20], and power. While these sectors contribute 24%, 12%, and 2% to Pakistan's GDP[21], respectively (State Bank of Pakistan), they tend to produce products that are unsophisticated and relatively uncompetitive in the global market (Faraz, Siddique, and Saeed, 2023).

Economic growth can't occur without investing financial credit in economic sectors that are complex and have long-term growth prospects (Hausmann et. al, 2014). How can banks identify which sectors to invest in?

One option is to leverage economic complexity research and databases and analyze bank advance exposure to various sectors and each sector's percentage contribution to GDP. But within the existing regulatory framework suggestions for adopting or exploring either of the two approaches would get shot down at the executive and board level, for a simple reason that it will make the bank in question stand out. In an over-regulated, even a beneficent, over-regulated market, it doesn't pay to stand out.

A second related area is the exercise of centralized authority. A single governing authority that oversees the financial sector and communicates banking regulations and sector-specific taxation policies. Other government agencies or tax authorities should coordinate and work via SBP for any policies that directly (or indirectly) impact Pakistan's financial sector. One governing authority leaves less room for confusion, crossed wires, or mixed signals on matters that affect the financial sector.[22] Two recent examples of the erosion of this authority were 1) the application of the super tax on the banking sector, and 2) the listing of Sukuks on the Pakistan Stock Exchange. The issue is not with the nature or intent of the initiative. The question is the signal such deviations send to participants in the market.

iv. Product development.

It is easy to recommend increasing credit exposure to new customers with new products. Implementation though has many challenges.

The first is the cost of product development. In the regulated world of financial services, new products need to be approved by multiple stakeholders before they are offered to customers. These stakeholders are internal and external; business, legal, and compliance; regulators and shareholders. Time, resources, and costs required to launch a new product become prohibitive. This is before opportunity cost. What do we do with our balance sheet and depositors while we wait for approvals to come through?

Then there is the incentive challenge. Why bother? If you could make guaranteed returns by doing something easier and simpler, why bother with something uncertain and riskier?

For new customer-focused products to be launched five things need to change.

a. A clear economic incentive to take risks and push for change. These incentives cannot be regulation-driven. They must be market-driven.

b. More receptive management and boards to new product ideas. The best motivations to change behavior are economic and competitive drivers.

c. More responsive and receptive regulators to risk-taking, capital loss, and new product approvals and applications. A consistent, faster, and more market-relevant approach to processing, approving, or declining product ideas.

d. More aware regulatory and statutory auditors when new products are launched.

e. A sandbox approach to new initiatives where

20 Note that manufacturing includes the sugar, textile, and cement industries, among others.
21 Gross Domestic Product of Pakistan; available via https://www.sbp.org.pk/ecodata/index2.asp
22 https://www.imf.org/external/pubs/ft/issues/issues32/

banks may run internal experiments and trials up to certain exposure limits with minimal regulatory approval, intervention, and review.

The best long-term incentive to innovate is competitive pressure. In hypercompetitive markets, banks compete on service quality, product innovation, mindshare, and efficiency. In walled gardens, banks have no reason to compete or improve other than when required to do so by the regulators. Pakistan's market is a walled garden dominated by five large banks. Rather than protect the elephants in the walled garden, there is a need to facilitate the ants on the floor, trying to get in and survive.

Using the list above, (c), (d), and (e) can only happen once (a) and (b) are addressed. To "lend more" and "lend differently" we need all five. In the absence of these five adjustments, we can't fault management teams opting for the easy way out. "This will never get approved", "This will take forever to get approved", or "Best of luck with the auditors" are powerful words that kill product initiatives in board and executive meetings.

What is a bank supposed to do while we wait for the five conditions to change? They do what they do today. Lend to existing customers. Tried and tested customers, where there is no break with established precedents and norms. Comfort lending.

v. SME Lending.

Take Small and Medium Enterprise (SME) as an example. In most markets, SME lending represents only a small proportion of the total SME population. Pakistan is no different. The primary challenges in increasing SME exposures are access to financing, reach, distribution, risk, and pricing. Here SME lending is not just lending to the estimated 3 million trade retailers in the country; it also includes lending to small businesses in manufacturing, logistics, education, and services. While the collective number of these enterprises may add up to 4-5 million businesses, only a million would be considered bankable under our current regulatory, accounting, and reporting regimes. Do we need a different standard to bring these businesses within the banking network?

Banks underwrite SME exposure when there are limited opportunities to deploy capital and deposits. From a risk perspective, it makes more sense to provide transaction banking services to this segment than to lend. In regional markets, it is common to see SME deposits ten times the size of SME credit exposure.

SME customers are more likely to borrow in lower interest rate environments and with products that subsidize, reduce spreads, require guarantees, and paperwork processing. There is an alignment mismatch between the segment and banks, in low and high-interest rates environments.

Traditional SME products - receivables factoring, export finance, equipment finance, growth, and capacity expansion - need specialized teams. Asset-backed products have similar requirements but are easier to approve. Flow products, those backed by cashflows of the business rather than assets or owner or sponsor guarantees, are harder. The segment requires a different lens and different models that require flow data. With the widespread adoption of internet and mobile banking post-Covid, this data is now available in abundance across banking networks. What is missing are models that put this data to work, market-relevant pricing, an appetite to take this type of risk, and alignment. The question is who will bell this cat?

Why don't banks do it? Multiple reasons.

a. When the risk-free rate is 19%, effective SME lending interest rates sit at 24%. To cover the cost of financing a business must earn net margins higher than 30%. A business earning 30% margins consistently doesn't need bank financing. And certainly not at the cost of 24%. They can tap informal and internal sources of financing more easily than bank financing.

b. Conversely a small business willing to borrow money at an effective cost of 24% needs additional examination to ensure it meets the borrower risk profile.

c. Banking spread comprises four components.

    i. The cost of financing, which is linked to the risk-free rate.

    ii. The cost of the operational base, which provides the infrastructure that makes lending possible.

    iii. A risk charge for default risk.

    iv. The cost of distribution.

Most SMEs find the collective charge, the spread charged on top of the base interest rate prohibitively expensive, especially in a higher rate environment. They would rather not borrow at these rates.

d. Internal pushback, scale, and regulatory compliance. The underwriting and compliance burden of an SME loan as a percentage of exposure is higher when compared to corporate loans. If a bank has lending capacity, it makes economic sense to chase larger exposure with the same resources than smaller ones.

e. Incentives structure. Newer banks can't compete with bigger players on pricing, counterparty limits, or transaction banking products. They have a higher incentive to chase SME customers compared to larger banks. Larger banks already have established relationships in place that account for a significant portion of their lending capacity.

While SME lending may not make sense in a higher-rate environment, rates are not likely to stay high forever. When the rate environment shifts and spreads decline, SME lending becomes the product that allows banks to earn higher spreads. When that time comes, a bank needs to be ready with a product that is acceptable to SME customers and can be scaled within the existing banking infrastructure.

How do we fix it? Scale, efficiency, and better pricing. No bank can win in this segment without these three factors. To increase retail exposure, we must make pricing for that exposure affordable. Affordability follows when bank lending is efficient and responsive.

vi. Better boards. Who?

From a governance perspective, a board is limited in its role. It is expected to set direction, consent to an organizational vision, review performance, suggest corrective action, and track and monitor long-term performance trends and goals. It is not expected to get involved in day-to-day management, intervene in management decisions, or get in the way of the management team's execution of its responsibilities.

Good boards are clear in their understanding of their role. Good boards are also curated and crafted and help ensure that management teams can deliver on their performance goals. They understand the limitations of their roles but use management incentives and control structures to get desired results.

What defines a good board? A good board is diverse to avoid groupthink. A good board tracks performance and delivery with respect to the stated vision. A good board challenges the status quo and an executive team's desire to stay within their comfort zone. A good board knows what reasonable competitive performance for its industry is. It strives to achieve it.

Banking boards are no different. They are only held to higher standards in terms of fit and proper tests. However, that filtering criteria often leads to groupthink and the absence of diversity at the board level.

Perhaps now is the time to review the formulation and structure of banking boards in Pakistan so that they are not filled with only bankers and owner representatives.

vii. Better models.

To be cost-effective we need better models. Loan approval and disbursement are labor and paper-intensive, irrespective of the underlying customer segment. Manual processes that require multiple layers of supervision, authority, and approval. In Pakistan, approvals take 30-90 days for entities with established banking relationships.

Banks use technology to improve turnaround times and generate cost savings throughout the credit process. For example, HDFC rolled out a 10-second loan approval and payout process in 2021 for its digital retail lending segment. While HDFC is an exception in the banking industry, improvements can be made in the local context which can reduce documentation, collateral, resource, and time requirements associated with a credit application.

Better models lead to better capital allocation and the ability to discover new venues for credit and investment. One small 5,000-acre agri-financing experiment in Okara by HBL led to a 5% - 77% increase in crop yields and 7% - 22% cost reductions over 4 years. Imagine extending that experiment to 6 million acres, representing less than 10% of total annual farmed acreage in Pakistan. Similar productivity and outcome improvement themes were noticed when Telenor Bank rolled out a financing and grant scheme for low-cost women-owned schools across 226 villages in rural Punjab. Imagine extending those benefits nationwide across low-cost schools. Quite often such schools are run by women owners. What would that do to our financial inclusion and education goals?

The current thinking in banking is driven by scale inefficiencies. Why do one thousand transactions with an average ticket size of ten million when you can do one transaction worth one billion? Bigger is better. Large accounts over small accounts. Large volumes over small volumes. Part of that mindset is linked to our inability to use technology effectively to service a large number of customers. While we have solved that challenge on the mobile and branchless banking front, we have yet to address it on the asset and advances side.

This requires a review and rework of how we receive, process, and engage with loan applications, documentation, KYC, collateral, credit scoring, collections, quality review, loan documentation, reporting, provisioning, write-offs, and settlement. One suggestion is expanding the identity rails part of the consumer network to include automated scoring. Another is centralized electronic invoicing at the national level. A third is collating and simplifying promises to pay. A fourth is the extension of credit scoring algorithms to include utility bill payments and household consumption profiles. Some of these elements require us to re-evaluate how we run and manage NADRA and eCIB today.

As we saw with mobile banking applications, only one large bank needs to get these processes right. The rest of the industry will follow through over the years. On the consumer side, one local Chinese restaurant in Karachi accepting bank cards as a valid payment option changes the profile for all the Chinese restaurants in that block. But that one bank and that one Chinese restaurant can't do this on its own. There is significant regulatory support and commitment required to bring about this transition. Not just in terms of frameworks but also in terms of mindset. Do we have the will and commitment to follow through?

viii. Recommendations. Conclusion.

At the heart of this debate is a simple valuation and investment concept. Economic value or profits versus accounting profits. Accounting profits are sufficient to cover the opportunity cost of capital. Economic profits create value beyond accounting profits. Economic profits generate economic returns. Simply put, when we factor in and account for all costs, there is something left over for distribution to shareholders, partners, and managers. That is not the case with accounting profits. Economic profits create economic value, accounting profits don't.

On paper, all profit appears to be the same. However, in the valuation world, economic profits are valued higher than accounting profits. In that world earning economic profits is indicative of performance. Conversely, accounting profits point to the absence of performance.

How are economic profits created? When we do something better than the benchmark. When we take risks and are adequately compensated for taking them. When we are more efficient than the market. When we fulfill economic needs at competitive price points.

If we are not efficient, do not take risks, are not competitive nor productive, we don't create economic value. How do we determine if we are efficient? We evaluate against a benchmark. For the last three decades, we have been looking at outdated benchmarks. Perhaps in the beginning and in the original context that benchmark was relevant. But when selecting that benchmark, we left out an important step, a periodic review and evaluation of relevance, calibration, and applicability.

The core mandate of the banking industry is lending. Banks spur and seed economic activity by lending. Not just any lending, but productive lending. Productive lending creates economic value on bank balance sheets by generating value greater than the accounting costs of inputs. The accounting cost of money is its opportunity cost represented by the risk-free rate.

Government debt doesn't create economic value because, by its very definition, it only pays the opportunity cost. A bank balance sheet invested in government debt only covers accounting rents. Such a balance sheet can neither create economic value nor contribute to real economic growth.

Government debt has value in terms of providing a stable and steady store of value for liquidity. When used beyond liquidity needs it impairs the ability of a bank to become a contributing productive part of the economy. There is a time and place for restricting a balance sheet to liquid assets. Examples would be, where there is a shortage of liquidity or a crisis of confidence. Outside that window, it creates productivity and performance challenges for its owners.

For instance, a liquid mutual fund that commits to only investing in government debt and ensuring same-day redemptions for its customers should invest only in government debt. There is nothing wrong with this strategy. Conversely, we don't need a banking license to buy, invest, or trade government debt. The banking license, branch network, and operational expertise required to run a bank are specialized assets. Collectively, if such a network is used to generate space for investing in government debt, it creates two challenges.

The first is a misallocation of resources. There are cheaper assets available that can do the same job more efficiently and at a lower cost. The choice directly leads to a destruction of value. The second is opportunity cost. If the more expensive asset class is used for doing the work of the cheaper asset classes, who is doing the work that the expensive asset class is supposed to do?

To an extent, a lower interest rate environment will address some of these challenges. The pressure on banking spreads will create pressure on the taxation system as the contribution of withholding taxes on profit on debt and the super taxes on banking income fall dramatically in numerical terms. Our primary purpose in initiating these conversations is to ensure that when these themes are discussed in banking and regulatory boardrooms, this time, we make better, more informed choices.

Systems in Pakistan often operate below potential. Mired in red tape, beholden to power structures, and burdened by nuisance value and friction costs associated with bringing about meaningful change. Despite being blessed by an educated middle class and a growing and enviable youth bulge, we barely make a dent in the world.

Part of the challenge in our over-regulated banking sector is the emphasis on safety. Minimizing risk at the cost of innovation. Innovation results from a desire to change but often breaks things. When safety is the prime motivator, breakage becomes a four-letter word. For decades, the regulator has driven banking innovation — ATMs, national connectivity, faster check clearance, branchless banking, consumer focus, and now digital and mobile banking. Yet many believe this lead-from-the-front approach focusing on safety restricts risk appetite, exposures, and growth. Banks are incentivized to lend within well-trodden paths, prioritizing uncompetitive sectors like energy, agriculture, logistics, and textiles while ignoring industries with higher potential. Absence of competition discourages new product development and the ability to bet on new sectors. Cumbersome approval processes and predictable returns make innovation a lost cause, not just for the regulator, but also within banking boards.

How do we escape this trap? We need market-driven incentives, responsive regulators, diverse opinions, forward-looking boards, and a sandbox approach to experimentation. Without these changes, banks will continue to prioritize comfort lending over decisions necessary for economic transformation.

Is it just burdensome compliance and underwriting requirements that deter banks? Or is there more to the equation that prioritizes larger exposures?

The mystery element "X" is scale. We scaled the liability side but left advances in the dark ages. Data-driven models, market-relevant pricing, and customer-driven products are one solution. Make smaller exposures viable and attractive. Make affordability, access, and responsiveness part of the banking mandate and social contract.

Change comes with a price tag. More so with digitalization, improving efficiencies, and building anew. There are regulatory burdens to overcome, skittish investors to pacify, and unprecedented economic challenges to confront. The question is not if these challenges are surmountable – they are. But are we willing to take them on?

The path forward demands courage. For regulators to rethink models; For banks to take calculated risks; for policymakers to align incentives with innovation. It's time to stop patching leaky buckets and build systems worthy of Pakistan's extraordinary potential.