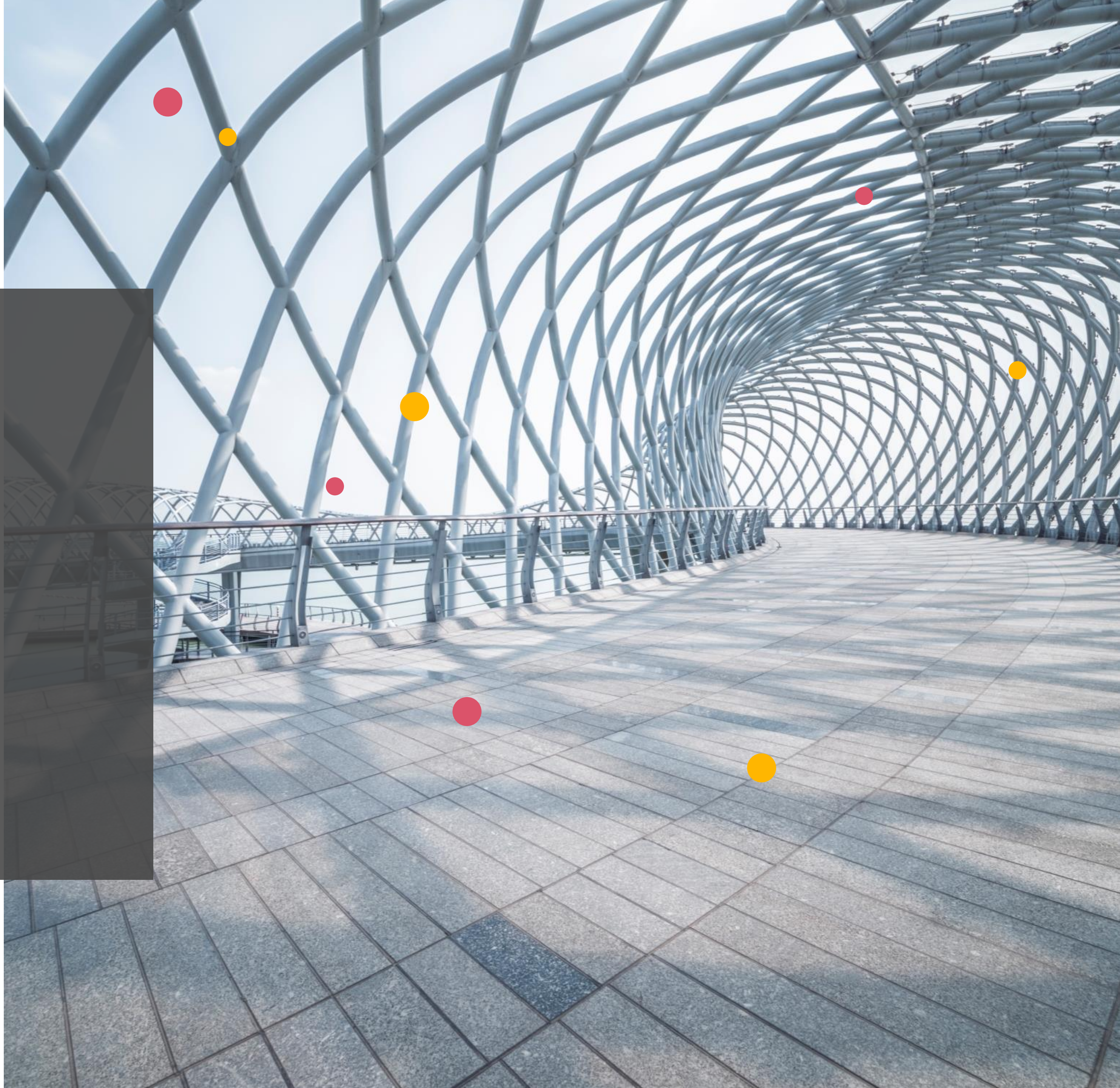
Banking Publication 2023

Navigating the Future of Opportunities and Challenges

Summary of Key Insights

A.F. FERGUSON & Co. | A member firm of the PwC network



Foreword

We are delighted to release our "Banking Publication 2023: Navigating the Future of Opportunities and Challenges" - the first of its kind Thought Leadership Initiative in Pakistan, providing detailed trends, insights and analysis for 2022 and beyond.

This publication is an outcome of extensive research and analysis of industry's financial performance and 10 core themes impacting commercial banks: (1) Financial Inclusion (2) Digital Banking & Payments (3) Customer Experience (4) Islamic Banking (5) Enterprise Transformation (6) Risk Management (7) Anti-Financial Crime (8) Environment, Social & Governance, (9) Culture & Talent; and (10) Tax Regime.

Insights shared reflect wide range of opportunities and associated enablers; notably priority sector intervention, inclusive financial services, next-gen lifestyle banking, eco-system collaborations, alternative lending, digital adoption, cash-less engagement, invisible banking, embedded finance, institutional agility and cost optimisation.

Besides these opportunities, many critical challenges that banks are facing have also been analysed including cash dominance, access to credible data, portfolio quality, integrated risk management, capacity building, compliance sustainability, ESG readiness, talent alignment, and Islamic banking conversion.

This document leverages valuable perspectives of various industry leaders and senior professionals, who we interacted with for the purpose of this publication. Their views reinforce the diversity and scale of opportunities, as well as intensity of challenges identified. Our insights are further complemented by findings from different PwC global and local publications, surveys and experiences across relevant themes.

Along side this publication, we are sharing another comprehensive compendium on Banking & Economic Analytics that provides financial analysis and select industry trends, with few economic highlights, to aid readers relate better to key messages.

We hope this document provides useful perspectives and a platform for you to initiate discussions on strategic forums.

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Territory Senior Partner

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We would like to thank all industry leaders and senior professionals who have contributed immensely to our strategic knowledge sharing endeavour:

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Summary of Key Insights

Financial Performance

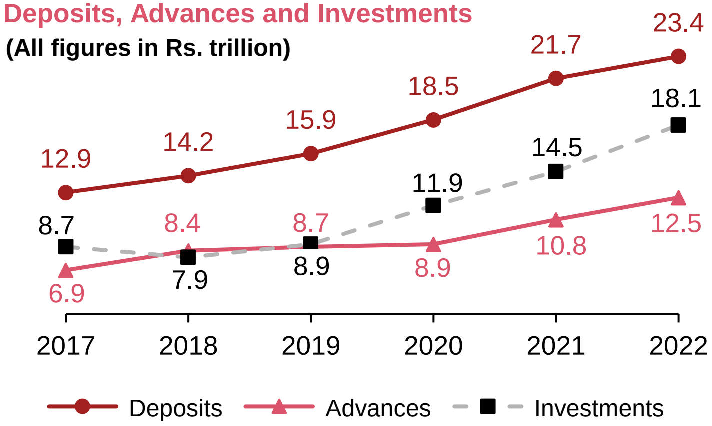
2022 proved to be a year of growth for the banking industry, as reflected by most of the indicators detailed in section 3.

Balance sheet growth

Deposits showed modest increase of 8% to reach Rs. 23.4 trillion and advances grew by 16% to cross Rs. 12 trillion. Significant expansion of 25% was noted in investments touching Rs. 18 trillion with a rising trajectory, while borrowings increased exponentially by 63% to reach Rs. 7.5 trillion.

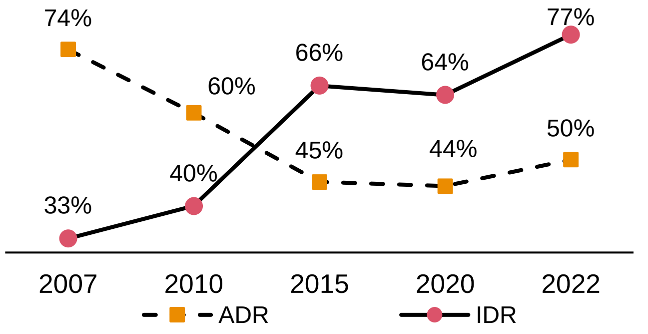
Deposits, Advances and Investments

(All figures in Rs. trillion)

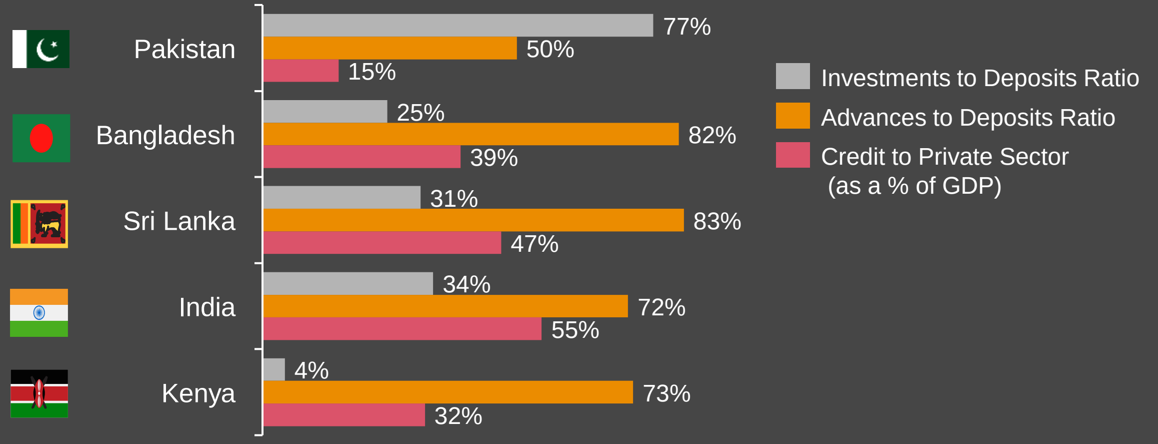


Pakistan's Advances to Deposits Ratio (ADR) has been gradually contracting and stands at 50% as of Dec-22, with lending to private sector at 15% of GDP as of Dec-20. Investments to Deposits Ratio (IDR), on the other hand, has elevated from 33% in 2007 to 77% in 2022. These key benchmarks, relative to certain other economies, indicate enormous potential for credit penetration in the country.

Advances to Deposits and Investments to Deposits



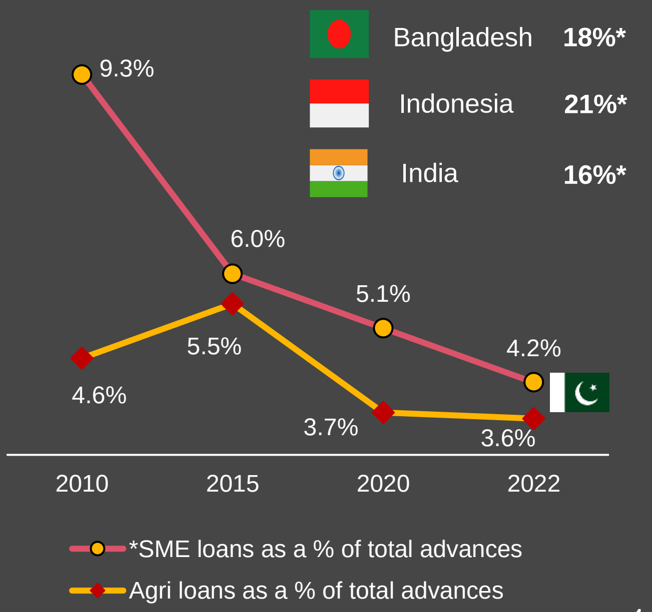
Pakistan vis-a-vis certain other economies



Contribution to priority segments of SME and Agri was less than 8% of total loans with declining trends, and almost same ~70% concentration in corporates over the last 5 years. In this regard, one of the key areas to address is the sub-optimal level of cashflow based financing, indicated by unsecured lending at only 2% of total loans.

To materially scale development finance, our credit bureau infrastructure may need to be infused with credit and alternate data, contributed by a host of market participants beyond banks. Ideally, this can be achieved by a national level big data initiative, along the lines of few successful regional experiences (details on page 77).

Loans to priority sectors as a % of total advances

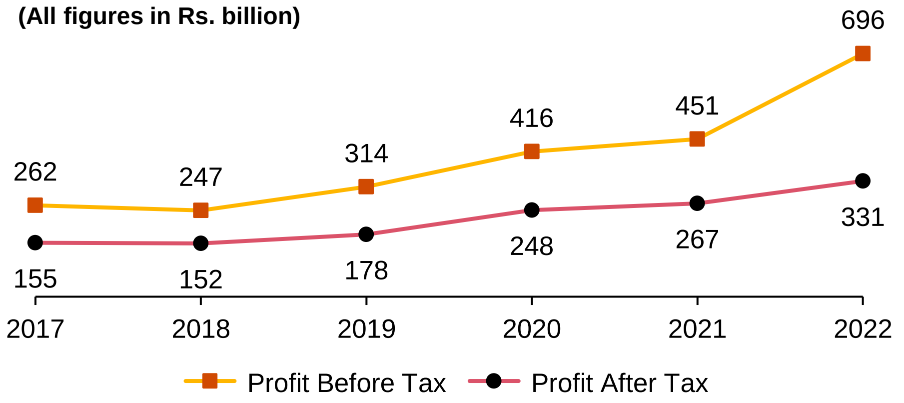


Rising profits and operating costs

There was a sharp rise in profitability on the back of higher margins/ spreads and non-funded income from different avenues. However, higher tax charges triggered disproportionate moderation in baseline profitability.

Profitability

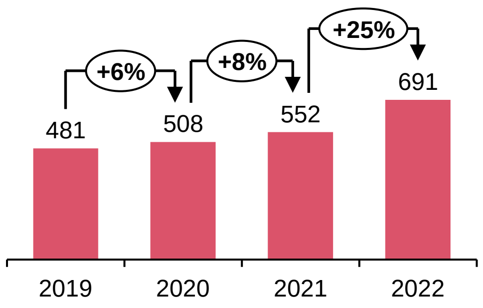
(All figures in Rs. billion)



Operating expenses registered an increase of 25% compared to relatively lower variations during the last few years. Considering current inflationary pressures and Rupee devaluation, these costs may continue to surge in the foreseeable future. Institutions may therefore target programme driven efficiencies under digital excellence, process reengineering and cost optimisation initiatives.

Operating expenses

(All figures in Rs. billion)



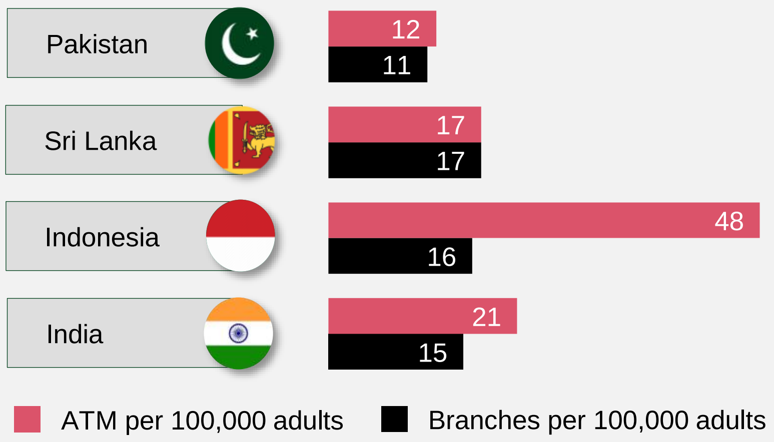
Financial Inclusion

Section 4 highlights substantial space in Pakistan compared to certain regional peers and emerging economies where financial inclusion is well above 50%.

Although rate of women inclusion reached double digits from 7% in 2017 to 13% in 2021, relative state vis-à-vis certain regional economies represents vast untapped potential. Rural inclusion of 15% is also below other jurisdictions.

Pakistan vis-à-vis other economies	Financial inclusion	Women inclusion	Rural inclusion
Pakistan	21%	13%	15%
Bangladesh	53%	43%	49%
Indonesia	52%	52%	46%
India	78%	78%	78%

ATM and branches per 100,000 adults

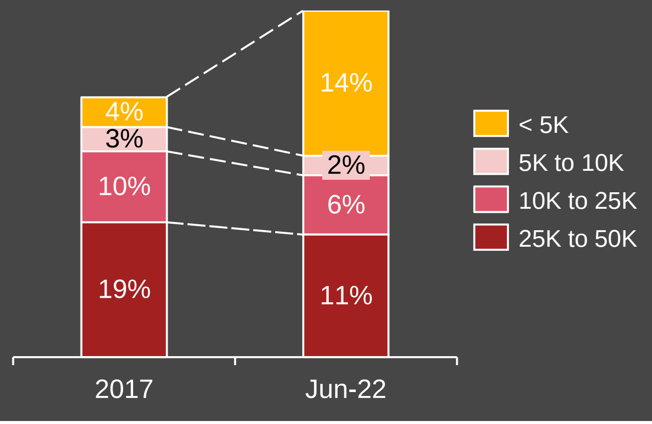


While physical distribution network has expanded over time, there may still be some room for penetration, more across rural and underserved areas. This may help further align 'branch and ATM to adults' benchmarks with those in few regional peers.

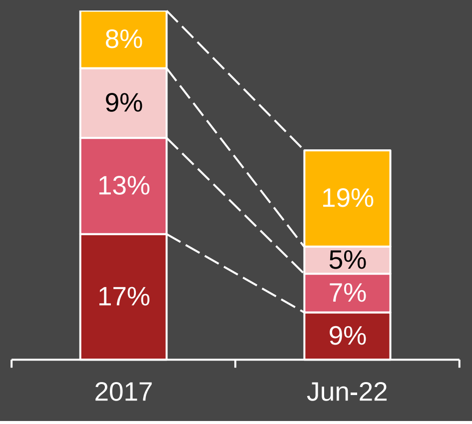
In relation to banked population, there has been gradual increase in low value accounts since 2017, relative to the total number of accounts.

Recent trends also indicate 31% decline in the number of accounts held by businesses i.e. from 8.9 million in 2017 down to 6.1 million in 2022.

5x increase since 2017, in the number of accounts held by individuals with deposit balance <Rs. 5,000

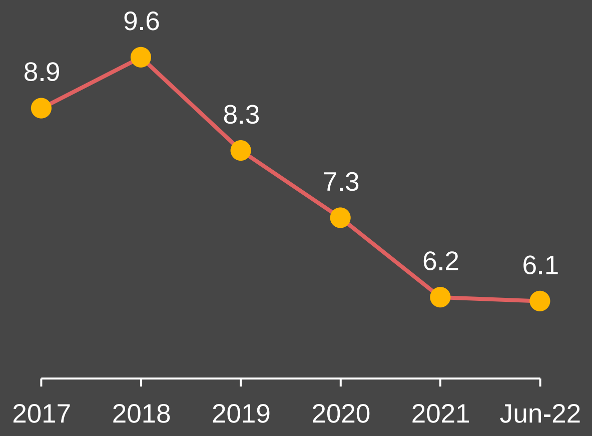


2x increase since 2017 in the number of accounts held by businesses with deposit balance <Rs. 5,000



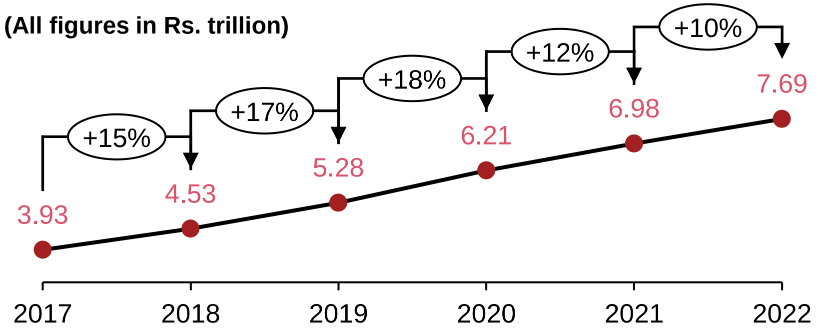
Number of accounts held by businesses

(in million)



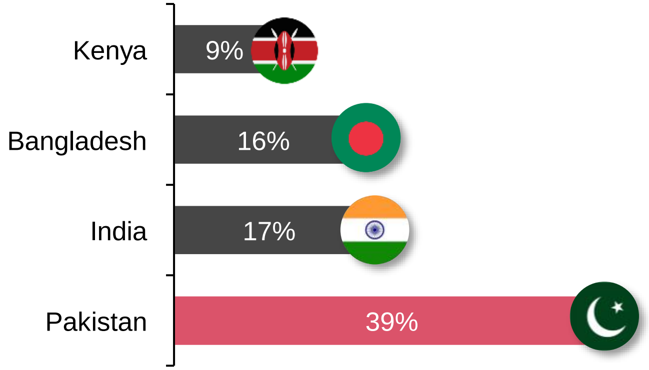
Cash in Circulation

(All figures in Rs. trillion)



Cash in circulation stands at Rs. 7.69 trillion, a huge 96% increase from Rs. 3.93 trillion in 2017, now approximating 1/3rd of total deposits held at banks. This increase in cash exceeds 84% growth rate in total deposits over the same 5-year period.

Cash-in-circulation ratio continues to remain higher in Pakistan at 39%



Financial inclusion may remain a persistent challenge, particularly due to inherent country dynamics and recent inflationary wave, creating further financial burdens and reducing the already low propensity to save.

Relentless collaborative efforts by regulators and industry stakeholders may augment overall capacity to deliver affordable, digital and customer centric financial products to the unbanked and underserved.

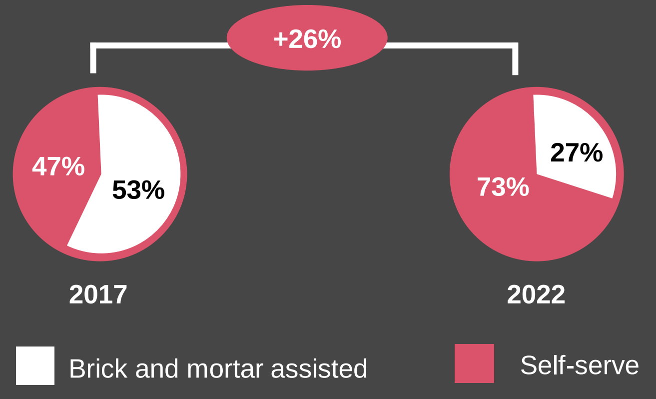
Digital Banking & Payments

Evolving customer behaviours, changing competition landscape with new Digital Financial Services (DFS) players, regulator's push for innovation and industry embracing the change are few developments likely to stimulate a promising digital future in the medium-long term. Section 5 elucidates these trends as well as underlying opportunities and challenges, together with global learnings from few emerging/ developed economies.

Transitioning from bricks to clicks

Banking industry has experienced digital proliferation with 26% decline in the share of brick and mortar assisted transactions since 2017. Particularly, mobile banking has picked up markedly with its contribution in total e-transaction volume surging from 3% in 2017 to 31% in 2022.

26% rise in self serve/ e-transaction volume

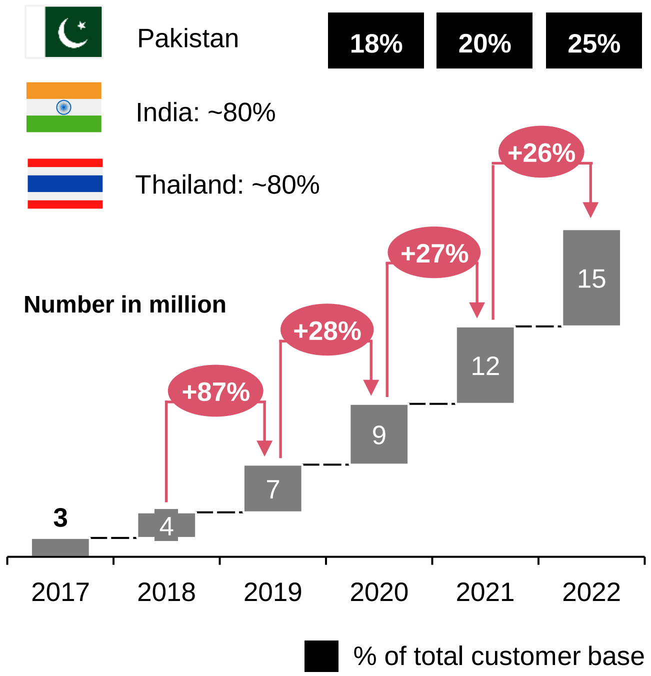


Mobile banking penetration

Although mobile banking adoption has been scaling, there is sizeable room for uptake considering that 25% of individual account holders have registered for this option, lesser than certain emerging economies where this ratio is around 80%.

Mobile banking adoption in Pakistan vis-à-vis few other countries

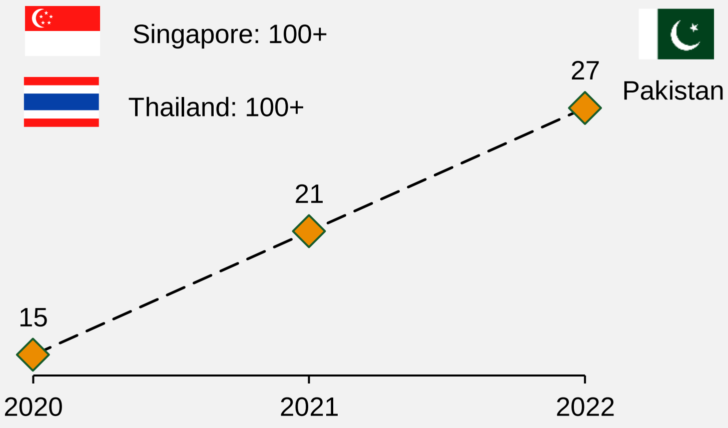
As % of total customer base



Accelerating mobile and internet banking engagement

There is also space for higher engagement through mobile and internet banking platforms where transactions (per annum) per registered user approximates 27 (2 per month), being lower than certain other countries.

Mobile/ internet banking transactions per user (annual)



Potential for cash displacement and P2M digitisation

Considerable opportunity for cash displacement and digital disruption exists considering 27% paper-based transactions and 46% ATM composition in total number of e-transactions, relative to negligible relative mix in regional economies.

	Paper	Electronic	Mobile & internet banking	ATM	Instant payment system
			Share of key digital channels in e-transaction volume		
Pakistan	27%	73%	38%	46%	3%
Singapore	0.4%	99.6%	53%	4%	7%
Thailand	0.2%	99.8%	53%	5%	35%
India	0.9%	99.1%	19%	10%	61%

While industry stakeholders may need to collaboratively promote a behavioural shift by pursuing structured loyalty/ digital engagement programmes, broader government and regulatory support is inevitable in creating a wider eco-system that incentivises digital and disincentives cash through aligned tax measures or other initiatives.

Industry stakeholders believe that incentivisation/ reward model is needed at 3 levels: (1) Customers: to move away from cash, (2) Merchants: to prefer digital and (3) Banks: to invest in acceptance technologies.

With diversion of P2M cash transactions to digital being a key objective, POS deployment grew by 18%. There is still a large untapped space for penetration and need for greater POS engagement.

	No. of POS (in '000)	Accounts per POS	Card use on POS
Pakistan	109	552	18%
Indonesia	1,762	130	90%
Thailand	915	124	35%
India	4,720	535	49%

As of Dec-22, there were 26 million RAAST ID registrations, with 41 million transactions crossing Rs. 892 billion. RAAST transaction mix stands at 3% of total transaction volume, with enormous prospect indicated by intervention levels in other economies.

Introduction of RAAST for P2M payments may well be a game changer with possibility to offer cost concessions to customers.

Cash preference with implications for a vibrant e-commerce market

Digital payments for online purchases remains negligible given dominant preference for cash, and certain structural and logistical challenges associated with e-commerce in Pakistan.

Cash on Delivery – Pakistan vis-à-vis certain other jurisdictions

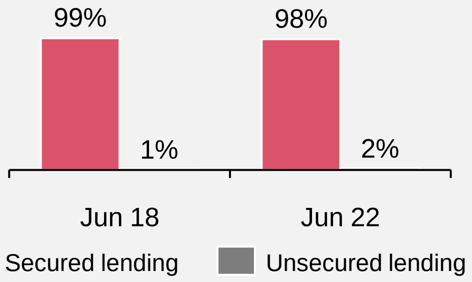
Pakistan	>90%	<20%	Thailand
Indonesia	<20%	<5%	Singapore

Digital lending – a potent enabler for expanding credit access innovatively

There may be vast potential to lend digitally through model-based credit decisioning, harnessing diversified set of credit/ alternate data.

The level of unsecured lending stands at 2% of industry's total credit portfolio, which indicates massive scope for cash-flow based lending including digital credits.

Secured lending vs unsecured lending



Few global developments and evolving trends

To remain competitive, banks globally are focusing on mobile-first; end-to-end friction-less journeys and hyper-personalised experiences, through an eco-system of third parties, leveraging customer data to offer smart propositions tailored around lifestyle needs.

Ambitions to super-apps is particularly trending in Asia, where certain banks intend to plan transitioning from a financial app into an every-day use super-app. Only when well-strategised, these banks may gain from higher rates of customer acquisition, satisfaction, retention and brand loyalty.

Global institutions are also increasingly adopting the growing trend of invisible banking. Examples of embedded finance continue to grow, from no click payments on ride hailing apps to point-of-sales loans from BNPL providers built into mobile shopping apps.

Meanwhile in Pakistan…

Industry stakeholders may be operating at varying levels of maturity, warranting a view on state of readiness and consequent digital transformation journeys that enable harnessing the true potential of digital. Depending on their relative positioning, banks may pursue following initiatives:

- **Design data-driven digital banking and payments strategies** that create an attractive proposition to acquire and retain the digitally native generation
- **Revisit digital banking and payments strategies** around customer segments, products, services and value propositions; aligned with consumer digital engagement levels, behaviours and expectations
- **Diversify solution suite**, **move into adjacent financial products** notably, savings, investments and consumer loans
- **Introduce app features and value-added services** around customer convenience e.g. voice commands, embedding payments into messengers, new digital payment use cases
- **Become the central contact for daily banking, building the B2B ecosystem** - from deals to loyalties, ride hailing, food deliveries – and joint offering with non-traditional players
- **Provide one window solutions addressing e2e financial needs of MSMEs** – deposits, collections, e-invoicing, payments, employee banking, financing, etc.
- **Focus on increasing app user base** through brand rejuvenation, continuous improvement in UI/ UX and targeted campaigns
- **Actively pursue digital lending propositions** backed by automated credit decisioning
- **Effectively integrate into the e-commerce space** and consider embedded financing options

To effectively deliver on disruptive digital strategies, reality is that the entire organisation has to undergo deeper digital transformation. This, in itself, is an uphill journey extending beyond technology and process digitisation to people, culture and mindset change, poised to adopt new business and operating models.

As the world turns towards eco-system banking, our institutions may need to further explore collaborative business models and the associated possibility of alternate revenue lines. This is critical as we move into an era of banking where net margins from payments business may shrink over time.

On the regulatory front, there may be certain game-changing initiatives at various stages from conceptualisation to launch, including blockchain-enabled shared KYC platform and strengthening the Agency Banking framework. Open Banking and Central Bank Digital Currencies (CBDC) are also on SBP’s agenda. Once implemented, these initiatives are expected to contribute significantly to the maturity of digital eco-system in Pakistan.

Customer experience

While banks globally have been investing substantially in customer experience (CX), an ever-increasing risk of customer churn persists, amidst intense competition for market share.

Certain incumbents internationally, as may also be the case locally, continue to pursue multi-channel engagement strategies that target general audiences, leading to broken or incomplete journeys that may reflect poorly on the brand.

Precisely for this reason, banks in Pakistan may need to go beyond interpreting obvious behaviors to deeply connect with the customer as a whole person. In general, they may be facing certain structural challenges along the customer lifecycle to:

- provide seamless on-boarding experience
- understand cognitive, emotional and behavioral nuances that influence customer led journeys
- deliver hyper-personalised solutions through the right channel at the right price
- capitalise on cross-sell and up-sell opportunities

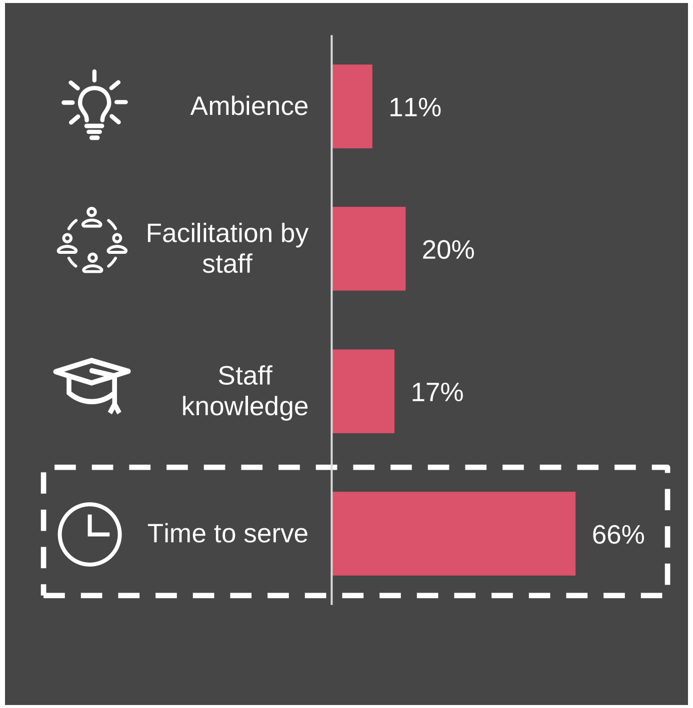
Insights from PwC Pakistan Digital Banking Experience Survey - Banking in the Digital Age (% of respondents)

Factors enticing switch from the primary bank

57%	Customer care
39%	Value added product features
35%	Security
38%	Attractive mobile banking propositions
37%	Rewards
35%	Service agility

As emphasised in section 6, consistent delivery on brand promise requires revisits and refinements to CX strategies, organisation and governance models on an ongoing basis. This does not only imply the incorporation of technology into core capabilities but also entails deeper CX led transformation across the entity.

Concerns during branch visits



As part of the programme, banks may wish to deploy customer-centric; mobile-first strategies for acquisition, leverage design thinking, enrich UI/ UX and establish strong governance around customer conversion and satisfaction.

Enterprise Transformation

To stay competitive, banks may need to convert constant disruption into more efficient, agile operations by pursuing sustainable transformation agendas across the following key themes, detailed in section 8:

1. Digital transformation
2. Tech modernisation
3. Cost optimisation
4. Emerging tech adoption
5. Branch re-modelling

For such transformations to be successful, banks may need to (1) take a medium-long term view, (2) execute the journey in a phased manner, (3) prioritise impact areas based on criticality and opportunity size and (4) have full sponsorship of the Board and senior management.

Risk Management

In these times of economic volatilities and fast paced digital evolution, there may be a need to support business agility by providing proactive and optimum risk value, driven from initiatives presented in section 9.

Credit risk dimensions

On the credit risk front, dynamics have changed manifold due to sharp and sudden shifts in Pakistan's economic outlook in 2022 which may alter portfolio quality going forward. Banks may consider upskilling credit risk functions to better manage varying risk profiles.

In 2023, we may also see some contraction in credit demand. In the wake of a cautious economic and credit outlook, banks may consider reassessing (1) risk strategies and appetite, (2) customer segments and products, (3) risk acceptance criteria, (4) rating models/ scorecards, (5) portfolio management capacity and (6) related tools and technologies, to optimise lending books.

While large scope exists for SME and agri penetration, a major challenge cited is availability of data. For this, there may be need to augment national data infrastructure and eco-system by establishing/ enhancing various records/ registries including credit, land, collateral etc. and expanding credit/ alternative data contribution by non-banks. In the short-medium term, banks may consider collaboration with fintechs and agritechs, etc.

ERM and GRC convergence

It is also an apt time to invest in ERM, with focus on non-traditional/ emerging risk categories and convergence with Governance, Risk and Compliance (GRC), to address general disparity in management of operational, compliance, and financial risks. Considering existing challenges and in the light of PwC Global Risk Survey 2022, banks in Pakistan may pursue holistic risk transformation that cuts across organisation, people, process and technology to deploy a futuristic, data driven approach, enabling enterprise-level dynamic view of risks.

Insights from PwC Global Risk Survey 2022

3/4th are planning to increase integrated spend across data analytics (75%), process automation (74%) and technology to support the detection and monitoring of risks (72%)

38% report that their risk functions have to actively seek external insights to assess and monitor risks

54% complement risk technology investments with people and process changes

Risk modelling

Globally, banks are validating and recalibrating their risk models given changing dynamics. International regulators and bodies are also emphasising on constant updates of risk rating solutions.

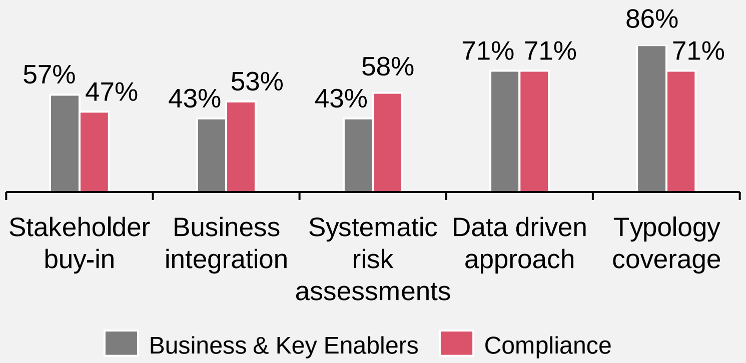
With profound changes in Pakistan's credit risk landscape and outlook, banks may consider validation and recalibration of existing risk models, besides constructing quantitative tools for other customer segments/ products. Focus may initially be on SME, agri and consumer segments which are more likely to be impacted by current economic conditions.

Anti-Financial Crime

With fast-paced shifts in financial crime risk landscape amidst domestic economic vulnerabilities and geo-political instability, we may see increasing threats of varying financial crime risks. This calls for a dynamic and robust path to further progress on the maturity ladder, which will also help in ensuring that the country remains sustainably compliant with FATF requirements.

One of the critical areas covered in section 10 is Regtech, where well-deployed technology can reduce overall cost of compliance by as much as 30% - 50%. Structured tech optimisation reviews/ validation and resultant remediation, aided by data driven models, may up the game for banks in their anti-financial crime readiness.

Another enhancement opportunity may exist in relation to enterprise-level financial crime risk assessment programmes. Findings from PwC Pakistan 2nd Financial Crime Survey reveal that 50% of respondents consider the level of maturity of risk assessments as "Needs Improvements", with significant areas reported as under:



Insights from PwC Pakistan 2nd Financial Crime Survey (% of respondents)

40% consider their financial crime systems to be in a steady state

47% find space for improvement with respect to holistic coverage of financial crime risks

30% shared feedback that their financial crime technologies have not been validated in the last 2 years

+50% institutions where such validations were conducted, this was done internally by Compliance function itself

Environment, Social & Governance

Banks are expected to play a key role in purpose-driven ESG by using their influence as industry actors and may need to align their business models to accommodate:

- Current and future regulatory changes
- ESG strategy and reporting
- Their product strategy and future growth

SBP envisions that banks will fully implement Environmental and Social Risk Management (ESRM) manual (issued in 2022) by 2025 while SECP also launched its own ESG roadmap in 2022. These developments may act as key levers in shaping how capital flows are channelised and investment portfolios analysed in the near future.

Banks may have to move swiftly to adapt to these developments and meet rapidly evolving needs of stakeholders. Within the possible ESG response options, banks in Pakistan may opt for a "Strategist" posture that:

- fully integrates sustainability into business model
- considers ESG part of the institution's purpose
- sets ambitious sustainability targets with responsibility at Board level

ESG led transformation journey has to be comprehensive and holistic, covering every aspect of business including (1) strategy, (2) governance, (3) product design, (4) policies and processes, (5) information systems, (6) data and reporting, (7) people and culture. Section 11 emphasises that banks embark on this transformation journey early to reap full benefits.

Islamic Banking

Over the years, Islamic Banking Industry (IBI) has shown phenomenal growth, with 20% share in total assets, 25% in advances and 22% in deposits of the overall banking industry as of Dec-22. Today, IBI network comprises 22 Islamic banking institutions, i.e. 5 full-fledged Islamic banks and 17 conventional banks (~80% of total), having Islamic banking branches.

There is considerable potential as acknowledged by many researches including one undertaken by SBP and Department for International Development, UK. This suggests robust demand from diversified customer clusters, with following example insights:

67%

sole-proprietors prefer only **Islamic**

Willing to pay more for **Shariah compliant products**

62% of banked respondents

45% of un-banked respondents

As per decision of Federal Shariat Court, all conventional banks are to be converted to Islamic mode by Dec-27. Following are key areas, explained in section 7, where banks may face challenges that can be addressed through holistic Islamic transformation and conversion programmes.

People & Culture	**Marketing & Communication Plan**
Technology	**Corporate & Investment Business**
Retail Business	**Retained Earnings**
Non-Performing Loans	**Borrowings & Treasury**
Policies & Processes	**Accounting Policies & Procedures**

Culture & Talent

Culture has risen sharply up the leadership agenda in recent years. Of the C-suite and board members who participated in PwC Global Culture Survey 2021, 66% were of the view that culture is more important to performance than the institution's strategy or operating model.

Culture rises up the leadership agenda

2013	2018	2021
53%	61%	67%

As highlighted in section 12, banks in Pakistan not only face talent scarcity; particularly in the areas of technology, digital, data sciences, financial engineering, Islamic banking, risk management, financial crime compliance etc. but also grapple with the need to recruit, retain and upskill their workforce on a continuous basis.

Top 10 HR challenges as per PwC HR Tech Survey 2022 (% of respondents)

- **39%** Recruiting/ hiring
- **27%** Retention of key talent
- **22%** Benefits
- **28%** Learning and development/ employee upskilling
- **22%** Remote or hybrid work

A medium-long-term but critical response strategy would be to collaborate with the academia to design and deliver targeted up-skilling programmes for the youth. Another important initiative that may be considered is establishing indigenous Centres of Excellence for trainings in requisite disciplines.

Diversity, equality and inclusion are key elements for improving working environment, driving innovation and enhancing business performance.

Designing experiences for employees including cultural adaptability for the next-gen workforce may be at the heart of transformation to ensure employee productivity, commitment and engagement.

2022 proved to be a turbulent year for Pakistan with acute slowdown on the economic front. In Part B “Economic Analytics” of the compendium to this publication, we have shared trends on few key variables, which may be indicating long-standing structural imbalances and the enormity of challenges at hand.

Our difficult economic conditions are at a time when the world is also encountering different levels of shocks, making the road to recovery even more daunting.

Experts we interacted with for the purpose of this publication are of the view that there have been historically persistent foreign exchange reserve imbalances, with past reliance on foreign aids/ grants and loans. Increasing import and consumption orientation has led to severe impacts on domestic economic value add.

They also feel that on the export front, while there may have been some progress at different times, lack of consistent intervention might not have produced desired level of sustainable outputs.

In their opinion, short-term measures may only serve as stop gap arrangements and a long-term revival plan is absolutely critical focusing on (a) optimising foreign exchange inflows through exports, investments and remittances (b) rationalising outflows primarily through a viable import substitution framework and roadmap; and (c) substantially managing flows by dissuading consumption of non-essential items.

Amidst a murky economic outlook, we appreciate the criticality of banks playing a pivotal role in economic rehabilitation, and the need for lasting support in these vulnerable times.