Pakistan 10 Year Strategy Paper for the Banking Sector Reforms

State Bank of Pakistan

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BLANK

Banking Sector Reform--A Vision and Strategy for the Next 10 Years

Executive Summary

1. **A growing and dynamic banking sector is essential for economic growth in Pakistan,** as growth in the banking sector and the real economy mutually reinforce each other. The banking sector constitutes the core of the financial sector in Pakistan. Private sector investment and consumption should be seen as the key drivers of the economy and must be supported by growing financial intermediation and services, including not only banks but also non-bank financial institutions, and debt securities and the stock market.

2. **Judged by any indicator, the dynamism and robustness of banking sector is impressive and stands out particularly relative to its state in early 1990s when the financial system was dominated by public sector dominated banks**. The growth in banking system has been driven by rise in deposits to Rs4.1 trillion and advances to Rs3.3 trillion. Banks as profitable ventures have attracted close to over $4 billion of foreign direct investment during 2006-2008. Almost half the assets of banks are now owned by foreign banks that are introducing innovation and technological improvements. Recapitalization and prudent lending supported by strong regulatory and supervisory framework have lowered net non-performing loans to historical lows. In line with international trends, SBP introduced Basel II and banks have higher capital adequacy levels --well above the minimum level for the sector as a whole. Despite economic shock and stress in stock market, the banking system in the first quarter of the fiscal year 2009 has shown an increase in profitability of the banking system. Central bank's policies, regulations and supervision systems have been substantially transformed and barring one area (i.e. noncompliance with consolidated supervision principles progress on which is also underway) SBP regulatory and supervisory framework is now in line with the international best practices and norms. This transformation of central bank was supported by the development of capacities and induction of highly qualified cadre of staff that has been trained abroad and in-house.

3. **Pakistan's banking industry and the broader financial sector has enormous potential to support faster economic growth and development.** When compared with other emerging market countries (EMCs), these sectors remain small in relation to the economy. In recent years, a wide range of important structural reforms already have taken place but more reforms are needed for the banking sector to grow into its full potential for supporting strong and sustained economic growth and development.

4. **Accordingly, a strategy for banking sector reforms over the next decade has been formulated** by the State Bank of Pakistan (SBP). The Banking Sector Strategy (BSS) is centered on reforms involving the SBP and the banking sector, which constitutes not only the core of the financial system in Pakistan but is also central to the monetary and financial stability responsibilities of the SBP. The BSS focuses on reforms that the SBP has the power and resources to implement or substantially influence.

5. **Implementation of the BSS has become more urgent in view of the recent pressures in the market**. Since the BSS was first outlined on July 1, 2008, the ongoing financial crises abroad and the deteriorating macroeconomic situation in Pakistan have led to a review of the strategy. Despite the dynamics of the overall situation, there is no need for any change in the overall thrust of the BSS but rather reinforces the urgency of reforms that will make the financial sector more stable and Pakistan a more attractive destination for domestic and foreign direct and portfolio investment.

6. **The BSS has been developed based on:** (i) a comprehensive assessment of the banking and the broader financial sector to identify areas or issues limiting financial sector development; (ii) Pakistan's forward looking economic development strategy; and (iii) experiences of other emerging countries and international best practices. The BSS has been developed with external technical assistance to bring in international experiences.

7. **Since the privatization of most of the major banks, the banking sector has grown in size and become more competitive and financially stronger.** Improved management brought high profitability, record low non-performing loans (NPLs) and capital adequacy levels well above regulatory requirements. Despite successful expansion in recent years, the banking sector continues to have a large potential for further growth, diversification and financial strengthening.

8. **Growth of the other financial subsectors has remained below their potential.** Although stock market capitalization showed spectacular increases in recent years, it did not play a major intermediary role, as there were few new listings and issues—and stock values have declined sharply in 2008. The private debt securities' market remains rudimentary in scope. The government debt market has grown in recent years to meet the government's growing financing needs but the framework for issuing, pricing and trading government securities remains under-developed. The growth of non-bank financial intermediaries has lagged behind that of banks.

9. The objectives of the BSS are to make the banking sector: (i) more responsive to the needs of the economy and thus help achieve a more rapid and sustainable economic growth; (ii) financially stronger, more resilient and stable; (iii) better regulated and supervised; and (iv) more efficient and stable by improving the infrastructure for financial intermediation.[1]

10. **The BSS focuses on reforms in ten key topic areas**. The focus is on banks, certain non-bank financial intermediaries and financial infrastructure, like payment and credit information systems, under SBP jurisdiction. The ten key topics for the BSS are to:

(i) ***Implement a financial inclusion program*** for banks to meet the needs of underserved economic subsectors, including outreach programs to meet the requirements of the agriculture, housing, SME and microfinance sectors.

(ii) ***Strengthen consumer protection*** through new legislation, codes of conduct and new institutional arrangements and improve financial education through educational outreach programs.

(iii) ***Strengthen competition and efficiency*** in the banking sector with more transparency, more diversification with new products and delivery channels as well as measures to reduce the market distortions created by the large banks in rural areas.

(iv) ***Further strengthen and consolidate the banking sector*** by continued efforts to raise governance and risk management standards, higher capital requirements and resolution of underperforming commercial and specialized banks.

(v) ***Strengthen prudential regulation and supervision*** by updating banking legislation and regulations, methods of supervision, and stricter enforcement of prudential rules for all banks, including state-owned ones.

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[1] These objectives are consistent with and expand on the strategic objectives outlined in the State Bank of Pakistan's Annual Report 2008-Part II, Performance Review of the SBP.

(vi) ***Introduce a framework for consolidated supervision*** and reorganize the regulatory architecture to allow better regulation and supervision of financial groups and conglomerates.

(vii) ***Develop a financial safety net*** of protection for small depositors, clearly structured lender of last resort (LOLR) facilities, an updated framework for market exit and resolution of unviable banks, and coordination arrangements with the GOP for dealing with systemic banking problems.

(viii) ***Strengthen the powers of SBP to maintain monetary and financial stability*** by updating the half-century-old SBP Act in accordance with best international practices for central bank independence, accountability and governance structures.

(ix) ***Deepen financial intermediation*** by developing not only the banking sector but also NBFIs, private and government debt markets and the stock market.

(x) ***Develop the financial infrastructure, especially payment systems,*** but also human resources, credit information, credit ratings, land and property registries and minimize procedural delays in the legal system to improve the efficiency of financial sector transactions.

11. **Most of the above reforms are already in process,** while others are at various stages of planning and preparation or pending implementation subject to changes in legislation. This paper aims to capture the objectives and broad elements of this strategy, which is reflected in a comprehensive reform program. The BSS will be finalized and implemented after consultation with stakeholders and in some areas after new legislation has been passed. The BSS has been developed by the SBP, which has full ownership of the reform agenda. In developing the BSS, SBP drew on international experience and expertise through technical assistance from the Asian Development Bank (ADB), the International Monetary Fund (IMF) and the Department for International Development (DFID) of the United Kingdom.

12. **Preconditions for effective financial sector reforms** are macroeconomic and political stability as well as an enabling policy environment in the real sector. Macroeconomic stability includes prudent fiscal policy and market-based public debt management policies. Successful implementation of the BSS thus requires the support of the GOP both on the micro reforms discussed in this paper and at the macroeconomic level.

13. **In conclusion, in the preparation of the strategy paper, I would especially like to acknowledge the** dedicated efforts of Mr. Carl Lindgren, (ex-Deputy Monetary and Exchange Affairs Department, IMF), and key SBP team members, in particular the following:

Riaz Riazuddin, Economic Advisor
Jameel Ahmad, Executive Director, Banking Policy and Regulations
Amer Aziz, Executive Director, Banking Supervision
Asad Qureshi, Executive Director, Financial Markets and Reserves Management
Inayat Hussain, Director, Banking Inspection Department
Muhammad Ali Malik, Director Domestic Monetary Management Department
Syed Irfan Ali, Director Banking Policy and Regulation Department
Sara Bakhtiar, Director Legal Services Department
Lubna Farooq Malik, Director, Banking Surveillance Department

Dr. Saeed Ahmed, Head Microfinance Department
Sahar Babar, Senior Joint Director, Financial Stability Department
Muhammad Javed Ismail, Senior Joint Director, Banking Surveillance Department
Maraj Mahmood, Senior Joint Director, Banking Inspection Department
Mahmood ul Hasan Khan, Joint Director, Financial Stability Department
Noor Ahmed, Joint Director, Microfinance Department
Arshad Mahmood Bhatti, Joint Director, Off-site Supervision and Enforcement Department
Nizamuddin Arshad, Joint Director, Banking Surveillance Department
Amer Hassan, Jr. Joint Director, Banking Surveillance Department
Raza Habib Raja, Jr. Joint Director, Banking Inspection Department
Amjad Iqbal, Jr. Joint Director, Banking Policy and Regulations Department

Dr. Shamshad Akhtar
Governor

1. Introduction

14. **Pakistan's financial system has grown in recent years but continues to have an enormous growth potential**. The system remains relatively small in relation to the economy, when compared with other emerging countries in Asia and around the world. Given that a dynamic and growing financial system is central to a growing economy, the small size (lack of depth) of Pakistan's financial sector implies that many financing needs cannot be met and that much of the country's economic potential remains unfulfilled. A wide range of important structural reforms already have taken place but many more remain to be defined and implemented, if the financial sector is to meet its full potential for supporting strong and sustained economic growth and development.

15. **The banking sector has gained dynamism, profitability, respectability and strength.** Deposit base rose to Rs 4.1 trillion and gross advances to Rs 3.3 trillion by September 2008. Supported by the growing financial intermediation process, banks' aggregate profitability rose from Rs 63.3 billion in 2005 to Rs 73.3 billion by 2007 and Rs 46.0 billion for half year 2008. Recapitalization and prudent lending has lowered banks' net non-performing loans (NPLs) to around 2.0 percent. Banks' capitalization and quality of assets have helped raise the risk weighted capital adequacy ratio to 12.1 percent, well above the regulatory minimum of 8.0 percent.

16. **While these achievements are impressive, many challenges remain,** including the need for greater financial access, availability of financial safety nets, and supervisory challenges for a dynamic financial infrastructure etc.

17. **This paper maps out a strategy for banking sector reforms over the next decade**. It is formulated by the State Bank of Pakistan (SBP) and is centered on reforms involving the SBP. But the Banking Sector Strategy (BSS) will also involve departments and agencies of the GOP, the SECP and ultimately all other stakeholders in the financial sector. The focus of the BSS is on the banking system, which presently constitutes the core of the financial system in Pakistan and is expected to remain the most important part of the financial system in the foreseeable future. The banking system is also of central importance for the monetary and financial stability responsibilities of the SBP. The strategy focuses on reforms that the SBP has the power and resources to implement or influence directly or support indirectly.

18. **This paper is organized as follows**: Section 2 includes a brief background section on the condition of the banking sector as well as a discussion of issues and problems that limit growth and development of the system. Section 3 discusses a vision for the future and the objectives of the BSS. The remaining ten sections cover the different focus areas of the strategy.

2. Background and issues

2.1 The status of the financial system

19. **The ratio of financial assets to GDP is commonly used as a measure of the "depth" or degree of development of a country's financial system**. The ratio allows for an analysis of the financial system's development over time and a comparison with other emerging market countries (EMCs). In June 2008, total financial sector assets in Pakistan amounted to Rs 7.6 trillion. On a net basis the amount of financial assets is substantially smaller, as debt securities and shares are included as assets of other financial institutions and therefore double counted. For a measure of financial assets on a net basis, a definition used by McKinsey and Co. has been used for comparative analysis, as it: (i) eliminates the double

counting of assets, and (ii) allows for an international comparison of financial sector size/depth and structure.[2]

20. **The stock of net financial assets in Pakistan has been relatively stagnant, if the bubble in stock market capitalization is excluded**. This means that although financial assets have grown rapidly in nominal terms in recent years, they have not grown that much in relation to the real economy as measured by GDP, especially in the last few years.

Table 1: Asset Composition of the Financial Sector

	CY01	CY02	CY03	CY04	CY05	CY06	CY07	H1-CY08
Asset (bln Rupees)	3042.7	3417.7	3943.7	4518.3	5201.5	5957.5	7115.2	7646.6
Growth Rate (percent)		12.3	15.4	14.6	15.1	14.5	19.4	7.5
As percent of Total Assets								
MFIs	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2
NBFIs	6.6	6.2	6.6	7.0	7.6	7.8	8.0	8.0
Insurance	3.7	3.8	3.8	3.8	3.9	4.1	4.6	5.5
CDNS	25.8	24.9	25.0	21.7	18.0	16.1	14.6	14.2
Banks	63.8	65.0	64.5	67.3	70.4	71.9	72.7	72.1
As percent of GDP								
MFIs	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
NBFIs	4.7	4.6	4.9	5.2	5.6	5.7	5.9	5.9
Insurance	2.6	2.8	2.9	2.8	2.9	3.0	3.4	4.0
CDNS	18.1	18.2	18.8	16.1	13.3	11.7	10.8	10.3
Banks	44.8	47.7	48.3	50.1	51.8	52.4	53.9	52.6
Overall	70.2	73.3	75.0	74.4	73.7	72.9	74.1	73.0

Source: Financial Stability Review, 2007-08

21. **Among different segments of the financial sector, the banking sector has grown most in relative terms**. Following its privatization, which started in the 1990s, the banking sector has gained dynamism and financial strength. As of June 30, 2008, the deposit base has risen to Rs. 4.1 trillion and advances (net of provisions) to Rs. 2.9 trillion. Supported by the growing financial intermediation process, banks' profitability rose to Rs. 73 billion in 2007 (and Rs 46 billion for first half year 2008), the proportion of non-performing loans gauged according to Net NPL to Net Loans ratio has been well contained and was 1.1 by December 2007 and 1.3 in June 2008. The overall assets of the banking sector have also increased from Rs. 3.6 trillion in December 2005 to Rs. 5.5 trillion by June 2008. While some liquidity strain has been witnessed in the second half of 2008, the sector stands on sound footing with regard to its ability to face market shocks. Additional data on the performance of the banking sector is provided in Annexure A, Tables 1 and 2.

2.2 Issues and constraints

22. **There are a number of important problems and constraints that limit the scope for banking sector growth and development in the absence of further reforms**. The issues include the following:

[2] Net assets according to the McKinsey definition include bank deposits, government and private debt securities and stock market capitalization (see Annexure B).

23. **Large segments of the economy, population and geography remain underserved by the formal financial system**. In the absence of reforms this gap that will only grow, as Pakistan's population rises further. There is a need to extend the reach of the financial system and better serve small entrepreneurs and households, especially in the SME, agriculture and service sectors, which account for most of the country's GDP and employment generation but presently receive a relatively small share of total credit.

24. **The extraordinary performance of the banking sector has induced Foreign Direct Investment (FDI) of USD 4.2 billion over the last 7 years**. Almost 90 percent of this has been received by the banking sector, which has attracted USD 3.7 billion of FDI. This notwithstanding, there is a need for further improving the investment infrastructure and incentives for the Non-Resident Pakistanis to bring FDI into priority areas like export oriented and technology enhancement industries.

25. **Lack of consumer protection and low level of financial literacy contribute to financial sector underdevelopment**.

26. **The privatization of the banking system made it more dynamic and competitive but it still has some way to go**. New products have been developed, especially in consumer lending. But competition is impeded by lack of transparency in the pricing of deposit-taking, and skewed by the dominance of a few large banks with vast branch networks and captive rural markets. Most deposit rates have remained steeply negative in real terms, while bank margins have remained high. The keener competition and lower intermediation margins that policy-makers expected from the privatization of banks have yet to materialize for the benefit of the real economy.

27. **The banking sector has been consolidating and most banks have strengthened their financial positions in recent years**. The consolidation has been driven by SBP regulations as well as business and efficiency reasons. At the same time, a small number of weak or unviable banks remain in the market, where they not only distort competition but also impose a drain on fiscal and supervisory resources.

28. **The operations of Development Finance Institutions (DFIs) require reconsideration**. DFIs were originally set up as bilateral ventures between the GOP and foreign governments with the objective of attracting foreign capital for and promoting economic collaboration in various industrial and export oriented projects. DFIs have had difficulties in their priority areas and entered into other business lines. There is a need reconsider their ownership structures and business models.

29. **Competition and continuous market innovations raise challenges for SBP in its role as regulator and supervisor of banks.** This will require the replacement of the Banking Companies Ordinance, 1962 (BCO) with a new Banking Act. It will also require continuous updating of regulations and supervisory practices as well as agile monitoring and enforcement in line with emerging international best practices.

30. **Banks and NBFIs have been developing conglomerate structures** to benefit from synergies in the cross-selling of financial products. This market driven process is largely positive but it does introduce new systemic risks as well as regulatory and supervisory challenges that have to be dealt with.

31. **The recent global financial market turmoil and the current privately-owned structure of the domestic banking system, highlight the need for a financial safety net to deal with contagion and systemic risks.** This includes depositor protection, liquidity and Lender of Last Resort facilities in the SBP, an exit framework to deal effectively with inevitable bank failures in ways that will strengthen rather that weaken the banking sector as a whole, and improved coordination mechanisms with the GOP in cases of systemic problems.

32. **Macroeconomic stability in general, and monetary and financial stability in particular, are prerequisites for financial sector development.** The challenges of dealing with a dynamic market-based monetary system and rapidly evolving private financial system call for a review of the policy making framework and governance arrangements in the SBP. This requires an updating of the 50-year old SBP Act of 1956.

33. **The financial sector is too bank-centered and needs to become more diversified in order to meet the country's future financing needs.** New issues of shares have been very limited and private corporate (listed) issues of Term Finance Certificates (TFCs) and *sukuk* are still of only marginal importance. Growing financing requirements of private and public infrastructure investment, particularly in the transportation and energy sectors, are likely to remain unmet unless new long-term financing sources are developed outside the banking sector. The GOP's Medium Term Development Framework for 2005-10 conservatively estimates that some USD 150 billion (Rs. 12.0 trillion) will be required for such investments over the period it covers.

34. **The growth and development of banking system and other financial institutions and markets are limited by shortcomings in the infrastructure for financial services and transactions.** Bankers consider the lack of skilled human resources as the principal limitation for expanded financial sector business. Improved credit information and credit rating systems would facilitate efficiency and new business lines, while more certainty and finality in financial transactions can be achieved by modernization of payment systems, upgrading land and property registries and improvement of procedural issues in the legal system.

3. Vision of the Future and Objectives for Reforms

3.1 Vision of the Future

35. **Financial sector growth and real economic growth reinforce each other**. Financial sector growth, reflecting increased financial savings and credit flows, is a major propellant for real economic activity. A faster growth of the financial sector, therefore, can be expected to result in increased and sustained economic growth. The ratio of total financial assets to GDP is generally used as a measure of financial sector "depth"; the higher the ratio, the more support the financial sector provides to the real economy.

36. **The future of Pakistan's financial sector can be envisaged on the basis of developments in countries that are more advanced in their financial sector development.** Many emerging market countries (EMCs) have gone through far reaching reform processes, and as a result have been able to substantially change the structure, dynamics and depth of their financial sectors.

37. **A comparison of the depth and structure of the financial sector in Pakistan with some other EMCs is illustrative.** Using the standardized definition of net financial assets of a worldwide McKinsey survey, the data show that the relative size of the financial sector of Pakistan, expressed as percentage of GDP, is roughly half the size of the financial sector of India or the average of all EMCs—and represents an even smaller fraction when compared with China and or all EMCs in Asia (excluding China and India).

Table 2: Financial Sector Depth and Structure in Emerging Markets and Pakistan, end-2006

Financial sub-sector	All EMCs	All EMCs ex. China and India	Asian EMCs ex. China and India	China	India	Pakistan	Pakistan
			(in percent of GDP)				(in Rs.bln)
Bank deposits	85	57	78	169	73	47	4,156
Govt. debt securities	34	34	43	30	34	32	2,751
Private debt securities	18	19	48	16	5	1	47
Equity market	79	70	83	92	91	32	2,771
Total financial assets	216	180	250	307	202	111	9,725
			(in trillions of USD)				(in Rs.bln)
Total financial assets	23.6	13.7	4.3	8.1	1.8	0.151	9,725
GDP	11.1	7.6	1.7	2.6	0.9	0.143	8,723

Sources: McKinsey Global Institute, *Mapping Global Capital Markets—Fourth Annual Report*, and SBP. The McKinsey definition is showed here for comparative purposes only. SBP's calculations of financial sector consolidation are given in Table 1.

38. **Table 2 illustrates the enormous potential for future financial sector growth in Pakistan**. The financial sector in Pakistan would have to double in size[3] to reach the level implied by the GDP ratios for India (202%) or the average for all EMCs worldwide (216%). This would mean a doubling in nominal terms. Such a doubling would imply a massive increase of financial intermediation, i.e., financial savings and credit flows in the economy. This scope for growth remains valid even after the precipitous declines in stock market capitalization in all EMCs in recent months. **Table 1** shows that substantial financial sector growth is feasible, provided that there are conducive macroeconomic policies and financial sector incentives as well as appropriate political, institutional, business and administrative conditions in place.

39. **If the financial sector is to reach its potential, it will require broad based growth not only of the banking sector but also of other financial institutions and markets.** The above table makes clear the important relative roles not only of the banking sector but also of government debt, private debt and equity markets. In most EMCs, the banking sector and the stock market are the most important financial intermediaries, as is the case in Pakistan. The financial sector of Pakistan mainly distinguishes itself from other EMCs, however, in that the private debt market is almost non-existent, while the government debt market in Pakistan is of a relative size more similar to that in other EMCs.

40. **The vision for Pakistan that one can draw from the above data is that future financial sector growth and deepening should be based on private sector intermediation,** including banking, equities and especially private debt markets. This would allow resources to be channeled to the private sector, both for private investment and consumption, which are the key drivers of growth in the economy. ***Banking sector growth*** will require more competition and innovation, diversification of credit away from the manufacturing sector to the presently under-served productive subsectors and the household sector.

41. **Based on the relative structure of the financial sector in other EMCs, a rough projection of future depth and structure can be made for Pakistan,** which gives an indicative scenario of overall system depth and composition in 2018 based on the end-June 2008 consolidation of the financial sector. In line with these projections, total financial sector asset are expected to increase to up to 100% of GDP in Pakistan based on the historical growth rates since 1997, and the current macroeconomic projections of the SBP which take into account developments in 2008 and the likelihood of the relatively low economic and financial sector growth for the next 2-3 years. Over the next 10 year period, these projections are contingent on un-interrupted and sustained economic growth, and continued efforts by the banking sector to expand their businesses and the scope of their operations.

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[3] This statement is based on the McKinsey Definition.

42. **Based on the projected growth in banking sector assets, the projections also estimate an increase in credit to the private sector**. With projected increases in the asset base, credit to the private sector as a percent of GDP should at least double by 2018, given the challenges being faced by the setback in the economic indicators in 2008.

43. **There is clearly vast scope for the banking sector to play a much larger role in support of economic activity than it does today**. By better capturing domestic financial savings, foreign remittance and foreign capital inflows, the banking sector will have more capacity to finance and support every type of viable economic activity, including investment and consumption expenditure by the private sector. Rapid growth in bank deposits and credit could be expected to reinforce and sustain higher economic growth.

44. **Specific targets of reforms include increases in banking sector financial assets and credit to the private sector**. This credit expansion would be mainly facilitated by growth in banking sector deposits, but also by development of the private debt market. Needless to say, this increase in credit cannot take place unless the banking sector reforms outlined in this report are accompanied by reforms to the debt and equities markets that fall under the jurisdiction of the SECP.

3.2 Banking Sector Reform Strategy (BSS)

45. **In view of the above considerations, the SBP is now launching a 10 year Banking Sector Reform Strategy (BSS)**. The BSS has been developed based on: (i) a comprehensive assessment and evaluation of the banking sector and the broader financial system that has helped identify the key issues and limitations mentioned above; (ii) Pakistan's forward looking economic development strategy; and (iii) lessons and experiences of other countries as well as the emerging regional and global financial architecture. In developing the BSS, SBP has received technical assistance from the ADB, UK DFID and the IMF.

46. **The objectives of the FSS are consistent with the strategic objectives of the SBP and build on its earlier Strategic Plan**. The five strategic objectives of the SBP are extensively discussed in its 2008 Annual Report : (i) Broadening Access of Financial Services; (ii) Ensuring Soundness of the Financial Sector; (iii) Maintaining Price Stability with Growth; (iv) Exchange and Reserve Management and (v) Strengthening of Payment Systems. The first two and the last of those objectives are also key objectives and components of the BSS, while the third objective is a precondition for successful reforms. The BSS also builds and expands on the existing SBP Strategic Plan for 2005-10, which included some 20 functional and management strategies; many of those strategies have been implemented, while others have been incorporated into the BSS.

47. **This paper lays out the key elements of the BSS**. The scope of the BSS is confined to reforms of the banking sector and to legal, regulatory and supervisory issues that fall under SBP's jurisdiction. Some reforms are already in process, while others are at various stages of planning and preparation. Changes in legislation are preconditions for many of the reforms; while most of the proposed legal changes already have been drafted, all legal amendments and new legislation will require the necessary time for Cabinet review and endorsement. Following is a summary of the objectives of the BSS, and the sections below outline the major areas of reform as they can be identified today.

3.3 Objectives of the BSS

48. **The broad objectives of the BSS are to**:

a. **Make the banking sector more responsive to the needs of the economy and thus help achieve a more rapid and sustainable economic growth.** This will include: (i) increased diversification into underserved economic subsectors; (ii) deeper penetration into underserved regions and population groups; (iii) more innovation and competition with new products and delivery channels; (iv) more effective mobilization of domestic and foreign resources; and (v) more effective channeling of resources into private investment, which will remain a key driver of economic growth.

b. **Make the banking sector financially stronger, more resilient and stable by:** (i) improving governance and risk management in banks and NBFIs; (ii) strengthening banks' and NBFIs' profitability and capitalization; (iii) facilitating better liquidity management; (iv) strengthening the financial safety net; and (v) resolving unviable institutions before they damage the system.

c. **Make the banking sector better regulated and supervised by:** (i) strengthening SBP independence and its powers to maintain monetary and financial stability; (ii) updating legislation and regulations, (iii) strengthening SBP authority and its methods of supervision.

d. **Make the banking sector more efficient and stable by improving the infrastructure for financial intermediation,** especially payment systems, but also other areas to allow for improved efficiency and reduced uncertainty in financial sector transactions: human resources, credit information, credit rating agencies, land and property registries and improved legal procedures.

49. **Preconditions for banking sector growth and development are macroeconomic and political stability and an enabling policy environment in the real sector**. This includes prudent fiscal policy and public debt management policies consistent with and supportive of the overall goals of developing a more diversified financial sector with a much expanded role for active government and private sector securities' markets. While many of these issues are beyond the jurisdiction of the SBP, the BSS will highlight areas that directly affect the SBP or where SBP can make a major contribution directly or indirectly to reforms outside its jurisdiction.

50. **The BSS has the following ten main areas of reform**:

1. Create a more diverse and inclusive banking sector
2. Improve consumer protection and financial education
3. Strengthen competition and efficiency
4. Consolidate and strengthen the banking sector
5. Strengthen prudential regulation and supervision
6. Introduce framework for consolidated supervision
7. Develop a financial safety net
8. Strengthen SBP autonomy, accountability and governance
9. Develop a more balanced financial system
10. Develop the financial infrastructure

4. Create a more diversified and inclusive banking sector

4.1 Develop a more diversified banking sector

51. **The role of banks in financial intermediation is unique, especially in dealing with small and start-up companies**. Banks are the only financial institutions that can overcome the information asymmetry between borrowers and lenders. Banks assess and manage risk by processing information on potential borrowers and their creditworthiness. After credit has been extended, banks monitor borrowers' performance and may extend additional credit as businesses develop; they are also closely involved in payments and transactions of their customers. Banks are therefore, uniquely suitable to deal with smaller and start-up companies and with the household sector, and need to move away from their excessive focus on financing large enterprises and the government.

52. **There is need to diversify banks' focus away from large companies to smaller companies, farmers and the household sector**. Most credit to the enterprise sector goes to the manufacturing sector (especially textiles), which receives a disproportionately large share of bank credit (40%) compared with this sector's contribution to GDP (20%). Aggregate data for all credit by borrower size shows an extremely skewed distribution: some 22,000 or 0.4% of all 5.2 million bank borrowers account for 65% of all bank advances—and the remaining 5+ million borrowers for the remaining one-third. At the very top there is even more concentration; the largest 50 borrowers account for 37% of all credit outstanding. Banks must be induced to focus more on the lower-end company sector and the household sector to diversify risk. Experiences elsewhere show that SME and consumer lending typically is more profitable than lending to large corporations or investing in government securities.

53. **Larger companies have access to different financial markets and should be given incentives to diversify their financing away from banks.** Most large companies have access to bond and stock markets in Pakistan and some even have access to foreign capital markets. Large companies typically have accounting and governance systems that allow markets (with the help of auditors and credit rating agencies) to overcome information asymmetries. In Pakistan, private debt and equity markets have been underutilized in the past but hold enormous promise for intermediating new resources, especially for large long-term projects that are less suitable for commercial bank financing.

54. **The above changes will require a combination of SBP policies and business opportunities.** An important driver of the process will be the policies of financial inclusion described below. Prudential exposure limits preventing large companies from relying excessively on bank financing may also help. Over time, large corporate borrowers should be induced to issue private debt securities and new offerings of equity. But ultimately the diversification will happen only when broader market and infrastructure developments will allow banks to pursue profitable new business opportunities.

4.2 Need to Implement a Financial Inclusion Program

55. **In Pakistan the level of financial exclusion from the formal sector is dramatic, especially in rural areas.** The formal sector mainly means different types of banks (and other types of financial institutions). Only 15% (25 million) of the population of 160 million has bank accounts and less than 4% (5.5 million) are borrowers; only one quarter of households has a member with a bank account. Moreover, while two- thirds of the population resides in rural areas, only 25% of total bank depositors and 17% of total borrowers reside in rural areas; in value terms the shares of rural customers are even smaller, only 10% and 7% of the total value of deposits and advances, respectively. Limited access to services is also evidenced by the low level of branch penetration in rural areas, where there are less than 2,500 branches for a population of 105 million people—or an average of 42,000 inhabitants per branch. This has held back the growth of savings and access to credit.

56. **There is an enormous pool of companies to be included in the formal financial sector**. There are an estimated 3 million companies in Pakistan of which only some 50,000 are registered by the SECP, including some 650 that are listed on the stock exchanges. Some 80,000 companies borrow from the formal financial sector, mainly from banks. This implies that there is a pool of nearly 3 million potential company customers to be tapped by the banking sector. Banks recognize the potential of SME lending but have been slow in developing products and processes for more penetration into this potentially highly lucrative market.

57. **To address these issues, SBP has established a Development Finance Group**, which has already developed a comprehensive Financial Inclusion Program (FIP) aimed at promoting access to development finance for all small and underserved companies and market segments. There is a need to encourage banks to increase their focus on smaller companies, farmers and the household sector. The FIP is supported by UK DFID and other foreign donor agencies.

4.3 Elements of the Financial Inclusion Program (FIP)

58. **In *Microfinance*, SBP and Pakistan Microfinance Network (PFM) has developed a multi-faceted microfinance strategy** to triple the number of microfinance (MF) beneficiaries from 1 million to 3 million by 2010 and then to 10 million by 2015. To support this program, SBP has encouraged commercialization of the microfinance industry so that it becomes financially and socially sustainable. Some of the specific actions being taken include:

(i) A more flexible prudential regulatory regime for microfinance banks (MFBs) to allow innovation and organic growth without abandoning prudential objectives. Limits for MFBs (and other microfinance institutions (MFIs)) will be adjusted at least in line with inflation and a two-tier regime is to be considered under which MFBs (and MFIs) with track record of prudent governance, risk management and financial success could be given more room to operate. This includes recently introduced capital adequacy requirements, which bring MFBs (and MFIs) into a competitive position at par with that of banks.

(ii) Encouragement of MFBs to improve their earnings quality and asset portfolios through improved risk management structures and practices, credit analysis and end-use monitoring. These measures will address the concerns over reduced capital adequacy ratios of these banks.

(iii) Encouragement of MFIs to develop commercially viable and financially sustainable operations, which will allow them to transform into MFBs to provide holistic services, such as savings, credit and fund transfers. A five-year tax holiday is given as an incentive for MFIs to transform themselves into full-fledged MFBs.

(iv) Encouragement of partnerships between commercial banks and MF providers to help banks enter into microfinance.

(v) Encouragement of a partnership between the post office (PO) network and MF providers. POs already manage over 4 million savings accounts, mainly small accounts below Rs 10,000, through more than 12,000 branches. There is scope for the PO and MF providers to join forces with the latter acting as intermediaries for funds raised by POs, especially as the operations of many MF providers are constrained by limited funding.

(vi) Encouragement of mobile phone-based banking services which is a cost effective way of bringing financial services even to the most remote areas of the country. This is an option with enormous potential as there are already nearly three times more mobile phone owners (some 90 million) than there are depositors. Mobile phone services reach almost every part of the country and are an extremely cheap way for banks and other financial institutions to extend their reach.

(vii) Banks, including MFBs, are encouraged to take advantage of SBP's recently introduced *Branchless Banking Regulations* for enhancing the provision of financial services through alternative delivery channels.

(viii) Development of domestic and international MFI partnerships.

(ix) Financial literacy and customer awareness programs.

59. **In *Islamic banking*, SBP has been promoting Islamic Banks (IBs) to provide formal financial services to the population that thus far has excluded itself for faith reasons**. A separate Islamic Finance Strategy paper has been developed which projects, based on the growth rate of IBs that Islamic finance will grow to constitute almost 12% of the banking system within five years. So far, IBs have no branches in rural areas, where they clearly have a substantial customer base to explore. SBP, under its new branch licensing policy, expects rural IB branches to increase at the rate of 20% of all new branches opened.

60. **To encourage sound growth of IBs, SBP has laid out a separate prudential regulatory and supervisory framework** that conforms to the framework of the Islamic Financial Service Board (IFSB)[4] **-** in the development of which Pakistan has played a key role. To ensure proper due diligence in the development of Islamic Finance (IF), SBP has constituted a Shariah Advisory Board, which approves broad policy, the regulatory framework and new Islamic financial products. SBP is working to develop a proper liquidity management framework and new instruments to allow the IBs to grow and compete with conventional banks in a prudent and sound manner. The establishment of Islamic MFBs has also been encouraged.

61. **Constructive progress has been made with the inclusion of *Sukuk* as eligible instruments under the SLR.** In September 2008, a first issue by the GOP of *Ijarah Sukkuk* worth Rs. 6.5 billion has given IBs a major boost by providing them with a risk- free SLR eligible instrument. The plans also call for a segregated depositor protection fund for IBs.

62 ***In SME financing*, SBP plans to promote such financing through supportive mechanisms, conforming to best international practices.** The SME sector faces a host of both demand and supply side constraints that impede credit delivery. On the demand side, lack of planning and entrepreneurial skills and various problems with the SME policy framework remain major hindrances, while on the supply side banks perceive financing these entities as high risk in the absence of credit history and collateral. This notwithstanding, the growth in SME credit has been significant. The share of SME credit in total outstanding advances was close to 12% as on end-September 2008 and the number of SME borrowers is around 214,948. SBP is helping banks in designing specific products, and developing a credit scoring system for SME finance. It will also help develop a financial reporting system for SMEs.

63. **In addition, banks are being encouraged to facilitate program-based SME lending** (in which banks establish the general criteria for meeting the specific financing requirements of businesses) and lending based on cash flow rather than collateral. Work is underway to develop appropriate credit

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[4] The IFSB is an international standard-setting organization that promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors.

enhancement mechanisms, which will facilitate bank lending to the sector. Steps already taken include the formation of an SME Credit Advisory Committee, work on development of a Credit Guarantee Scheme, establishment of an SME Help Desk to foster a more business-friendly policy and regulatory environment for SMEs and booklets on financing products available for SMEs. In addition, SBP is considering offering training programs for commercial bankers in SME lending methodologies and appraisal techniques, and is exploring with banks and other financial sector institutions the feasibility of establishing venture capital funds focusing on SME promotion.

64. ***Agriculture lending* has received a significant boost with the banking system meeting its target of Rs 200 billion set for 2007/2008.** This notwithstanding, outstanding agriculture advances account for only 6% of total advances and the current flow of credit meets only 45% of the sector's credit requirements. SBP's strategy for agriculture credit seeks to double the number of borrowers from 2 million to 4 million and to meet 75-80% of the agriculture credit requirements within 3 to 5 years. SBP has encouraged a revolving three-year credit scheme under which farmers can borrow for one year and continue to borrow without providing documentation each year. Guidelines have been issued for lending to the livestock, fisheries and horticulture subsectors and programs are being launched for the dairy sector. In addition, a *Small farmer special financing scheme* has been promoted based on group based lending and a *Crop loan insurance scheme* has been structured which is now being offered by some insurance companies. Agriculture credit based on Islamic principles will be promoted and capacity building provided to farmers and bankers in regional languages.

65. ***Banking in rural areas* will be promoted by new innovative approaches to branching**. Existing SBP rules call for banks to establish at least 20% of their new branches in rural areas. As competition for deposits grows and different types of rural lending are found to be profitable, it is expected that banks will find their rural operations to be increasingly attractive. Innovative products and methods of selling them will also increase banks' reach and may change the "brick-and-mortar" nature of branch operations. Commercial banks have been given the option to open full-fledged branches, sub branches (with limited general banking functions), booths (for collection of various fees and bills), Mobile Banking Units and Sales and Service Centers. SBP has also introduced *Branchless Banking Regulations* with the objective of providing banks with cheaper non-traditional delivery channels (retail agents, mobile phones) to increase their outreach to un-banked and rural communities.

66. **SBP projects financial penetration ratios to be raised** through an enabling policy environment and the various outreach programs described above from a national coverage of 19,000 persons per bank branch in 2007 to 15,000 in 2012 and 12,000 in 2017. The coverage of ATM outlets is projected to increase from 57,000 persons per ATM in 2007 to 12,000 in 2017.

5. Strengthen Consumer Protection and Financial Education

67. **The protection of consumers of financial services is weak in Pakistan, as is financial literacy more generally.** Over time, competition between banks is likely to improve service levels and financial literacy campaigns may have a positive impact. But such improvements are likely to be unacceptably slow. SBP is therefore planning to introduce a number of reforms and to speed up the process.

5.1 Consumer Protection

68. **SBP has already taken actions and will take further measures to rapidly improve customer service standards and consumer protection.** The following mechanisms have been put in place to ensure that banks render good service and deal fairly with customers:

i. Guidelines for timely and effective resolution of customers' grievances were issued in 2004;
ii. An on-line complaint form was introduced in 2004 to give bank customers an easy and convenient way of lodging complaints and seeking early problem resolution;
iii. A *"Consumer Education"* link has been created on the SBP website to educate bank customers on the complaint process and redressal mechanisms;
iv. The Office of Banking Mohtasib (OBM) established by law (BCO) and functioning since 2005 has been able to resolve a number of long outstanding complaints of bank customers;
v. Appeals against decisions of the OBM are handled by appeal committee constituted by SBP;
vi. *Prudential Regulations for Consumer Finance* in place since 2002, seek to minimize consumer inconveniences;
vii. SBP issues a half yearly review on "Complaint Redressal", which analyzes the type, pattern and trend of complaints and makes recommendations on key operational and policy issues;
viii. A Complaint Tracking System was introduced in 2006 to allow SBP to follow up on complaints more efficiently;
ix. A new Consumer Protection Department was created in SBP in 2006 to allow more focused attention to customers' complaints and consumer protection, and to address grievances in an efficient and timely manner (4,000-5,000 complaints were handled in both 2006 and 2007).
x. SBP has recently established Customer Facilitation Centers (CFCs) at the Consumer Protection Department and all sixteen field offices of SBP Banking Services Corporation; and
xi. Procedures for collection/recovery of debt have been streamlined, for which SBP has issued minimum standards to be observed by Banks/DFIs in their efforts for collection/recovery.

69. **To supplement and reinforce the measures already taken, SBP plans to:**

i. Introduce a new ***Consumer Protection Act*** consistent with international best practices, which would provide guidance on a range of issues, including transparency, confidentiality, availability of statements, account servicing, protection against fraud, unfair contracts and lending practices, methods of debt collection, arbitrary penalties. The new legislation will also seek to establish an appropriate dispute settlement mechanism. Consumer protection codified in existing SBP regulations will be reviewed and updated in line with the new legislation.
ii. Introduce a new ***Financial Crimes Act*** to better define financial crimes, strengthen monitoring and establish penalties of such crimes.
iii. Encourage Pakistan Bank's Association (PBA) to adopt a ***Banking Code of Ethics***, which will be used as a basis for committing all banks to fairness, disclosure and proper ethical standards.
iv. Strengthen the newly established ***Consumer Protection Department*** of SBP to monitor compliance with existing and new laws, regulations and codes.
v. Strengthen the role and functions of ***Banking Ombudsman***, which will remain a body independent of SBP, to be better aligned with the above reforms.
vi. Introduce new ***transparency rules*** in the pricing of deposit and credit contracts (as discussed below).
vii. Introduce a ***Depositor Protection Scheme*** to provide protection to all bank depositors up to an established limited amount (as discussed below).

5.2 Financial Literacy

70. **SBP will sponsor a long-term campaign to enhance financial literacy.** It will take the form of a special Financial Literacy Program (FLP) to cover both rural and urban areas. The program will aim at preparing the ground for a healthy basic understanding of financial services. It will be targeted at families, adolescents, students, children, small entrepreneurs and the population at large in order to make everyone better equipped to manage their own finances. This will include developing products and advisory services targeted at people in need or who are financially at risk; the goal would be to create a better understanding of the need for financial foresight and planning.

71. **The FLP will require the active participation and support of the banking industry and other organizations.** While SBP will spearhead and take the initiative in this program to educate and enlighten a new generation of households and entrepreneurs, the FLP will necessarily require a broad-based effort. Support needs to come not only from individual banks and banking industry associations like the Pakistan Banks' Association (PBA), but also from NGOs and various other organizations and institutions. Moreover, the National Institute of Banking and Finance (NIBAF) and its offices, and collaboration with other training institutes like the Institute of Bankers Pakistan (IBP) will facilitate the FLP. The SBP will promote the view that banks will not only become better at providing services but will also become more profitable, if they have knowledgeable and critical consumers, who challenge them to develop better, more effective and innovative solutions and products. Ultimately, such efforts will boost economic activity more generally and create a more diversified and stable financial sector.

6. Consolidate and strengthen the banking sector

6.1 Further consolidation

72. **The banking sector has been consolidating in recent years as a result of market synergies and increases in minimum capital requirements (MCRs).** The number of conventional commercial banks already has declined from 41 in December 1997 to 23 at the end of 2007 through mergers, acquisitions and closures.[5] Meanwhile, the numbers of IBs and MFBs has increased from 1 to 12. Some remaining weak banks with lagging performance still need to find merger partners. As the most attractive mergers already have been consummated, additional mergers are unlikely without SBP regulations forcing banks to do so.

73. **Further consolidation is necessary to ensure that banks remain strong and well capitalized.** Banks will need financial strength and certain size to maintain capacity for adequate governance structures, and increasingly sophisticated internal control and risk management systems.

74. **SBP requires banks (and DFIs) to further increase their MCRs**. Banks will be required to increase their MCR from Rs. 5.0 billion at end-2008 to Rs. 6.0 billion at end-2009 and Rs. 23.0 billion by the end of 2013.[6] All banks, with the exception of microfinance banks (MFBs), will be required to comply. The MCR requirements for DFIs have been kept the same as previously instructed, i.e. to raise their paid up capital to Rs. 6.0 billion by December 2009. This will force banks (and DFIs) either to consolidate further by finding merger partners or exit the market. With the higher MCRs a new spate of

[5] See Annexure A, Table 1.
[6] Foreign banks, whose Head Offices maintain paid-up capital of at least equivalent to US$ 300 million and have a CAR of at least 8% or the minimum prescribed by their home regulator, whichever is higher, will be allowed with the prior approval of SBP to raise assigned capital of Rs 3 billion, if operating with less than 5 branches and Rs 6 billion if operating or planning to operate with 6 to 20 branches by December 2010.

consolidation is expected in the banking sector, resulting in emergence of stronger but fewer banking institutions.

75. **A moratorium on new bank licenses will remain while new licensing of MFBs will be encouraged.** Exceptions to this would require up-front compliance with the Rs. 23.0 billion MCR. Microfinance banks (MFBs) will be outside the ambit of the moratorium but licensing of MFBs will henceforth be either under national or provincial charters. To increase the number of MFBs, SBP is encouraging well established NGOs to restructure themselves into legally established MFBs, so that they can operate under effective and transparent ownership and with adequate capital. Already the KASHF foundation has been licensed by SBP and has started functioning as KASHF Microfinance Bank.

76. **The establishment of new categories of deposit taking institutions will be considered to serve regional or niche markets.** The wide difference in size between banks and MFBs justifies consideration of allowing additional types of banking institutions. At the moment commercial banks are not reaching downward enough in customer size and MFBs are not financially capable of reaching beyond the micro borrower. Consequently it is the SME sector that is relatively ignored. The middle tier institutions would be large enough to enjoy reasonable scale, and they would be required to focus on the SME business, including those related to agriculture. They may also opt for operation in a limited geographical region, with focus on rural areas. With the rise in minimum capital requirement for commercial banks to Rs.23.0 billion by 2013, the banks that are not able to meet this capital may be considered for candidates for conversion into such types of institutions, provided they agree to operate in this new business model. This idea will be further deliberated in the future, before a more structured policy framework is formulated.

77. **Undercapitalized commercial banks owned by federal or provincial governments will need to meet capital adequacy and other prudential ratios.** Those banks that do not comply will be intervened by SBP and resolved through merger, recapitalization or liquidation. Over the years, SBP has developed capacity to manage the resolution and restructuring of problem banks. It has successfully revived/restructured 5 banks, and is presently processing the restructuring of three public sector banks. However, the pace of restructuring remains slow and require active support from the Government for their timely restoration.

78. **Three of the specialized government-owned banks have made only limited contributions to the economic sub-sectors that they target and must exit the market.** The House Building Finance Corporation Ltd. (HBFCL), Industrial Development Bank of Pakistan (IDBP) and SME Bank have out-served their purposes. Their weak financial performances have forced them to borrow from the SBP, which in turn has impacted SBP's balance sheet negatively and forced it to make regular large loan loss provisions. Compensating for such losses is not an option in the medium term, given the present fiscal stress and the need to enforce rules of competition and financial viability. In view of this, resolution programs are being implemented for these institutions: the SME Bank is being privatized, the HBFC restructured prior to privatization and the IDBP is being incorporated as a public company and will be available for sale.

79. **The fourth specialized government-owned bank, Zarai Taraqiati Bank Ltd. (ZTBL), needs financial and operational restructuring.** This bank is highly strategic, as it provides about one third (31.7%) of all credit to the agriculture sector. Different public sector approaches have failed in the past to transform ZTBL. The most important unresolved issue is its excessive debt liabilities as well as shareholding pattern. SBP has proposed that the Government should pave the way for its eventual privatization, considered to be critical for augmenting its scale and efficiency.

80. **The capital strength of the banking sector has increased substantially in recent years.** The average risk-based capital adequacy ratio (CAR) for all commercial banks strengthened from 11.4% in

2000 to 13.7% at end-2007 and 12.1% by end June 2008, substantially above the required minimum level of 8.0%. The end-2007 number even understates the improvement that has taken place, due to a major tightening of banks' loan loss provisioning rules in 2007. The strengthening comes both from new capital injections and retained profits.

81. **The average CAR conceals capital weaknesses in some banks that require restructuring.** At end-2007, three banks with a market share of about 5% had CARs below 8.0% while another 6 banks with a market share of about 21% had CARs in the 8-10% range.

82. **SBP considers an increase in the minimum CAR necessary** and has raised it from 8.0% to 9.0% as of end-December 2008 and to 10.0% by end 2009. In addition, it has linked the actual CAR requirement of a commercial bank with its supervisory rating and banks with poor ratings are required to hold additional capital (in percentage terms) by the year-end-2009.[7] This is expected to force weaker banks to strengthen their financial management and/or merge into stronger banks. It is also a mechanism to reward banks who are well managed and receive better CAMELS rating.

83. **SBP is developing a liquidity management framework**. Currently, liquidity management is carried out through open market operations (OMO) in the form of reverse repo/repo operations, supplemented by the discount window. SBP is in the process of developing a liquidity management framework with the introduction of a formal interest rate corridor, which will enable it to modulate short-term liquidity in order to ensure stable conditions in the short term money market. The interest rate corridor will also operate through reverse repo / repos, thereby setting a corridor for short-term interest rates, consistent with policy objectives.

84. **Specific Treasury Bills will be created for this purpose**, for implementation of monetary policy objectives including OMOs and mop ups under the explicit interest rate corridor. These will not replace existing MRTBs and will be created only when MRTBs fall below a pre-determined trigger point. A structured mechanism for this purpose will be introduced by SBP in due course. Benefits of switching to an explicit interest rate corridor include gradual reduction of reliance on the more direct instruments of monetary policy. It will enable SBP to de-emphasize the targeting of bank reserves and focus increasingly on interest rates. Eventually this will help in reducing CRR / SLR without engendering liquidity pressure.

7. Strengthen competition and efficiency

7.1 Competition

85. To assess the degree of competition in banking, SBP has examined the market structure of the banking sector, including the number of banks, concentration indicators, contestability, and performance measures such as margins or profitability. The concentrated structure of the sector raises questions about the ongoing consolidation and persistently high banking spreads and profitability. For example, consolidation can potentially reduce competition as the number of banks is reduced.

86. **The conclusion of SBP's competition analysis is that the structure of the banking sector can be described as monopolistically competitive**. This conclusion is based on the analysis of various concentration ratios and variation coefficients, including indexes that take into account the relative size and distribution of the banks in the system. The details of this analysis are available in SBP's forthcoming Financial Stability Review 2007-08. These conclusions conform to the realities on the

[7] SBP uses a composite rating of each bank based on its CAMELS-S approach under which it reviews banks' Capital adequacy, Asset quality, Management, Earnings, Liquidity, Sensitivity--and Systems and controls in order to assign a composite rating on a scale of 1-5.

ground, as banks in recent years have competed aggressively to increase the size of their loan books by venturing into areas like SME, consumer and agricultural financing.

87. **The above conclusion has to be qualified for banking in low-banked areas, where the largest** banks remain in a uniquely competitive position on the basis of their large branch networks, while other banks are at an early stage of expanding their networks. Although traditional concentration measurements show a decline in concentration nationally, these results need to be qualified for low-banked areas, where the big banks *have a dominant presence* due to their branch networks, economies of scale and relationships built over the years. Other banks have started operations in these areas, partly as a result of SBP regulatory requirements, but it will take them many years to reach the presence and level of operations that the big banks enjoy. This process may be speeded up by the outreach programs described above and new delivery techniques and channels, including branchless banking. Expansion by MFBs also holds promises of improved financial services in rural areas.

88. **On the issue of market contestability,** SBP has concluded that the banking sector is reasonably contestable, despite the presence of the implicit moratorium on new bank licenses and a high MCR. SBP is considering the licensing of new categories of small institutions to increase the number of delivery channels under its outreach program. Already, there has been a substantial increase in the number of new Islamic banks and MFBs, which have been increasing their market shares in the banking sector. The market share of IBs has increased to 4.3% within a period of 6 years and together IBs and MFBs hold a market share of around 4.5%. Entry of strong international banks like Barclays and SAMBA and reputable international investors like Temasek, DEG and IDB provides additional support to the existence of a contestable market.

89. **The market shares of the biggest banks have declined significantly since 2000**. This decline has affected their assets, credit and deposits alike. The asset share of the top five banks has declined from 68% at end-2000 to 51% at end-March 2008. Their lost market share has mainly been captured by the next five largest banks, whose market share has increased from 9 to 22% in the same period. The main reason for the growing share of the second group of banks has been their pursuit of mergers and acquisitions and aggressive efforts to increase their lending. Although the combined market share of the ten largest banks declined from 77% to 73% between end-2000 and March 2008, their dominance of the banking sector does continue.

90. **To enhance competitiveness, SBP will focus on continuing to broaden and deepen the financial system further.** Efforts are under way to (i) review the actual behavior and conduct of banks related to the structure of the banking industry and take the required actions, (ii) encourage contestability by allowing entry of new banks and (iii) encourage bank competitiveness by promoting development of non-bank financial intermediaries. Furthermore, competition in the banking system is likely to grow as the increasing demand for advances results in a need for higher deposit mobilization.

7.2 Interest rates

91. **To assess the degree of competition in banking, SBP has examined the market structure** of the banking sector, including the number of banks, concentration indicators, contestability, and performance measures such as margins or profitability. The concentrated structure of the sector raises questions about the ongoing consolidation and persistently high banking spreads and profitability. For example, consolidation can potentially reduce competition as the number of banks is reduced.

92. **Competition and price signals drive a market-based financial system.** The market sets the prices (interest rates) for money and credit, which in turn drive the allocation of financial resources and bring about efficiencies and innovations. A few large banks with substantive market power and access to low

cost funds by virtue of their age-old captive clients and markets distort the price mechanism, as they are the principal price-setters. As a result, real returns have been negative for most deposits, which has deterred effective mobilization of funds, and distorted the yield curve and the pricing for loans and advances. With steadily rising competition, rising deposit rates for time deposits has helped raise the Weighted Average Deposit Rate (WADR) through 2007 (**Table 3**).

Table 3: Banks' weighted average interest rates and spreads, 2004-07 [8]

Month/year	12/04	12/05	12/06	12/07	6/08
WALR	6.69	9.81	11.10	11.27	11.96
WADR	1.30	2.55	3.66	4.13	5.18
Spread	5.39	7.26	7.44	7.14	6.78
Real WALR	-0.68	1.30	2.22	2.48	-9.54
Real WADR	-6.07	-5.96	-5.22	-4.66	-16.32

Source: SBP

93. **Savings deposits, which account for 43% of all deposits, have long been remunerated at particularly low yields.** In early 2008, the average yield was about 2% p.a. with the largest banks capturing most such deposits through their vast branch networks. For years, banks were able to keep their deposit rates very low in absolute terms and at negative levels in real terms. With the sharp increase in inflation in 2008 all deposit rates, and rates on savings deposits in particular, became increasingly negative in real terms.

Table 4: Profits of 4 Largest and All Other Banks, 2006-07; & Sept 2008

Banks	Assets			Deposits			Profits b/tax			Profits a/tax			Branches	
Month/Year	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006-2007	2008
							(in percent of total)							
4 largest	46	46	45	48	47	47	64	70	78	63	69	78	61	58
All other	54	54	55	52	53	53	36	30	22	37	31	22	39	42

Source: SBP

94. **Interest rate spreads and profits were high, especially in the largest banks.** Spreads have been quite high when compared with spreads in other countries. This reflects the long-term structural excess liquidity in the banking system, which has allowed the largest banks to keep their funding costs down and generate substantially higher profits than banks without branch networks. In September 2008, the 4 largest banks accounting for 58% of all branches but only 47% of the total deposits generated 78% of all profits in the banking sector (**Table 4**); this was an increase in profits on a reduced deposit base from 2006.

95. **Taking advance action, SBP has sought to reduce structural distortions that have impeded competition.** Effective June 1st, 2008, SBP introduced a minimum deposit rate of 5% p.a. for all PLS savings product as all banks--and the largest banks in particular—for quite some time had enjoyed ample access to a pool of excessively cheap savings deposits, especially in rural areas. As the market matures, competition will encourage better alignment of interest rates both on deposits and advances. Large corporate borrowers that have been largely dependent on banks may over time find it more attractive to

[8] Weighted average lending rate (WALR), weighted average deposit rate for all maturities (WADR); real interest rates calculated based on change in consumer price index in previous 12 months.

raise financing in the debt and equity markets. In other countries such financing is typically cheaper than bank borrowing.

96. **SBP has taken steps to address the issue of widening interest rate spreads.**[9] The 5% p.a. floor rate for all saving deposits constituted a major increase from the average rate of 2.1% p.a. paid by banks in 2007. Due to the recent liquidity strains in the banking sector, SBP lowered the levels of the CRR and SLR to prevent banks from increasing banking spreads further. By seeking to lower interest rate spreads, and improving the efficiency of banks, the SBP is seeking to gradually reduce intermediation costs to the benefit of the entire economy.

7.3 Transparency of interest rates

97. **Interest rates in Pakistan are unusually non-transparent.** Ninety percent of deposits are remunerated through "Profit and Loss Sharing" (PLS) arrangements rather than at explicit interest rates known to the depositor in advance. The yields on PLS accounts are determined ex post by the banks based on non-transparent formulas, which result in most banks doing little actual profit sharing. Lending rates are required to be linked to KIBOR, and the premium on KIBOR once mutually agreed, cannot be changed for the duration of the loan.

98. **There cannot be a competitive market without transparency of interest rates.** On the one hand, depositors seem relatively unresponsive to interest rates as indicated, for example, by the absence of migration into NSS deposits in periods when NSS has offered very attractive yields. On the other hand, the share of time deposits has been growing in response to increasingly attractive yields, which indicates that companies and individuals indeed do respond to interest rates. Transparency regarding the level and basis for determination of interest rates is an issue of financial literacy as well as consumer protection.

99. **Transparency regarding returns on deposits requires a review of PLS schemes.** The present non-transparency of PLS contracts allows banks to determine *ex post* arbitrary yields with impunity (this is also a consumer protection issue). The PLS system in its present form is unique to Pakistan and excessively beneficial to the banks. Although PLS deposits originally were supposed to conform with *Sharia* principles, they were ruled non-compliant by the Supreme Court in 1999. Since then, new conforming Islamic instruments have been offered by Islamic banks and by conventional banks in Islamic branches or windows. Given that the present PLS system awkwardly falls in between the two systems, SBP is of the view that further reflection is warranted to introduce effective transparency in interest rate delineation to differentiate between Islamic versus conventional deposits, so that depositors are offered either conventional interest-based deposits or conforming Islamic profit sharing deposits.

100. **To improve transparency in the pricing and documentation of loans**, banks have been barred from including any clause in the loan documents that could allow them to change lending rates unilaterally and make explicit all service charges so that the borrower will not incur hidden charges during the term of the loan.

101. **Banks have been required to post deposit rates in a prominent place in all branches.** The rates should be presented for all standard deposit and lending products in a uniform format of annualized percentage rates (APR). Additional conditions that affect the APR of deposits should be transparent and made known to depositors. Transparency will help the price formation process and help educate depositors. Similarly, banks are required to disclose their schedule of charges on their respective websites and in their branches in order to bring awareness to their customers.

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[9] For details, see "Efficiency of Financial Intermediation: An Analysis of Banking Spreads" in Financial Stability Review 2006, State Bank of Pakistan.

102. **SBP has taken steps to proactively keep the public informed about interest rates.** Banks are required to publish their deposit rates on saving deposits in the newspapers on half yearly basis. Banks publish these rates in the form of a box in key newspapers as well as on their websites, covering bank deposit rates for savings deposits and standard maturities of time deposits. Further, newspapers publish NSS rates, primary and secondary market rates for standard maturities of PIBs and TBs, KIBOR rates and daily exchange rates based on the information posted on SBP's website. This provides impetus to the SBP's broader campaign of transparency and financial literacy.

8. Strengthen Prudential Regulation and Supervision

103. **In recent years, SBP has introduced a broad range of prudential regulations** to strengthen risk management, internal controls, corporate governance and capital adequacy. SBP has also provided banks with guidance for promotion of development financing and consumer credit.

104. **The legal and regulatory framework for banks needs continuous updating and upgrading in view of evolving international best practices.** Although the regulatory framework has been updated it needs further changes to keep pace with emerging international best practices emanating in the Basel Committee on Banking Supervision (BCBS) and other international standard setting bodies. The Banking Companies Ordinance (BCO) is outdated and needs renewal. Remaining regulatory challenges include the need to introduce limitations on banks' single and related party exposures, tighten capital adequacy rules and fully implement the Basel II regime. In addition, there is a need to put in place new regulatory and supervisory frameworks for dealing with financial conglomerates.

8.1 New banking legislation

105. **A new Banking Act (BA) has been submitted to the GOP to replace the BCO.** The new BA has been drafted to take into account the changed operating environment for banks since the BCO was introduced in 1962. The objectives of the new law are to foster a competitive banking system that will be able to meet the needs of the Pakistani people for financial services and to stimulate economic growth and promote financial stability. It will also give powers to and promote accountability by the SBP in carrying out its functions under the law and serve as an aid to the courts when they are called upon to interpret banking and other issues related to the law that may arise. [10]

106. **The new draft BA seeks to provide a comprehensive framework** for the authorization, licensing, ongoing supervision, permissible activities, governance, a structured process for resolution of troubled banks and various financial and operational requirements of the banks. In addition, it will cover payments systems and e-banking, enforcement powers to prevent illegal banking and deposit taking, a framework for conducting banking business based on Islamic principles, clear and transparent criteria for entry into and exit from the business of banking, detailed provisions regarding ownership and management of banks as well as clear delineation of responsibilities with accountability in case of any wrongdoing, judicial challenges posed to SBP from undue litigation, fit and proper criteria for management, board members and chairmen of banks, enabling provisions for anti-money laundering.

107.**The draft BA elaborates the powers of the SBP as the sole supervisor of the banking sector**, including its authority to issue regulations and perform supervision, specific powers needed for the conduct of consolidated supervision, as well as provisions on bank secrecy, corrective actions and

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[10] For additional details on objectives of the draft BA, see Annexure C.

remedial measures, liquidation and winding-up of banks. In addition, the draft BA provides a legal basis for cooperation between SBP and SECP, clarifies overlapping responsibilities between the SBP and the Federal Government and gives clarity to cross-border cooperation with foreign supervisors.

108. **The new draft Banking Act was prepared by a Banking Law Review Commission** appointed back in 2000 and has been reviewed by the Pakistan Banks' Association (PBA) and by other interested parties, including by international organizations like the International Monetary Fund. The final draft BA is expected to be submitted to the Cabinet and Parliament for consideration in early 2009.

109. **In the meantime, urgent amendments to the existing BCO are under consideration** by the Cabinet. These amendments seek to give SBP the necessary powers to undertake consolidated supervision of financial groups and conglomerates and transfer deposit-taking NBFIs to the regulatory jurisdiction of the SBP. Those amendments are also part of the draft BA.

8.2 New prudential regulations

110. **Implementation of the Basel II regime of minimum capital adequacy will continue.** The new regime was introduced at the beginning of 2008 with the obligatory application of the Standardized Approach to credit risk and the Basic Indicator Approach to operational risk for all commercial banks. This followed a year (2007) in which all banks had been required to run the new regime in parallel with the old Basel I regime. Banks already have made major advances in implementing the new framework although many are still facing challenges in areas like integrated risk management policy and collateral management. Banks have been hampered by the limited availability of external credit ratings of counterparts in Pakistan.[11]

111. **SBP has made it optional for the banks to adopt and implement more advanced approaches of Basel II.** The application of the basic approaches of Basel II is not likely to result in any major change in banks' CARs when compared with the previous Basel I regime. Impact studies done so far indicate that lower capital requirements against credit risk by and large are offset by new capital charges against operational risk. Given the dearth of external ratings, banks will not be able to reap the full benefit of the new Basel II regime and lower their CARs unless they move to the advanced approaches. For that they need further improvements in their data bases and risk management systems, which will take time. So far, no bank has asked SBP for permission to start implementation of the advanced approaches. Meanwhile, SBP has made it mandatory for all banks to carry out internal risk ratings to force them to review their risk management systems and capabilities. Some of the larger banks can be expected to opt for the advanced approaches within the next few years. Any transition to those approaches will be subject to approval by SBP to enable it to evaluate the readiness of the bank and the efficacy of its risk management systems.

112. **There is a need to tighten loan concentration limits** and re-examine regulations regarding exposures of large companies/borrowers in general and to related companies or groups of companies in particular. High exposures are partly the result of reluctance by companies to seek alternate non-bank sources of financing, as bank financing has been relatively cheap and easily available. In the past, SBP also has relaxed exemptions from prudential regulations on corporate exposures relatively easily. Excessive corporate exposures pose a threat to individual banks and may cause broader financial instability. Stricter limitations on bank exposures to large companies would induce those companies to

[11] Almost one half of banks' on-balance sheet exposures require external credit ratings but such ratings are not common in Pakistan. Only one sixth of those exposures have ratings and most are banks, which means only a very small portion of corporate credit exposures have external credit ratings.

raise more capital in debt and equity markets. This would strengthen individual banks and the banking system, improve risk diversification and broadly contribute to financial stability.

113. **Regulation on the management of liquidity risks requires further attention.** The recently observed liquidity pressures in the domestic banking system and abroad has brought new attention to the effects of swings in liquidity condition on banks' viability. The Basel Committee is reviewing regulations for liquidity risk and once new best practices are promulgated internationally, the SBP will need to adapt them to domestic circumstances. SBP will also need to review liquidity management as a central bank and lender of last resort, especially in view of the recent liquidity strains in the banking sector, which SBP was able to alleviate by lowering of Cash Reserve Requirement (CRR) and Statutory Liquidity Requirement (SLR) for banks.

8.3 Change in regulatory and supervisory approach

114. **SBP is reconsidering the balance between rule- and principle-based approaches to guide its prudential regulation and supervision in the future.** A rule-based approach for regulation seeks to codify all prudential requirements into laws or regulations, while a principle-based approach seeks to limit law and regulations to broad statements of principle. The former approach provides certainty to the banking industry but limits the flexibility of SBP to adapt to changing circumstances and change regulations in view of experiences. In supervision, the choice is between an approach seeking compliance with the regulatory framework and risk-focused one seeking to identify and monitor major risks. Pakistan has traditionally relied on a rule-based regulatory and compliance-based supervision approaches.

115.**The danger of relying too heavily on rule-based regulations is that good principles may get lost in the details** and that the industry becomes too focused on complying with the wording of the rules rather than their intent. For example, under a rule-based approach, if the law identifies the need for banks to implement sound risk management frameworks, regulations would need to spell out frameworks in great detail, which could then limit prudent innovation and system development. Meanwhile, a principle-based approach would allow SBP to develop its own understanding of best practices in line with basic principles and share those practices with banks; it could also allow banks more leeway to test and develop their own frameworks subject to approval of the SBP.

116. **SBP will seek a balance between these two philosophies.** Risk management practices are still evolving in the banking industry. Banks will need some guidance both in the form of clear principles and detailed rules. As the financial sector becomes more complex and dynamic, banks and NBFIs under SBP jurisdiction will need to adapt quickly to changing circumstances and SBP will need to be prepared to adapt along with them. This will necessarily place new demands on SBP staff, which will make it necessary for SBP to recruit, train and retain staff that fully understands the business of financial intermediation as well as the demands on a modern regulator and supervisor. SBP must seek to facilitate diversification, innovation and growth, while at the same time focusing on strengthening risk management capacity in banks, and systemic stability.

117. **SBP needs to adjust its supervisory approach in line with the changes being proposed in the legal and regulatory framework.** While banks needs to work for improving their critical control functions, like internal audit, compliance and risk management, SBP needs enhanced emphasis on the improvement in the structures, policy frameworks, human capital deployment and implementation of policies and procedures in these areas. This will help SBP focus and more effectively utilize its supervisory resources on key risk areas.

118. **There is a need for renewed focus on corporate governance in banks.** In recent years, SBP already has made major efforts to improve banks' corporate governance practices toward best international practices. The existing corporate governance framework and practices will require further analysis and assessment and will need re-codification to bring into compliance with international best practices and to incorporate new statutory provisions and requirements under the new BA. A key issue which has been debated internationally since the advent of the global financial crisis is the level of compensation for senior executives. Banks may voluntarily link executive compensation to performance targets and objectives set by their boards or HR committees. It is likely that SBP will need to introduce some regulatory guidelines to rationalize compensation packages and frameworks for monitoring of executive performance.

119. **Reliance on technology is increasing in the banking industry both for product development, marketing and efficient modes of service delivery.** SBP has encouraged the industry to reap the benefits of technologies through product innovation and service enhancements. Mobile banking is one such example. SBP has already put in place the *Branchless Banking Regulations* and the *Electronic Payment and Fund Transfer Act, 2007*. Supervision of this emerging area needs a special supervisory skill set as well as a new effective supervisory framework to be put in place before the market expands into this area.

9. Consolidated supervision of financial conglomerates

9.1 Need for consolidated supervision

120. **Commercial banks are moving into conglomerate modes by venturing into other sectors.** Some banks have acquired or merged NBFIs such as investment, brokerage, asset management and insurance companies into their own operations, while other banks have kept NBFIs as subsidiaries or acquired associate holdings in insurance companies. Conglomerates have become the norm, as banks broaden their product offerings and seek cross-selling opportunities. Presently, 5 banks (and one DFI) own shares in insurance companies, 12 banks have interests in asset management companies and mutual funds, and many are involved in other areas like leasing, financial advisory and brokerage services, *modaraba* management and foreign exchange.

121. **Financial conglomerates present a major challenge for the SBP.** It is generally acknowledged that financial conglomeration makes good business sense and should not be stifled by regulation but instead be subject to appropriate regulation and supervision. The challenges imposed by financial conglomerates include the following:

- Unless there is strict implementation of sound banking practices, there is a danger that a bank can become a cheap source of financing to other members of a group without proper assessment and pricing of intra-group exposures and proper management of the risks involved.

- Failures elsewhere in the conglomerate group can expose the bank to contagion risk, if another member of the group performs poorly or has major problems; reputational problems are particularly problematic.

- Conflicts of interest when group members borrow at below market rates or get access to commercially sensitive information that can be used by other group companies.

- Regulatory arbitrage, when assets and liabilities, including value impaired loans, are shifted around within a group to minimize its overall regulatory burden, including capital adequacy requirements.

- Risk that bank depositors end up carrying the residual risk for non-financial businesses, especially in cases of mixed conglomerate groups that include commercial businesses.

122. **Regulation and supervision of conglomerates must focus on preserving the integrity of the banking system.** This is important because risks emerging from conglomeration are almost entirely concentrated in the bank(s) of a conglomerate group. The primary concern of regulations and supervision is to prevent an otherwise sound bank from being impaired by association. These concerns are addressed through consolidated supervision, which places a supervisory net around all members of the group.

9.2 New framework for consolidated supervision

123. **Central to the reforms proposed is the need for the SBP to regulate and supervise banking groups on a consolidated basis and to apply prudential norms to all aspects of the business of groups that include banks.** SBP will be implementing a new framework for consolidated supervision based on best international practices established by the BCBS and elaborated in the Basel Core Principles for Effective Banking Supervision as well as in various BCBS guidelines. The introduction of consolidated supervision in Pakistan will require a new legal and regulatory framework and some changes in the regulatory architecture.

124. **SBP has developed a legal framework for conglomerates, which includes a number of new rules and practices.** The law should give the regulator powers to:

a. Require ownership structures to be transparent, enforce fit and proper criteria for owners, prohibit commercial enterprises in a group, review ownership of parent and related companies, define investment and strategic ownership, limit cross-ownership and ring-fence a bank from parent and related companies.

b. Require corporate structure to be transparent, demand that a parent company is either a bank or a non-operating holding company, restrict cross-shareholdings and determine which non-bank activities can be included on banks' balance sheets.

c. Establish prudential limitations on solo (bank only) and consolidated (group) basis: capital adequacy rules, and limitations on large exposures and exposures to related parties by the entire group.

d. Set rules for the governance structure of boards and management, require at least one outside director in each subsidiary, make use of whistle-blowers, and require a single auditor and the use of same financial year for all members of the group, risk management policies for entire group and supervisor access to all relevant information.

125. **So far conglomerates structures have not been guided by any regulation**. There are no rules or guidelines for structures of conglomerate groups and present structures are largely a result of the privatization of banks over the last decade. Furthermore, ownership of banks is highly concentrated and there are no limits on commercial companies owning banks, while there are limits on banks owning such companies. Most groups have a bank at the top but there are also groups headed by non-operational holding companies and other combinations. Related ownerships are not subject to any form of consolidation. The structures have evolved over several years and cannot be changed in the short run.

126. **It is necessary to set some long-term goals for conglomerate structures and to define a strategy for their implementation.** Long-term goals would include: (i) diversification of the shareholder base of banks, (ii) separation of commercial and banking activities to allow the "ring-fencing" of bank and

financial members from the risks of commercial group members, (iii) establishment of criteria for investment-type and strategic ownership, and requiring existing owners falling in between the two definitions to increase or reduce their ownership to conform with such criteria over time, (iv) requiring all groups to be headed by a non-bank holding company, except where headed by a bank and (v) the elimination of mixed conglomerates. Reasonable transition periods over several years will be offered to allow groups to adjust their businesses to the new framework.

127. **The current regulatory architecture is not suited for consolidated supervision.** The structure and division of responsibilities between the SBP and SECP means that some members of financial conglomerates are under-regulated and that no single agency has the power to regulate a financial group or conglomerate as a whole. Consolidated supervision requires seamless coordination between all regulators and supervisors involved. This is not feasible with the present architecture, given a track record of poor coordination between the two agencies.

128. **There has been a trend internationally towards the creation of single regulatory agencies** with responsibility for all regulation of the financial sector. The idea of a unified agency also has been floated in Pakistan but is not practical.

129. **Creation of a single regulatory agency for the financial sector is not practical in Pakistan.** There has been an international trend of creating single regulatory agencies with responsibility for the regulation and supervision of the entire financial sector. The idea of a unified agency also has been floated in Pakistan. It must be recognized, however, that no such agency would be able to create and sustain the same functional and financial independence, professionalism and system capabilities like those of SBP. The importance of those features, which are essential for the effective supervision of the core banking system, has been highlighted by the upheavals taking place in the global financial markets.

130. **After enactment of the proposed amendments to the BCO, SBP will become lead supervisor for any financial group that includes a bank.** Given that the focus of consolidated supervision is protecting the financial integrity of the bank, the responsibility for supervising any group including a bank must be with SBP. As called for under the Basel Core Principles, the lead supervisor should either have the power to regulate all members of a financial group directly or exercise control indirectly through licensing conditions of banks. As lead supervisor, SBP would have the powers to license the bank or holding company at the top of the group, and set and enforce prudential standards for the rest of the group through licensing agreements for the bank or non-bank holding company. SBP would also license "controllers" of bank or groups and require transparency of ownership structures as a condition for licensing. In addition, SBP would be able to ring-fence banking from other commercial activities of a group, insist on risk-mitigation systems for the group as a whole, and establish criteria for the conduct of investment banking business and other similar activities on commercial banks' balance sheets or as separate entities.

131.**The role of SBP as lead supervisor would be strengthened after the transfer of all deposit-taking and lending NBFIs from SECP to SBP jurisdiction.** This transfer of jurisdictions is already part of the proposed amendments of the BCO and under consideration by the Cabinet. Such a transfer could be expected to improve regulation and supervision of NBFIs and facilitate more effective consolidated supervision. It would also free up resources for the SECP to bolster its capacity to modernize the regulatory and supervisory frameworks for the debt and equity markets and for other potentially important financial sub-sectors like mutual funds and pension managers, and insurance companies.

10. Develop a Financial Safety Net

132. **A market-based system dominated by privately owned banks requires a financial safety net.** In the past, the financial system needed no explicit safety net, as most banks were owned by the government, which explicitly and implicitly stood behind the institutions it owned. But the privatization of most of the banking sector has made a safety net necessary as a complement to prudential regulation, supervision and enforcement. It proposed that such a safety net be established to consist of four components: (i) a depositor protection scheme (DPS), (ii) lender of last resort (LOLR) facilities, (iii) an effective exit framework for unviable banks and (iv) an effective coordinating framework for systemic banking problems.

10.1 Depositor protection

133. **Depositor protection is ambiguous in Pakistan and needs to be clarified.** Under the Banks (Nationalization) Act of 1974, all bank deposits are protected by the government. But this provision, which was introduced at the time when banks were nationalized, no longer is appropriate in a system where most banks are privately owned and even the largest state-owned bank, NBP, has private shareholders. This law should be removed and replaced with an explicit but limited depositor protection scheme (DPS). There is a need to make all depositors understand that banks now are privately owned and that deposits no longer are guaranteed by the government and that depositors are expected to be careful in the placement of their deposits. This will be hard for the public at large to comprehend, as no bank depositor in recent memory has lost money in Pakistan. The situation calls for an explicit depositor protection scheme (DPS) that will protect the vast majority of small depositors.

134. **A DPS seeks to protect small depositors and their continued ability to make payments.** Protecting the safety of small un-informed depositors is a major criterion for enhancing deposit mobilization. It is also a major consumer protection issue. The size of deposits protected under a DPS would have to be strictly limited in order to reduce moral hazard. It should seek to protect the vast majority of depositors in full, while exposing larger depositors to risk. This can be achieved with a coverage limit of Rs. 100,000 per depositor per bank, which would fully cover 77% of all eligible accounts in the banking sector in number but only 22% of the total value of deposits.[12] Business, interbank and government accounts will not be covered under DPS to avoid moral hazard.

135.**Established with a limited role of a paybox,** DPF will only be required to collect premium payments, verify depositors claim in case of bank failure and make payouts accordingly. Because a paybox is likely to be active only periodically, i.e. in case of bank failures, there are practical advantages to place it under the aegis of the central bank/financial sector supervisor while ensuring its legal autonomy. This setup would help avoid supervision by multiple agencies. The need for permanent staff would also be minimized, as personnel from financial supervisors could be deputed on a need basis. It would also benefit from economies of scale in information technology and other support services by sharing with a larger agency like financial supervisor. These cost and operational benefits explain growing acceptance of close association of DPF with central bank/financial supervisor in many of the newly established deposit protection schemes around the world.

136. **A DPS increases depositors' confidence in all banks and helps the competitive position of small private banks** in relation to large or government owned banks, which may be viewed as safe because they are "too big to fail." In a system with banks of very different sizes, like the one in Pakistan, a DPS

[12] Such a limit would be the equivalent of about 3 times per capita GDP in Pakistan (Rs. 34,294 in 2008). Internationally, coverage varies between 2 to 4 times of GDP.

reduces the probability of bank runs, which can be damaging to confidence in banks more generally and lead to contagion in other banks. Managing expectations associated with a DPS is critical, as it does not prevent all bank-runs or systemic crises, but can be a helpful tool in managing runs and crises in general. An information campaign needs to explain to the public what depositor protection means.

137. **Compulsory participation by all banks is essential and must be established by law.** A draft law establishing a DPS has been prepared by SBP and is under consideration by the Cabinet. Government-owned banks would be included in the DPS and the existing government guarantee provided to all banks under the Banks (Nationalization) Act would be rescinded. It is proposed to include Islamic banks with a coverage level similar to that in conventional banks but with a segregated deposit protection fund to ensure shariah-compliance. MFBs would be excluded initially but will be included later under a separate scheme with a lower coverage limit.

138. **It is proposed to establish a Depositor Protection Fund (DPF) to manage the DPS.** The DPF would be a subsidiary of SBP, managed by its own Board and funded by an initial capital contribution from SBP, premium payments from banks and income from its own investment. In addition, it would be able to borrow from the SBP. The DPF would charge all banks a fixed premium, at least for the first few years. The deposit coverage limit and the premium charged could be changed by a decision of the Central Board of SBP. The DPF would be organized so as to facilitate rapid payout of protected deposits in case of a bank closure/suspension of business; the decisions to close/restructure the bank will be made by the SBP.

139. **SBP has advanced plans for introducing a DPS in Pakistan.** The DPF would be guided by its own charter and the new Banking Act. A concept paper has been prepared and there has been consultation with the banking industry. A draft DPF Act has already been sent to the Cabinet for consideration and SBP is ready to launch the DPF, subject to the necessary legislation.

10.2 Lender of Last Resort

140. **A principal role of SBP is to provide liquidity to the banking system in times of systemic illiquidity problems.** SBP's principal objective as LOLR is to maintain liquidity in the banking system as a whole and ensure the smooth functioning of the payments system. Another objective is to ensure that solvent banks do not fail due to temporary illiquidity. At present, SBP provides liquidity for solvent banks facing temporary liquidity problems using different instruments. With its off-site monitoring mechanisms and on-site inspections of banks SBP has a good idea of banks' solvency situation.

141. **The SBP Act must be changed to better specify SBP's role and powers as LOLR.** Under existing law the SBP has very limited scope to function as LOLR: the SBP Act calls for all lending to be secured. SBP can provide liquidity to the overall market but has limited capacity for providing liquidity to individual banks. Once individual banks have run out of un-encumbered government securities, SBP has no other effective instruments with which to meet banks' liquidity shortfalls. When a bank runs out of collateral and becomes illiquid, SBP would need to close it. Recent liquidity problems in the market have tested SBP's ability to manage the stress situation, which SBP has managed successfully through its monetary tools.

142. **The SBP needs broader legal authority to deal with illiquid banks.** The law should define what institutions are eligible for SBP support, including guarantees of different kinds, and what assets qualify as collateral. It is proposed that only scheduled banks, including branches of foreign banks, be eligible counterparts for LOLR support and that all NBFIs be excluded from access.[13] All support should be

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[13] Under BCBS rules responsibility for supervision of liquidity rest with the host supervisor.

short-term. The recent action by SBP of providing short-term liquidity support with a guarantee provided by the GOP is mechanism that should be embedded in law.

143. **The traditional dilemma in designing a policy framework for a LOLR is the balancing of rules versus discretion.** It is relatively easy to establish rules for standing liquidity facilities and normal discounting operations against high-quality collateral in normal times. But when liquidity conditions become abnormal and individual banks or the entire banking sector become subject to liquidity pressures, an LOLR needs a fair amount of discretion to deal with different circumstances. This is often referred to as "constructive ambiguity." It is not proposed that the new SBP law become too prescriptive but rather that SBP be given broad powers to provide liquidity support in different forms and be able to accept a broad range of collateral, including owners' pledges of shares, in return for the liquidity support. The law should require SBP to prescribe meaningful corrective actions for all banks seeking LOLR support.

144. **SBP is developing a set of internal rules and criteria,** which will help it make consistent decisions and better justify its actions and facilitate accountability afterwards. It should seek to make its decisions consistent both among classes of banks and over time. New LOLR operating rules need to distinguish between bank-specific and systemic problems. Such rules would be based on different policy scenarios but would also leave sufficient room for tweaking and policy changes in view of different economic and financial realities of each situation. SBP is seeking legal powers to make all LOLR support conditional on corrective actions by the borrowing bank. LOLR policies and rules will be closely coordinated with bank exit policies. LOLR rules are for internal use and it will be up to the SBP to determine what general rules and criteria it may wish to make transparent. Details of corrective actions by individual banks using LOLR facilities will remain confidential.

145. **Unsecured LOLR lending would have to be guaranteed by the government.** Such lending should be considered potential solvency support, and take-over of the institution for an eventual resolution strategy.

10.3 Exit framework for banks

146. **To protect the banking system as a whole, unviable banks will be forced to exit the system.** Unviable banks or groups of banks can endanger the system as a whole for different reasons, including insolvency, illiquidity or various perverse or imprudent pricing or risk-taking practices. Removal of such banks strengthens the system and reduces the risk of contagion. An exit framework should facilitate early and efficient exit with the aim of minimizing costs to various bank stakeholders and the government. The exit process should seek to provide fair treatment of unprotected depositors and creditors, maximize the value of bank assets and reduce systemic risk.

147. **Banks can exit in many different forms,** including closure and liquidation or other resolution options including mergers, purchase and assumption (P&A) transactions, and the establishment of a bridge bank. Exit can take the form of voluntary liquidation or conversion to a non-bank company, or be forced by the SBP. When liquidity and/or solvency problems in a bank reach the point where the bank is unviable, the SBP must force it to exit the market. When a decision is made to close or suspend the operations of a bank it also becomes the trigger for the Depositor Protection Fund (DPF) to spring into action.

148. **A Prompt Corrective Action (PCA) regime can help SBP take early action.** Such a regime would oblige SBP to take specific actions once certain trigger ratios are reached. The typical PCA regime is based on CARs. Once a bank's CAR falls to below the regulatory minimum CAR, certain prescribed actions are triggered. As the ratio declines further, the required actions become stronger until the SBP is forced to intervene and take over the bank for resolution. The new draft Banking Act will give SBP the

authority to implement a CPA regime, which will be defined in regulations and uniformly applied to all banks or classes of banks.

149. **A strong legal framework for bank exit is provided for in the new draft Banking Act.** Under this SBP would have strong powers to intervene, reorganize or close unviable or failing banks. The law also seeks to ensure that SBP decisions are not put on hold or reversed by the courts. There is an appeals process built into the legislation, which calls for speedy procedures in an assigned court or tribunal that is familiar with financial issues. The law will make it clear that the exercise of any rights to appeal does not automatically lead to an interim restoration of old owners and directors.

150. **In addition to legal powers, the SBP is updating its policy framework on bank exit.** This is important, given that the exit of any bank can have wider implications for the system as a whole. Small or medium-sized banks are typically easier to deal with but closure of even a small bank can lead to unforeseen contagion or have a broader impact, especially if it is part of a financial or mixed conglomerate group. Exit of larger banks are even more difficult to deal with, because of the central roles they play in the credit delivery and payments systems and the damage their failure could inflict on confidence more generally. Such banks often are referred to a "too-big-to-fail" (TBTF) banks. Even if these banks may not be closed, the law must give SBP strong powers to intervene in, remove owners and managers of and reorganize such banks. The necessary internal SBP policy framework for robust bank exit has been developed and will be put into effect in 2009.

10.4 Coordination with government

151. **Effective coordination is of utmost important for the management of a financial safety net.** The fact that the DPS, LOLR and bank exit all will be managed by SBP is an extremely beneficial aspect of the proposed safety net in Pakistan. This will allow supervisors, managers of LOLR facilities and the DPF to operate on the basis of the same data and share such data on a timely basis, which is crucial for effective policy making and management in rapidly changing circumstances. SBP also has a tradition of confidentiality, which is essential to the process. Having a coherent team of professionals that trust each other, are prepared to share information and ideas and have rehearsed various problem and crisis scenarios, is crucial, given Pakistan's fractured institutional environment. An effectively managed financial safety net is essential for the stability of the banking sector and the economy at large.

152. **SBP has the power under the law to handle individual bank problems without government interference.** It should be considered a natural extension of SBP's existing banking supervision and enforcement powers.

153. **At the same time, SBP will be keeping the GOP informed about problem banks and SBP actions**, especially if there is a potential need for government solvency support. Protocols and memoranda of understanding (MOUs) will be developed on the type of information to be shared, what form such sharing should take and the timing of such sharing without interfering with or complicating SBP's policy implementation, or undermining bank secrecy.

154. **Systemic problems or an outright crisis would require a broader policy coordination framework that necessarily will have to involve the government.** Broader problems would most likely require unsecured LOLR support and/or direct solvency support that would need to be guaranteed or provided by the government. Such problems could have broader fiscal and other macroeconomic effects that the government would need to be fully aware of. To the extent systemic banking problems are the result of some kind of macroeconomic or political developments or shock, they go beyond the scope of a traditional LOLR support and need to become part of a broader package of corrective macroeconomic measures.

11. Strengthen SBP autonomy, accountability and governance

155. **Many aspects of the SBP Act have become outdated and require reconsideration.** In 2004, a mission under the IMF-World Bank Financial Sector Assessment Program (FSAP) pointed out a number of areas in which the SBP Act of 1956 fell short of best international practices and the Basel Core Principles for Effective Banking Supervision. These shortfalls included issues of autonomy, governance and SBP's relationship with the government that reflect statist circumstances of the 1950s rather than an appropriate mode of operations for a central bank in today's market-based and largely privately owned financial system.

156. **It is important that the law give SBP a clear focus and necessary powers to ensure monetary and financial stability**, which are preconditions for financial sector growth and development. The law would need to define SBP's roles (i) in monetary policy formulation and management, (ii) as adviser to the GOP on fiscal policy and domestic debt management, and (iii) in the oversight of the country's banking and payments systems as well its money and foreign exchange markets. This requires a review of the role and powers of SBP as laid out in the SBP Act.

157. **There is consensus that changes to the SBP Act are needed.** Policymakers and lawyers consulted by SBP both inside and outside Pakistan have recommended that an entirely new central bank law be drafted rather than a patchwork of further amendments to the existing SBP Act, which already is more than 50 years old. Accordingly, SBP has proposed to the GOP that an entirely new SBP Act be considered.

158. **Modern laws give autonomy to central banks and make them accountable.** The new SBP Act would give SBP more autonomy to act in pursuit of clearly defined goals of monetary and financial stability. It would make it explicit how the SBP has to report on its performance to the Cabinet and Parliament. Increased accountability should be seen as an essential counterweight to more autonomy. In addition, the new SBP Act would strengthen governance by redefining the roles of the Central Board and the Governor, and specifying the role of the Monetary Policy Committee.

159. **The new SBP Act would complement the new Banking Act discussed above.** The new SBP Act will establish the SBP as the primary regulator and supervisor of all banks and will make, *inter alia*, explicit its responsibility for financial stability. It will clarify the SBP's role as lender of last resort and establish the conditions under which SBP may provide unsecured loans to institutions of uncertain viability in situations when systemic stability is at stake. It will give SBP unambiguous powers to intervene in unviable banks and will reiterate its role as lead supervisor of financial groups, conglomerates and holding companies.

160. **The new SBP Act would strengthen SBP's ability to conduct an independent monetary policy** and foster monetary stability, which is a precondition financial and economic growth and development. The new Act would do so by limiting the government's access to central bank credit and thus help direct the government's borrowing into market-based instruments, which, in turn, would be supportive of debt market development more generally. The Act would require the SBP, in its role as financial advisor to the government, to advise the Debt Policy Coordination Office on the most effective strategies and instruments to use in its domestic financing. The new Act would limit the government's involvement in the banking sector to systemic situations only.

161. **The new SBP Act would define SBP's role in other areas of the financial sector reform agenda.** This would include definition of its role and powers to oversee the country's payment systems and its role in financial inclusion efforts through development finance and nurturing of various categories of smaller bank and non-bank deposit-taking institutions.

12. Develop a More Balanced and Diversified Financial System

162. **The financial sector in Pakistan is too bank-centered and there is a need to develop other financial intermediaries and markets.** Most large companies have access to bond and stock markets in Pakistan and some even have access to foreign markets. Broadening and deepening the financial sector requires increased emphasis on the development of the private debt securities market as well as insurance companies and private pension funds. Reforms in the sub-sectors, which fall under the responsibility of the SECP, should be considered complementary to banking sector reforms. Such reforms have lagged behind banking sector reforms and hold major potential for future growth.

163. **The development of non-bank financing will require a combination of official policies, market competition and business opportunities.** SBP policies of financial inclusion and prudential limits on exposures to single counterparties or groups of counterparties may redirect large corporate borrowers towards issuing private debt securities and increased reliance on new issues in the equity market. Private debt markets in particular have enormous potential for intermediating large long-term investment projects that are less suitable for bank financing.

164. **Non-bank financial intermediaries have substantial growth potential**. With the exception of mutual funds, the growth of most NBFIs has been anemic in recent years. NBFIs are facing direct competition from banks and are not likely to grow significantly until their funding costs become more competitive. The insurance sector has substantial long-term growth potential, especially in the life insurance sector. This potential may not be realized until the sector gets an infusion of innovation and efficiency, which could come from banks associating themselves with insurance companies and/or privatization or reorganization of the sector. Mutual funds can be expected to continue their rapid growth once market conditions stabilize. Private pension funds have an enormous potential, as indicated by the growth of such funds in some other EMCs, where they have become important institutional investors and providers of long-term funds. Pension funds and insurance companies can be expected to become major holders of private debt securities in Pakistan as well.

165. **The equity market has provided little new corporate financing in recent years.** Despite the spectacular growth in market capitalization in recent years—much of which has disappeared in 2008--the market has not done a good job of mobilizing resources for the corporate sector. There have been few initial public offerings (IPOs) and equally few secondary issues. Some large banks and companies have preferred to list global depository receipts (GDRs) on foreign stock exchanges rather than tap the local market. Banks dominate the equity market with bank shares representing about one third of total market capitalization; NBFIs bring the share of the entire financial sector to nearly 40%. Between 2002 and end-2007, the number of listed companies declined by almost 10% to 652, largely in response to new SECP regulations on disclosure and governance that caused many closely held companies to de-list in order to avoid scrutiny.

166. **The equity market has tremendous scope to grow,** as indicated by the fact that its market capitalization in relation to GDP is less than half the size of that in its peers in other EMCs. New policies are needed to invigorate the market and attract new company listings and new stock issues.

167. **Private debt securities have the biggest growth potential,** as seen from the above comparisons with other countries. The availability of long-term financing through private securities markets would be a key impetus for private investment. Corporate borrowers with need for long-term financing, especially for investments in infrastructure, plant and machinery, and housing will find long-term rupee bonds attractive (fixed income instruments are not feasible until macroeconomic stability is ensured). This will not happen, however, until bank credit becomes less freely available and relatively more expensive, which, in turn, will not happen until there is growing credit demand from high-yield areas like consumer

and SME credit and underserved sub-sectors like services and housing (it is expected that such demand will grow as a result of SBP's outreach efforts.) Demand for private debt instruments would come from institutions with long-term investment needs as mentioned above.

168. **The basic structures for issuing and trading private securities already exist but need to be updated and strengthened.** Listing and rating requirements for primary issues exist but need reviewing to ensure a regulatory framework that is simple and encourages the issuance of private debt securities. Larger companies have accounting and governance structures that allow markets (with the help of auditors and credit rating agencies) to overcome information asymmetries. There already is a benchmark KIBOR yield curve and a secondary trading platform for government securities that also can ensure an effective market in private debt.

169. **Government financing in the domestic debt market and through NSS needs to be reviewed** to make it more efficient and market-based. This would reverse a recent trend of such financing becoming less linked to market conditions and more dependent on SBP. There is a long-term need for domestic government borrowing to finance public sector investment, especially in the areas of transportation and energy infrastructure. This will require new borrowing strategies and instruments to give more depth and sophistication to public debt markets; that would not only give the government a more efficient funding source but also have positive impact on the development of the private debt market.

170. **The above reforms in the broader financial system require actions by the SECP and GOP.** Reforms are bound to be slow and gradual. This notwithstanding, the SECP and GOP must seek to promote broader financial sector developments through enabling policies and by ensuring competitive financial markets. The aim should be balanced financial sector development, where the various sub-sectors support and give growth impetus to each other and to the real economy.

13. Development of Financial Infrastructure

13.1 Infrastructure under control of SBP

171. **The wholesale payment system is being upgraded and renewed.** In July 2008 SBP launched the Pakistan Real Time Interbank Settlement Mechanism (PRISM) which is a real time gross settlement (RTGS) system for wholesale payment transactions. The system is designed to handle all large-value payments in Pakistan, including interbank money and securities market transactions, domestic leg of FX transactions and net settlement positions from retail and bank card clearings. SBP is in the process of drafting detailed operating rules for participants in PRISM to ensure completion and finality of settlements. SBP is considering adding additional rules to resolve gridlocks and the introduction of an intra-day liquidity facility and the creation of a National Payments Council to ensure close coordination with payments system participants. An oversight framework of the PRISM/RTGS system is also being established in SBP.

172. **The retail payment system is next in line to be modernized**. Preliminary work has started on modernization of the retail payments and settlement system where the aim is to encourage electronic and mobile phone based transactions. The strategy is to work together with a wide range of stakeholders in the area of retail payments to promote an intensive use of efficient electronic payment instruments. SBP will promote a high level of standardization, schemes that allow straight-through-processing and development of infrastructure for new retail payment instruments and alternative channels for making payments. This work is complex, as it involves extensive consultations with a multitude of different stakeholders. SBP will seek, with technical assistance from ADB, to define a clear strategy and an implementation plan. Such a plan will be closely coordinated with the various efforts of financial

inclusion and will include a major effort to educate consumers. It is expected that the reforms of the retail payment systems will take 2-3 years to be completed.

173. **The electronic Credit Information Bureau** (eCIB) of SBP has already helped strengthen credit risk management in all financial institutions. With up-to-date (almost real-time) data and coverage of almost 5 million consumer and commercial borrowers, it provides financial institutions, both large and small, an invaluable risk management tool. The data includes not only outstanding amounts but also repayment histories and some non-financial information. The comprehensive coverage of corporate borrowers down to very small consumer finance amounts provides a unique statistical basis for credit scoring techniques and other methodologies. SBP will help further development of operational software for borrower analysis and credit scoring, which will help banks in their credit analysis, especially of smaller borrowers that lack collateral and/or a credit history. This will be consistent with and supportive of the financial inclusion programs.

13.2 Infrastructure outside the direct control of SBP

174. ***The human resource base*** **needs to be developed to meet the needs of an expanded financial system.** The financial sector representatives consider availability of financial professionals their most important resource constraint. If the financial services sector is to grow and develop, the country needs to make an organized effort at developing the skills sets that are needed. Skills are not only needed in the banking and NBFI sectors but also for the securities markets and growing new areas like pension and investment fund managers. In addition, areas like IT and virtual banking require new skill sets that need to be promoted and developed.

175. **SBP is planning to take some initiatives to support a broadly based effort to train financial sector professionals.** Such initiatives will be taken with the PBA, as well as universities and professional schools. The training should cover basic training in finance and economics and include areas such as accounting, auditing, credit assessment, IT applications, etc. SBP will, with other sponsors, seek to include special curricula in these subjects in universities and professional schools and set specific targets for the number of students graduating. SBP will also directly support such training with information campaigns and by assisting with course materials and lecturers.

176. ***Credit rating agencies*** **need to be promoted.** Corporate ratings are needed not only for implementation of the standardized approach under Basel II but also for listing of private debt securities and new companies on the stock exchange. The availability of independent credit agency ratings is thus essential for development of the private debt and stock markets. There are now two rating agencies, which rate only a few companies. Their business opportunities are extremely limited, as there is little demand for their services. Companies have few incentives to subject themselves to the external scrutiny of rating agencies and some companies have even delisted from the stock exchange to avoid such scrutiny altogether. The incentive framework for the services provided by private rating agencies needs to be analyzed with a view to identifying measures that will result in more companies being rated and more debt securities issued. Although this work mainly falls under the responsibility of the SECP, SBP is prepared to provide analytical support to help facilitate more listings of private companies and private debt securities and development of the private debt and equity markets.

177. ***Land and property registries*** **need modernization.** Land and property titles are available in urban but not in rural areas. Improved land titling systems in rural areas could be seen as a precondition and necessary underpinning for an improved credit extension process by facilitating collateralized lending for the agriculture, SME and housing sectors. Security and accuracy of titles is essential, which requires streamlined and secure document recording and storage systems. SBP is exploring ways to facilitate pilot studies and develop off-the-shelf systems that would make it affordable for local and provincial

governments to introduce new registries and systems over the medium term. Such reforms would be important complements to the financial inclusion campaign.

178. ***The judicial system* needs reform for the efficient functioning of the financial system.** Legal certainty and enforceability of contracts are important preconditions for financial services and transactions. The court system needs to be better equipped to deal with financial transactions and disputes. This would require a long-term effort to train judges in commercial and financial law, provide the courts with proper administrative resources and perhaps the establishment of additional specialized courts to deal with financial matters. SBP would be prepared to assist the judiciary in the training of judges. In many aspects, the judiciary is clearly an area beyond the mandate of the SBP and even beyond the executive arm of the government. But it is an important dimension of financial sector reform and the court system must not be allowed to atrophy for lack of resources. Given that any upgrading of the court system is a budgetary issue in times of extreme budgetary constraints, consideration should be given to introducing a small levy on all financial institutions that would be earmarked for support of the courts.

Annexure A, Table 1: Number and Ownership of Banks, 1997-2008 [14]

End of year	**1997**				**2000**				**2007**				**Jun-2008**			
Banks	P	LP	F	All	P	LP	F	All	P	LP	F	All	P	LP	F	All
Commercial banks	*6*	*16*	*20*	***42***	*6*	*14*	*21*	***41***	*4*	*26*	*6*	***36***	*4*	*25*	*6*	***35***
Largest 10	3	3	4	10	3	3	4	10	2	8	--	10	2	8	--	10
All others	3	13	16	32	3	11	17	31	2	18	6	26	2	17	6	25
o/w Islamic	--	--	1	1	--	--	1	1	--	5	1	6	--	5	1	6
o/w MFBs	--	--	--	--	--	--	--	--	--	--	--	--	--	6	--	6
o/w other	3	13	15	31	3	11	16	30	2	13	5	20	2	6	5	13
Specialized banks	*4*	--	--	***4***	*4*	--	--	***4***	*4*	--	--	***4***	*4*	--	--	4
All banks	10	16	20	**46**	10	14	21	**45**	8	26	6	**40**	8	25	6	**39**

Source: SBP

[14] Public sector banks (P), local private banks (LP) and foreign banks (F).

Annexure A, Table 2: Financial Soundness Indicators for Banks, 2000-2008

Period	**2000**	**2002**	**2005**	**2006**	**2007**	**Q2-CY08**
All banks						
Profitability						
ROA	-0.2	0.1	1.9	2.1	1.5	1.7
ROE	-3.5	3.2	25.8	23.8	15.5	16.7
Asset quality						
Gross NPLs	23.5	21.8	8.3	6.9	7.2	7.7
Net NPLs	12.7	9.9	2.1	1.6	1.1	1.3
Capital adequacy ratio						
Risk weighted CAR	9.7	8.8	11.3	12.7	13.2	12.1
Commercial banks						
Profitability						
ROA	0	0.8	2.0	2.2	1.6	1.7
ROE	-0.3	14.3	25.4	23.7	15.0	15.7
Asset quality						
Gross NPLs	19.5	17.7	6.7	5.7	6.3	7.0
Net NPLs	10.1	8.3	1.4	1.1	0.8	1.1
Capital adequacy ratio						
Risk weighted CAR	11.4	12.6	11.9	13.3	13.8	12.4
Specialized banks						
Profitability						
ROA	(2.3)	(12.1)	(1.2)	(1.8)	(0.9)	3.6
ROE	…	…	…	…	…	…
Asset quality						
Gross NPLs	52.4	54.7	46.0	39.1	34.3	29.8
Net NPLs	31.6	28.5	23.1	18.7	14.0	10.0
Capital adequacy ratio						
Risk weighted CAR	(3.3)	(31.7)	(7.7)	(8.3)	(7.8)	(0.7)

Source: SBP

Annexure B: McKinsey Definition of Financial Assets

The global capital market is defined as the cumulative collection of markets where global capital supply is matched by global capital demand through bank and securities market intermediaries.

To size the capital market, McKinsey sums together bank deposits (including currency in circulation), the market value of publicly traded equities, and the outstanding face value of debt securities. This sum represents the amount of capital that is intermediated through banks and securities markets without double counting. It excludes securities that represent portfolios of such assets—for example mutual funds, pension funds and insurance companies—to avoid the double-counting of securities in those portfolios. It also excludes the value of derivatives, since those are risk-shifting contracts that derive their value from movements in financial asset prices and are not a means of shifting capital from savers to borrowers.

The data base covers more than 100 countries. For each country, the database contains data on the market value of the equities issued in stock exchanges, excluding American Depository Receipts, which are tracked back to the exchanges of the underlying stock, the outstanding value of the debt securities issued in the country, and the amount of private bank deposits (including currency in circulation, which strictly speaking is not intermediation through banks but rather through central banks).

Debt securities are further divided into private and government. Private debt securities are issued by corporations and financial institutions, including agencies such as government-sponsored enterprises. Outstanding values of asset-backed securities, such as mortgage-backed securities and other securitized assets. Government securities include securities issued by local and provincial governments and central banks.

The database includes GDP data for each country to allow calculation of the value of financial assets relative to the size of the underlying economy. For aggregation purposes and comparability, all financial asset figures are at their nominal end-of-year values and are expressed in US dollars.

The definition does not include the value of real estate or other illiquid assets, which are other important means of household savings and wealth, due to lack of data availability or comparability among the more than 100 countries in the data base.

To measure bank intermediation, the value of deposits rather than the value bank loans are used because of difficulties in measuring lending volumes on a comparable basis in all countries. Because deposits form the basis for lending, McKinsey expects trends in both measures to be the same in the medium and long term.

Source: McKinsey Global Institute, *Mapping Global Capital Markets,* Fourth Annual Report, Appendix: Technical Notes (pp. 77-80), January 2008.

Annexure C: Objectives of Draft Banking Act

(i) **To incorporate spirit of Basel Core Principles**: The draft Banking Act has been prepared in line with the Basel Core Principles. These principles are global standards on which countries of the world are evaluated by international institutions, investors and banking community around the world.

(ii) **Structured process for resolution of troubled banks**: Detailed provisions regarding reorganization of problem banks has been provided in the draft Act to avoid systemic risk.

(iii) **Framework for Payments System and e-banking**: The BCO was drafted way back in 1962 when banking products and services were different. With 5 decades down the road, there is tremendous change in the way banking business is conducted. Particularly, the technology factor has changed the playing field. The draft Banking Act recognizes the new concepts and technologies. Enabling provisions for electronic filing of information, documents and returns have also been incorporated in the draft Act.

(iv) **Enforcement powers to check illegal banking and deposit taking**: Although provisions are available in BCO, a provision to seek assistance of local police has been incorporated in the draft Act while carrying out inspection etc of entities involved in illegal banking business.

(v) **SBP‘s powers to issue prudential regulation**: Explicit powers have been provided to SBP to issue Prudential Regulations to banks which was otherwise not available in BCO.

(vi) **Islamic Banking**: A new part has been included in the draft Act which outlines framework for conducting banking business based on Islamic principles. The sections on Shariah Advisors and Shariah Board have been incorporated.

(vii) **Entry and Exit - banking business**: Clear and transparent criteria has been provided for entering into the business of banking. The licensing requirements have been structured as per international best practices. The concept of annual license fee has been provided. Accordingly, framework for reorganization and liquidation of banks has been provided to instill certainty and transparency. Clear powers and criteria of cancellation of license have been provided.

(viii) **Ownership & management reforms**: Detailed provisions regarding ownership and management of banks have been provided in the draft Act. Clear delineation of responsibilities with accountability and liability in case of any wrongdoing has been provided in the draft Act. Restrictions and criteria for holding shares of banks have been incorporated.

(ix) **Prohibited & permissible businesses**: Detail of permissible and prohibited business by banks has been further elaborated with power to SBP to declare any business as banking business.

(x) **Supervisory powers of SBP**: Powers of SBP in relation to its assigned functions have been greatly enhanced based on international best practices.

(xi) **Judicial challenges to SBP**: It has been observed that SBP is unnecessarily entangled in Court cases by no fault of it. If a bank borrower has dispute with any bank, SBP is implicated as a party to the case. Most of SBP’s cases in courts are unnecessary and without any grounds. Provision has been incorporated which provides situations in which SBP can be made party. This would bring court cases against SBP down by drastic margin.

(xii) **Outdated/ non-functional provisions of BCO**: Since the BCO was enacted a long ago, it contained outdated provisions, nomenclatures and references which needed to be removed.

(xiii) **Fit and proper criteria** for Board members and Chairman has been provided in the draft law which was otherwise applied through regulations

(xiv) Enabling provisions for **anti-money laundering** have been provided in the draft Act.

(xv) Provisions relating to **inspection, audit and reporting** have been upgraded with enhanced powers of SBP to take action against banks, auditors.

(xvi) Provision relating to **deposit protection fund** have been incorporated to protect the interest of depositors of banks.

(xvii) Legal basis for **cooperation between SBP and SECP** has been provided. This can greatly help in assessing activities of Groups especially their internal dealings.

(xviii) **Regulatory powers of SBP** have been enhanced in all the regulatory areas under the draft Act.

(xix) Schedules provide **activities** which bank can undertake and **penalties** for violations of draft Act. The list of activities has been upgraded by including activities like derivatives, providing financial advisory services, selling insurance products and financing of projects etc.