

January 1, 2009

SBP Governor's Statement

Dr Shamshad Akhtar, Governor, State Bank of Pakistan has issued the following statement on the culmination of her three-year term today:

“Upon assumption of the Office of Governor, SBP on 2nd January 2006, I launched a major stock taking exercise to define the baseline of where the institution stood and based on a thorough review and stock taking identified successes and weaknesses of the economy, the financial sector and the SBP recognizing its principal functions as a monetary and exchange rate policy making body, regulator of the banks, and responsible for payment systems and financial stability. SBP's transformation has been an ongoing process and changes have evolved over the years and strengthened the capacities of the central bank.

Another substantive structural transformation has been launched since 2006 building on the tradition of my predecessors' who have also strived to achieve the Mission of strengthening SBP. The key objective of the structural reforms adopted by SBP is to serve the national development objectives and goals by feeding properly and on a timely basis economic policy making process in the country, while modernizing the central bank and the banking system strengthening its robustness. The year 2008 did deviate from the economic trends set in the last few years and original projections. This was largely because of the disruptions caused by series of shocks that disrupted the progress achieved in past years. Despite multiple shocks, the economy revived backed by appropriate and the continued demand management dosages and other measures by the central bank. The banking system despite economic and stock market shocks remained strong. Profitability remained good and non-performing loans while registering growth remain within reasonable ranges and are effectively provisioned for.

Notwithstanding, economic challenges still remain complex and substantial. SBP continues to strive for excellence and also for ensuring that central bank safeguards country's economic and social interests and augment the banking system's robustness so that this sector can continue to serve the national interest and meet the requirements of productive sectors and of the public including poor and vulnerable. In order to set on record, this statement aims to document the key milestones achieved in the last three years and highlight the emerging challenges. These need to be read in conjunction with the central bank economic and financial reports.

The key developments and milestone are as follows:

1. The Board of Central Bank was restructured with the support of the Government in 2006. The Management and the Board has upheld the emerging corporate governance principles and laid the broad framework of an effective Board and Management relationship extending its effective oversight and maintain accountability. Terms of Reference of all the Committees of the Board were redefined. The Board has been meeting on regular basis and has approved strategic, policy and administrative proposals presented by the Management. It has supported Management's strive for "Change" and greater accountability.
2. SBP has been restructured into four modern and cohesive clusters to define appropriately the roles and functions of each cluster in light of the developments across Pakistan in the context of growing size, complexity, diversity and challenges of the financial markets and for SBP to come at par with other regulators in the region. New Office of General Counsel, Risk Management, Development Finance Group with a dedicated Financial Inclusion Office, and the Financial Management Unit etc. were created and all offices were empowered and upgraded to operate on modern principles. All cluster heads were fully empowered and their accountability has been strengthened. A number of offices such as the corporate secretary office, the payment system, accounting and finance, audit, external relations etc. have been strengthened.
3. Incentive structure was modernized by properly implementing performance management system which was a prerequisite for the introduction of a unified market aligned compensation structure and merit based performance. Career development policies have been introduced and implemented to attract and retain the competent and specialized talent. Several promotions were launched to reinvigorate staff in line with their potential and performance.
4. Reforms have also been launched in the subsidiaries of the central bank including the Banking Services Corporation and the National Institute of Banking and Finance with latter now being 100% subsidiary of central bank. The central bank has worked with the banking industry to institute a new vision and mission to upgrade the Institute of Bankers Pakistan (IPB).
5. Monetary Policy making process and its implementation has been reformed. Under the new institutional arrangements, a cross-functional committee chaired by Governor reviews and formulates the Monetary Policy Statement (MPS) whose framework has been augmented and its analysis and communications has been upgraded. MPS is approved by the Monetary Policy Committee (MPC) of the Central Board which is chaired by a non-executive member of the Board. Supportive framework for effective implementation of MPS has also been put in place. Regular feedback has been provided to the Government on measures being taken and those yet to be formalized to

enhanced fiscal-monetary coordination which has been a subject of much debate. Given the macroeconomic challenges, in the six monthly MPS, the central bank has had to tighten its monetary policy stance and SBP policy discount rate rose from 13.0 to 15.0 percent by the end of November 2008. The year 2008 has been the most complex year where demand of monetary management was steep given the excessive Government borrowings from SBP stock that rose to Rs1390 billion at 29th November 2008 in wake of the global commodity price pressure and other factors. This destabilized the macroeconomic stability gained with much difficulty and persistence & effective monetary management earlier.

6. In midst of the economic complications, SBP has also been strengthening its Liquidity Management systems. Among others, the central bank resorted to drastic reduction in the cash and statutory liquidity reserve requirements to inject desired level of liquidity to lubricate financial system which had otherwise dried up because of excessive reliance of the Government on financial system to meet its budget requirements. It has also announced in consultation with the Government a volume based auctioning of government debt. A new Liquidity Management Framework has been drafted and will be released shortly.
7. SBP has strengthened its economic and financial sector surveillance systems. Besides quarterly and annual economic and banking reports, a new comprehensive Financial Stability Review has been released annually in 2007 and 2008. The key issue outstanding, that remains to be addressed, is the need for further diversification of the financial sector as well as enhancing its penetration given the lack of depth and breadth in the financial system. Work on the latter has been launched with the approval of the Government in 2007 of the Microfinance Strategy paper whose implementation is well underway. A number of innovative schemes have been launched including the credit guarantee scheme that will help raise the required liquidity for the microfinance industry.
8. Besides producing economic reports, Economic Advisor's office has been strengthened to develop wider research capacities of central bank. SBP has launched work to develop Dynamic Stochastic General Equilibrium Model which will help develop capacities for inflation targeting and better understand the microeconomic behavior of economic agents as well as price and wage dynamics etc. Several working and policy papers have been delivered and SBP represented itself in a number of national and international seminars and conferences.
9. Banking sector reforms have been underway full-steam. The capital base of banks has been raised and provisioning requirements tightened. Basel II implementation is underway. Corporate governance of banks' boards and their oversight has been enhanced. Banking surveillance is now more rigorously performed and a Risk Analysis Division has been set up to develop and implement "Model Based Approaches to Stress

Testing.” Several other initiatives have been launched to cushion the health of the banking system. Banking inspection and supervision systems have been overhauled to strengthen the oversight of the banks.

10. Foreign exchange management has been a key responsibility of the central bank. Operating a managed floating exchange rate regime, exchange rate remained quite stable in 2006 and 2007, however, the rising fiscal and external current account deficits in FY08 destabilized the exchange rate. Notwithstanding, the exchange rate management was supported by provision of exchange for oil payments as well as conducting timely and appropriate interventions. At the same time, central bank worked with the Government to build reserves which has helped the country during the recent difficult times. While foreign exchange reserves came under tremendous stress causing them to deplete, however, with the proactive reserve management, strive to seek for timely deposits and other measures, central bank was able to make timely payment of all debts and other obligations. On 1st July 2005, SBP reserves were close to \$9.8 billion and they incrementally were build to \$14.3 billion by October 2007. However, at the beginning of July 2008, the FX reserves fell to \$ 8.3 billion and before the IMF stabilization program the reserve position was at \$ 3.3 billion as on 25th November 2008. As of December 2008, FX reserves grew to \$ 9.97 which helped double the SBP reserves.
11. Business Continuity Management has been strengthened and work has been launched to set up a Disaster Recovery Centre in SBP. SBP has also encouraged adoption of business continuity at the banking industry level.
12. IT systems have been fully upgraded. Real Time Gross Settlement and Payment system has been operationalized and within the organization, technology has become an integral element of management systems enhancing productivity and efficiency.
13. Internal Audit function has been independently overseen by the Board’s Audit Committee. Internal Audit reports are reviewed at Management level and issues addressed enabling the Bank to strengthen its internal controls steadily.
14. Financial sector law reforms were fast tracked to ensure that SBP and financial markets operate in line with best practices of central banking. Notable among the new laws that have been promulgated are: the Payment Systems and Electronic Fund Transfer Act, 2007 and the Anti-Money Laundering Ordinance, 2007 and now its amendments have been prepared. Several other new laws have also been drafted and are in various stages of processing: (i) the State Bank of Pakistan Act, (ii) Banking Act to replace the Banking Companies Ordinance, 1962 which was modestly amended also in the last year, (iii) Amendments to the Banking Companies Ordinance have been submitted to the Cabinet in 2008 to support the introduction of the consolidated supervision system, (iv) Deposit Protection Law, (v) Consumer Protection Law, and (vi) the Financial Crimes Act.

To build on these and other new initiatives, a well conceptualized Banking Sector Strategy and a blue print of reforms have been prepared to steer the financial sector based a road map to guide and prioritize initiatives in the context of available resources. The market based, globalized and technologically advanced financial markets of 21st Century with interdependencies across borders have made it imperative that, maintaining price stability, the central banks act with speed and precision to contain the damages to the economy due to adverse domestic and international developments.

SBP has prepared a **“Pakistan 10 Year Strategy Paper for the Banking Sector Reforms (BSR)”** that is released end December 2008. The strategy draws on (i) lessons learnt and experience gained, (ii) consultation with the banking industry and other stakeholders, and (iii) incorporates international best practices. **The BSR 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.
- (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.”
