FINANCES

BUSINESS PLANNING AND BUDGETING

Achieving excellence in performance at acceptable cost is a key success factor in progressive organizations. There are a number of factors driving an organization; whether the approach is for-profit or essentially a non-profit outlook. External and internal environmental considerations shape the choices made in determining the overall strategic direction.

In terms of the *External Environment, t*echnology has propelled the world into change. Development in communication is dissolving international boundaries; people, goods, services and funds now shift easily across regions and borders. Domestic economies cannot isolate themselves from external forces where Customers' expectations are multiplying in an increasingly competitive setup. Traditional business practices need change for alignment with current needs in order to remain successful. Demands of the *Internal Environment are also decisively* influenced by the flow of information. The informed public is now challenging the public sector to be accountable, efficient and prudent with public funds. Public sector institutions are expected to explain their policies and expenditures to their stakeholders and find the right balances between information overload and effective communication.

State Bank of Pakistan, by virtue of being the central bank has to play a leading role in shaping for continued economical growth in the existing and evolving competitive environment, which is expected to further intensify under the WTO regime in the coming years. While broad based changes in the overall economic and financial environments are caused through policy measures and enabling regulations and adoption of best practices on a system wide basis, the task also required a successful transformation of State Bank's internal orientation and processes on modern lines and formalized initiative was taken in 1999 for State Bank's transition to a proactive, efficient and dynamic institution.

The key to this transition was institutionalization of the Change Management Process through implementation of Business Planning and Budgeting from the financial year 2002-2003 aimed at revolutionizing SBP services standards and streamline related costs. The main objectives of the initiative are to:

- Clearly define goals with matrix of performance criteria
- Establish benchmarks
- Strengthen Corporate Governance and Accountability a all levels
- Allocate available resources with appropriate delegation of powers so that Bank's functions are carried out in an efficient and cost effective manner
- Provide tools for ongoing monitoring and evaluation of performance

BUSINESS PROCESS RE-ENGINEERING

A major innovation in the business process re-engineering at the State Bank of Pakistan was the integration of various fragmented and compartmentalized processes of business planning and budgeting under one single framework i.e., Business Plan.

The Business Plan is prepared at the departmental level taking the goals and objectives of each department as the starting point and then putting together the Operational and Developmental projects, which will translate these measurable objectives into actual outcomes. The plan then develops the resource envelope – human resources, financial, computing etc.- required to achieve these projects within the financial year. Each departmental plan also outlines the key performance indicators (KPIs) and Key result areas (KRAs) for the units as well as the individual staff members on the basis of the approved business plan. These KPIs and KRAs are then used as the inputs for performance management system and training of each department.

The bottom-up approach to formulation of the business planning is then tested against the overall institutional priorities and budgeting constraints. Adjustments are then made in each departmental business plan in light of the feedback received at the review done by the CMT. The SBP business plan thus represents the aggregation of all agreed and prioritized departmental plans and is submitted to the Board of Directors for its consideration and approval.

Once the business plan is approved by the Board and changes, if any, made in the plan are conveyed to each department for updating and reflecting these changes. The Annual Budget, annual training Plan and Annual Human Resource Plan are then built upon the finally approved Business Plan.

A mid-year review is held by the CMT to appraise itself of the progress made and resource allocations are made at that time from slow moving to fast moving projects.

The business planning process, initiated in the fiscal year 2002-2003 for the first time, has helped in achieving consistency between the goal specification, resource allocation and performance appraisal. The process is continuously refined and adapted in the light of actual experience.

While the heads of individual departments were made accountable to optimally manage the resources allocated to them and produce planned performance, it was also imperative that they are given the financial authorities to circumvent bureaucratic impediments. A new financial authority structure has been formulated and approved by the management.

NEW CHART OF ACCOUNTS

With the implementation of state-of-the-art financial systems i.e. ORACLE ERP and GLOBUS Retail Banking System it was imperative to design and develop a dynamic and standard Chart of Accounts (COA), which can fulfill present, as well as future needs of the State Bank and its subsidiaries. SBP-COA structure has been kept flexible to cater for basic elements like categorization of financial information as required under Generally Accepted Accounting Principles *(GAAP)*, International Accounting Standards *(IAS)*, statutory requirements and at the same time provides value added features like facilitation in exercising proper controls and ability to generate MIS from different dimensions. The New Chart of Account has been designed to maintain real-time, on-line data with segregation as well as consolidated on functions, departments, divisions and on nature as to various categories of expenses, assets, liabilities etc.

Functional Segregation and Real-time Consolidation: Company concept has been used to maintain real time, online financial information as to separate companies, as well as consolidated information at corporate level. It also fulfills control and statutory requirements to segregate data for SBP, BSC H.O, BSC Offices and NIBAF. *Cost Center* strategy allows maintaining and displaying real-time on-line data on departmental and divisional levels for each company. This structure facilitates to monitor cost variances at division, department and company level, consolidated as well as segregated in real-time mode. Parent and Child cost centers concept is used to roll up the data real time as well as maintain it at each level.

Nature of Cost Segregation and Real-time Aggregation: Fundamental *accounting* classification into Assets, Liabilities, Income, Revenue, Expenses etc. has been ensured in Natural Account Segment. Further three levels of accounts namely, Child, Parent and Grand Parent have been provided to group the information in a logical and at the desired detailed and summary levels.

Information Grouping as per the requirements of Financial Statements of State Bank is also a Key feature embedded in the COA.

Systems based MIS Generation and Flexibility: Reliable and timely MIS generation ability is heavily reliant on COA structure used for recording information. Intra Segments hierarchies and Inter Segment combinations, flexibility to use different segments independently, provide SBP COA a dynamic base vital for systems supported MIS generation. These features have tremendously enhanced the range and dimensions for MIS generation, vertically as well as horizontally. A very vital aspect, taken special care of is that the flexibility of the overall structure, which allows to quickly adjust any change in, both business as well as MIS, requirements without disturbing the basic structure. Along with the above stated structure and flexibility another 4 character segments is also available to meet any major future requirement.

THE BUSINESS PLANNING & BUDGETORY PROCESS

Business Planning and Budgeting was traditionally undertaken every year with performance evaluation of departments/individuals and variance of budgeted costs vs. actual at the corporate level. However, the new model is more structured, focused and participative with the objective of revolutionalizing SBP’s service standards and costs.

Objectives:

The new model has been developed and implemented with following objectives:

- Clearly defined goals with matrix of performance criteria
- Establish benchmark of standards
- Strengthening Corporate Governance and Accountability at all levels
- Allocation of scare resources and delegation of financial powers
- Establishing linkages with strategic plan and performance management system
- Tool for monitoring and evaluating performance

Planning Environment

Vision: The process of planning begins with the development of a vision of the institution. Every employee of the bank owns this vision and departments have developed departmental vision in alignment with the institutional vision statement.

Strategic/Corporate Plan: Strategic / Corporate plan spans over a longer term which normally is for 5 years and sets the direction of the institution. Typically, the plan covers the main functions and institutional initiatives. Governor’s Concept Paper establishes the basis on which detailed Strategic Planning is being evolved.

Business Plan: It is a spin off of the strategic plan and cascades down to individual departments and divisions. The plan covers a one year period and provides details of resource requirements in terms of Manpower, IT, Training and Space.

Budgets

The requirements worked out in Business Plans are translated into financial figures. The Budgets provide a base for decision making on allocation and rationalization of resources.

Performance Management System

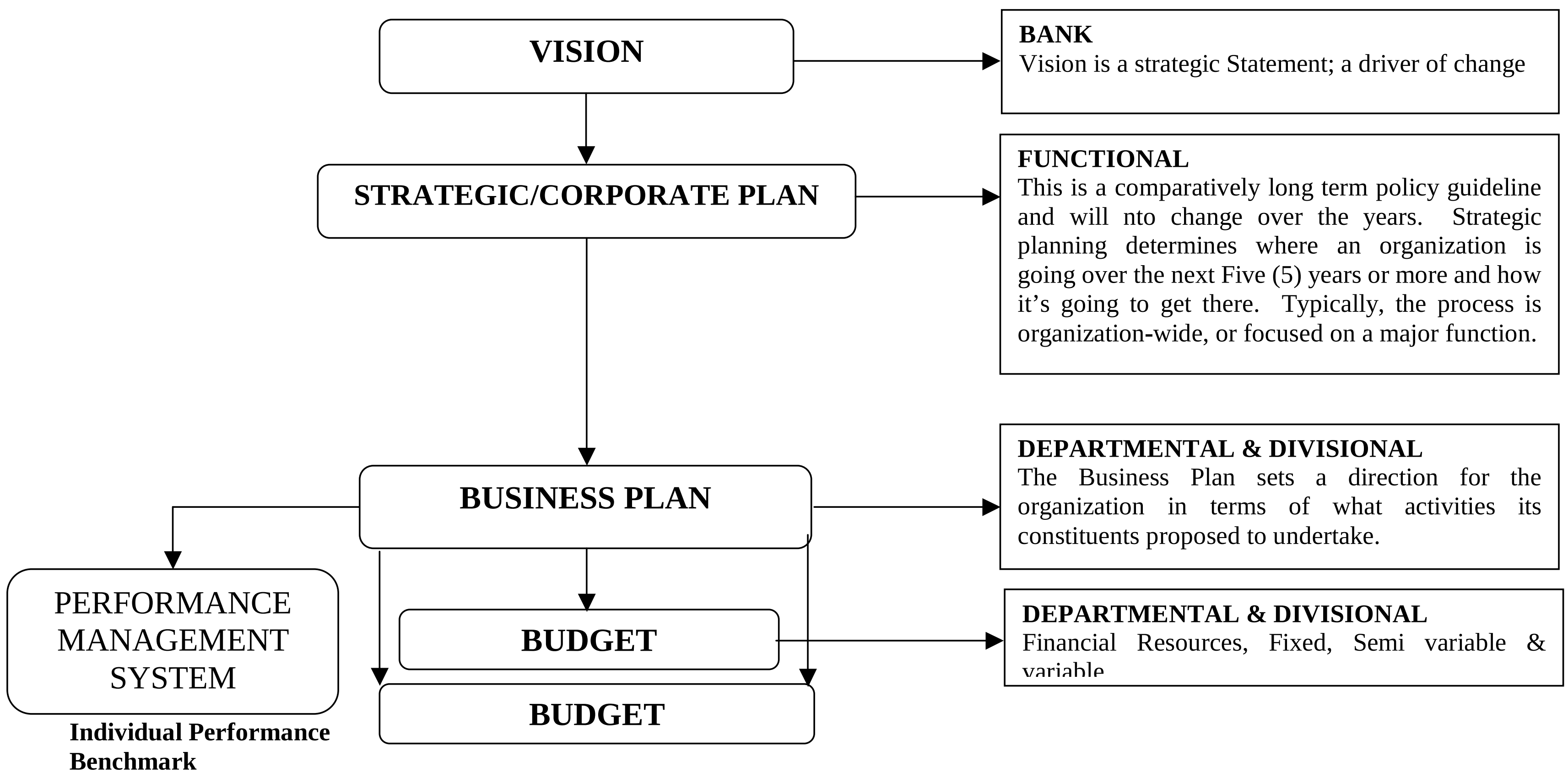
Performance Management System is an off shoot of Business Plan of a division which is cascaded down to individuals.

Monitoring

Monitoring mechanism ensures the achievement of goals in time. Business Plan and Budget is a dynamic document and therefore updated with change taking place with the involvement of all the stakeholders.

ILLUSTRATION AS FOLLOWS:

PLANNING FRAMEWORK
BUSINESS PLAN INTEGRATION AT ROOT LEVEL



Methodology of Implementation of Business Planning and Budgeting

Business Plan
The business planning process commenced on the basis of strategic direction set by the Governor through his concept paper and paper on capacity building. These papers provide the strategic plans for each of the bank's significant projects, areas of change and overall strategic direction.

Approach
As a strategy, a participative approach was adopted for development of departmental and divisional business plans. All the Heads of Departments led their teams to develop Operational Goals and Developmental Goals based on broader output plans which flow from the concept paper. The exercise invariably involves assessment of resource requirements in terms of Manpower, IT, Training and Space.

Budget
The resource requirement are converted into operational and capital budgets for current operation as well as for developmental projects. The conversion is made using various budgeting methods such as Zero Based, Historical, Activity based, Unit Cost and best economical estimates.

Evaluation and Approval
Plans and Budgets, after evaluation by Heads of Departments and concerned Executive Directors are approved by the respective Deputy Governors.
Departmental budgets after consolidated are then reviewed by Budget Committee headed by DG (Management) and resource allocation/rationalization made on broader institutional guidelines delineated by the Governor.
Individual departments are required to present their Business Plans and Budgets to CMT chaired by the Governor. Incorporation of relevant feedback from the top management within the final approved Business Plans thus forms the performance benchmarks for all the departments.

The Corporate Business Plan and Budget are presented to Board's Sub-Committee on BP&B and approved by the Central Board.

Monitoring of Business Plans and Budgets

All the Heads of Departments were enabled continuous monitoring of their business plans and costs incurred on achievement. A monthly variance analysis was provided to individual departments.
As desired by the Central Board, a mid term review was presented to Central Board in March, 2003 highlighting the achievements for the half year and targets to be achieved by the year end.

Budgeting Organization

To ensure execution and effectiveness of Business Planning process, management hierarchy has been put in place providing channels to refine/evolve/restructure the business planning/ budgeting proposals. The activity therefore takes on its meaning as an effective and crucial planning tool for the management. The hierarchy is as follows:

- Budget Sub-Committee of Board
- Budget Committee headed by DG (M)
- Business Planning & Budgeting Division- Accounts
- Departmental Budget Coordinators
- Services Department Coordinator
- Budget Coordinator- Management

Approval Process

The bottom up approach is established through the hierarchical approval process as from the very roots, the Business Planning activity assumes shape thus bridging the gap between the strategic global perspective of the top management with the operationally focused environment within the departments. The approval process thus flows as follows:

- Departmental Heads
- Executive Director
- GMT & DGs
- Budget Committee headed by DG
- CMT headed by Governor
- Budget Sub-Committee of Board
- Central Board

Planning Cycle

The planning cycle has been devised to coincide with workshops held for all the core and services departments within SBP for designated personnel who may range from Senior managers to entry grade officers. Keeping in view the purpose and rationale, the following string of activities comprise the Business planning/ budgeting activity at SBP:

o Analysis and MIS-Q3	2nd Week April
o Core Dept Plan	4th Week April
o Vetting/Approval	1st Week May
o Services Dept. Plan	3rd Week May
o Vetting/Approval	4th Week May
o Consolidation	1st Week June
o Approval Budget Com.	2nd Week June
o Approval by Sub-Com.	3rd Week June
o Approval by the Board	4th Week June

Budget Monitoring/Budget MIS

Tools to keep the management abreast with developments within the business plan and its implementation have been devised and are as follows:

- Online Information to Directors ORACLE GL & FA
- Monthly Variance Report, Cost by Input / Output Reports to Directors and EDs
- Quarterly analysis report to Budget Committee headed by DG (M)
- Half Yearly Report to Budget Sub-Committee & Central Board

Flexible Budgeting

Throughout the Business planning/ Budgeting activity the aim has been to ensure flexibility element to be an inherent feature of the process. At any point in time when deemed necessary the Budget will be adjusted for changes in Business Plan or Financial Allocation through Approval Process.

- Departmental Head
- Executive Directors
- Deputy Governors
- Budget Committee
- Governor
- Budget Sub-Committee and Central Board

Performance Measures

The management requires to see where it stands interms of the measures it ahs initiated or implemented. These measures have also been designed to ensure that the direction proposed to be undertaken is indeed being followed. These measures are as follows

- Self Assessment
- Financial Measures
- rends in costs
- Unit Costs
- Bench marking studies
- Stake holders Surveys

IMPLEMENTATION/MONITORING MECHANISM

Approach

The Business planning activity in State Bank of Pakistan is not a rigid/ inflexible activity. As a strategy the approach has been to get as much feedback as possible. The whole process has been designed in a way so as to ensure Participation from personnel concerned to ensure Ownership & Commitment.

Business Plan

The individual components of the Business plan are formation/identification of Operational goals and performance benchmark against each one to ensure accountability and measurability. New initiatives or first time activities that lead to value addition in SBP are then catalogued in terms of Developmental Goals and finally in order to execute all of the above, the requirements of Information Technology support, Human Resources, office equipment and additional space requirements are established.

Budget

The next step that falls in line, is conversion of resource requirement in monetary terms. The budgeting activity incorporates the monetary translation of the operational duties in terms of operational budget and capital budget for current business developmental projects anticipated expenditures.

- Operational Budget
- Capital Budget for
    - Current Business
    - Developmental Projects

IMPLEMENTATION TOOLS

Zero Based Budgeting is used in SBP whereby each department has to justify its funding every year and establish that the expenses incurred are a value addition contributing to efficiency in achievement of the organizational goals.

Cost Classifications define fixed variable costs against each chart of account head.

MIS Reports are being generated on a monthly, quarterly, yearly basis or as per needs of the management.

Online Monitoring of Financials

Encumbrance Accounting

Cost Allocation especially fixed asset through fixed registers

BUSINESS PLAN & BUDGET REVIEW: FY 2002-03

A review of the business plan achievements in each core function and the budget variances are explained in the following paragraphs:

BUDGET

As part of the strategy to link the business plan with budget, delegate financial powers and instill accountability at departmental level, every department developed Financial Resource Plan i.e. Capital and Revenue expenses budgets to achieve operational as well as developmental goals defined in their Business Plan. The departmental budget estimates were consolidated to present a budget of State Bank of Pakistan and its subsidiary SBP-Banking Services Corporation.

The summary financial performance of State Bank of Pakistan and SBP-Banking Services Corporation against the budget for the year 2002-2003 is explained in the following paragraphs:

A total amount of Rs.7.9 billion was budgeted for the year 2002-2003. Out of this, 46% or Rs. 3.6 billion was allocated toward corporate costs. The expenses incurred on currency printing, banking to government and charges paid on IMF quota, fall outside the discretion of State Bank of Pakistan.

SBP's Consolidated Budgeted Revenue Expenses during the year 2002-2003 remained within the budgetary limit and stood at Rs. 7,823.75 million as against budget allocation of Rs. 7,984,11 million, showing a positive variance of Rs. 160.36 million. A review various budgeted heads is given below:

CORPORATE COST

The Corporate expenses showed a saving of Rs. 151.68 million against the budget allocation of Rs. 3,651.20 million. The individual explanations of each of corporate cost is given below:

a) **Agency Charges:** These are the charges, which SBP pays to National Bank of Pakistan on account of handling of Federal as well as Provincial Government Transactions. The expenses under this head resulted in a negative variance of Rs. 139.68 million against the total budget of Rs. 1,250.00 million, mainly due to increased volume of government transactions, which were almost 11% higher than those in the year 2001-2002.

b) **Currency Notes Printing Charges:** The expenses under this head of account stood at Rs. 1,845.96 million, showing a positive variance of Rs. 155.24 million over budgetary estimates of Rs. 2,001.20 million. The saving was on account of price variance.

c) **SDR Charges:** The charges paid to IMF on quota allocation to Government of Pakistan fall under this head. Actual Expenses showed a positive variance of Rs. 136.12 million as against budget estimates of Rs. 400 million due mainly to declining interest rates. The interest rates decreased from 3.65% in 2000-2001 to 2.27% in 2001-2002 while the same were hovering around 1.72% in 2002-2003.

ESTABLISHMENT EXPENSES

Establishment cost constitutes about 41% of the total budget. About 90% of the establishment expenses such as salaries, pension, benefits, gratuity etc. are fixed in nature. The total actual establishment expenses for the year 2002-2003 stood at Rs. 3,190.67 million as against the budget allocation of Rs. 3,215.76 million thus showing a positive variance of Rs. 25.09 million. The individual analysis of each head of account is summarized below:

a) **Salaries:** The aggregate expenditure under head Salaries stood at Rs. 2,457.42 million as against budget allocation of Rs. 2,580.39 million showing a positive variance of Rs. 122.96

million. The positive variance was mainly due to the employees retired under ERIS and normal retirements during the year 2002-2003.

b) **Pension & Other Benefits:** The head Pension, Gratuity & Other benefits depicted a negative variance of Rs. 138.85 million as against 2002-2003 budget of Rs. 249.28 million. The negative variance was caused by pension payments to employees who opted for retirement under ERIS as well as due to the impact of increase in pension effective April 2003 for employees retired from 31 December 1992 to 31 August 2002.

c) **Medical Expenses:** The actual expenses of SBP Employees Medical Facilities stood at Rs. 278.11million as against budget of Rs. 301.76 million, showing a positive variance of Rs. 23.65 million. The positive variance was mainly due to discharge of medical liability through encashment of medical facilities by employees opted to retire under ERIS.

d) **Raining Expenditure:** The SBP is putting a lot of emphasis on upgrading the quality of human resources by providing continuous training to enhance the knowledge base and skills level of employees. The process of departmental Business Planning has also necessitated developing specialized job related skills. The training expenditure during the year 2002-2003 stood at 67 million as against budget of Rs. 84.33 million. Out of total budget of Rs. 84.33, an amount of Rs. 70 million was provided for NIBAF Expenses in the budget 2002-2003. The total expenses for the year 2002-2003 of NIBAF, a subsidiary of SBP, remained at Rs. 58.14 million showing a positive variance of Rs. 11.86 million.

OPERATING EXPENSES

SBP's Operating Expense constitutes almost 14 per cent of total actual budgeted expenses. The aggregate actual expenses for the year 2002-2003 remained at Rs. 1,133.56 million as against budget of Rs. 1,117.16 million. This head is showing a negative variance of Rs. 16.4 million or 1.5%, mainly due to increase in depreciation of additional EDP equipments acquired under WB funded IT Project at State Bank of Pakistan. Following are the major heads of account under operating expenses:

a) **Rent, Taxes & Insurance:** The head Rent, Taxes & Insurance is showing a positive variance of Rs. 62.16 million. The total actual expenses for the year stood at Rs. 16.86 million as against budget of Rs. 79.02 million.

b) **Utilities:** The total expenses under this head remained at Rs. 102.38 million against budget of Rs. 128.61 million showing a positive variance of Rs. 26.22 million.

c) **Fees paid to Outsiders:** The expenses under this head include Directors' Fee, External Auditors' Remuneration and Legal & Professional Charges. SBP's total actual expenditure under this head remained at Rs. 29.04 million as against budget allocation of Rs. 40.10 million, showing a positive variance of Rs. 11.06 million.

d) **Stationery & Computer Consumables:** Total expenses under this head of account remained at Rs. 22.82 million as against budget allocation of Rs. 24.70 million with a positive variance of Rs. 1.88 million.

e) **Traveling Expenses & Allowance:** Expenses under this head were contained at Rs. 69.32 million as against the budget allocation of Rs. 86.33 million showing a positive variance of Rs. 17.01 million.

f) **Communication Expenses:** The expenses under head communication remained at Rs. 40.75 million as against budget estimates of Rs. 86.23 million. This head included Postage, Telegram, Telephone, Fax, Internet, Website Charges, Swift & Reuter Charges and V-Sat Charges.

g) **Remittance of Treasurer:** There is a negative variance of Rs. 1.47 million as against the budget allocation of Rs. 27.75 million. The cause of negative variance was enhanced remittances requirement, arising out of replacement of soiled currency notes from circulation.

h) **Repair & Maintenance of Bank Property:** There is a positive variance of Rs. 36.19 million as against budget allocation of Rs. 73.99 million for the year 2002-2003.

i) **Miscellaneous Expenditure:** Expense under this head were at Rs. 279.74 million against budgeted figures of Rs. 270.44 million. There is a nominal negative variance of Rs. 9.30 million and the majoe expense booked under this head related to one time payment of Rs. 169.20 million to liquidators for out of court settlement in the BCCI case.

j) **Depreciation:** In the year 2002-2003, Depreciation (Non-cash) charged to Bank's asset escalated to Rs. 505.62 as against the estimated figure of Rs. 300 million thus showing a negative variance of Rs. 205.62 million. The very cause of negative variance is the depreciation charged on addition of EDP equipments financed under Financial Sector Deepening & Intermediation Project (FSDIP) by World Bank.

UN-BUDGETED EXPENDITURE

These expenses could not be foreseen at the time of preparing budget for the year 2002-2003. These unbudgeted expenses include payment of Rs. 405.02 million to Privatization Commission on account of privatization of UBL, Service charges of Rs. 584.19 paid to commercial banks on mobilization of remittance of Foreign Currency, Rs. 268.89 million paid to employees under Early Retirement Incentive Schemes and Rs. 594.88 paid to employees of SBP BSC who opted for retirement under Special Early Retirement Package. Further, an amount of Rs. 587.87 million was paid as arrears to retired employees who had opted for Voluntary Golden Hand Shake Scheme in 1997, in compliance with the order of Supreme Court of Pakistan in a case filed by the retired employees.

AUDIT

An independent, objective and forward looking evaluation mechanism is essential for an organization not only from the point of view of obtaining reasonable assurance in respect of the control environment but also in terms of availability of an effective tool for verification of the results being obtained and value addition through identification of weaknesses in performance and professionally sound recommendations and advice. Toward this end, KPMG's local affiliate firm of Chartered Accountants were engaged as consultants to carry out a study of SBP's Audit Department and submit their proposals for a complete transformation of the audit function on modern lines. The recommendations are in consonance with the spirit of the change of approach from traditional compliance based to a risk based audit approach and best industry practices. On the basis of the suggested restructuring for the Internal Audit, functional aspects of the departmental work have been firmed up as under:

1. Internal Audit Charter approved by the Governor, shall govern the functions of Internal Audit Department.

2. In order to provide appropriate level of independence and add objectivity to the Audit Department's work, the reporting lines have been established provide that the Audit department of SBP shall be headed by a "Director Audit" who shall report to the Governor and the Audit Committee. Director Audit will ensure appropriate degree of coordination with other Departmental heads and external Auditors and shall also be authorized to communicate directly with the Central Board of Directors at his discretion as considered appropriate.

3. Additionally, all departments will come under the review of the audit department.

The revised Audit Manual based on the Risks Based Audit Approach has been progressively implemented after providing the requisite training to the staff. The Audit department has completed its first round of audits of different departments and in line with the automation underway in the bank, has also established an IT Audit Cell.

The Business Plan 2002-03 of State Bank embodies organization's Operational and Developmental goals, which flow through a focus on core central banking activities while delegating responsibilities of secondary functions to the wholly owned subsidiary namely Banking Services Corporation. Separating the operational side of providing services to the government and other non-core activities, the State Bank was able to narrow down its efforts for attaining an accelerated pace of reforms in the areas of monetary policy, exchange rate management, banking supervision & regulation and the payment system.

The Business Plan therefore concentrated on visible improvements in the efficiency, effectiveness and transparency in central bank's workings both as related to the external as well as internal stakeholders. The over-riding consideration for individual departments business plans, which were consolidated in the form of institutional business plan in the light of various budgetary and other constraints, remained to be the eventual contribution toward:

- Strategic direction of SBP. A longer-term approach has been set through the Governor's Concept Paper for progress toward organizational vision. Yearly developmental projects have therefore been accordingly linked for completion of strategic goals in the time horizon of 3-5 years.
- Building capacity to meet future challenges. Technology and development of new products and delivery mechanisms, point toward an increasingly competitive future environment. Attaining real time monitoring & surveillance capacity in the financial and economic set up predominantly run by the private sector and responsiveness to such developments have been the basis of a number of development projects.
- Enhance quality of product output. The change initiative brought out expectations of high quality information, reports and services in line with international best practices. A large number of initiatives were geared toward this aspect.
- Expansion of the product spectrum. A large number of initiatives in the form of reports and discussion papers along with market based policy guidelines outlined to the stakeholders have established central bank's problem solving stance in the interest of an enabling and stable business environment.
- Efficiency of operations and responsiveness. Elimination of redundant internal processes and duplicated information, delegation of powers for streamlined decision making remained the focus of several internal projects including those undertaken to enhance the technological base and institutional skills set.

It is encouraging to note that apart from certain timing adjustments which had to be made in respect of the ongoing IT projects due essentially to external factors, by an large the overall business plan objectives were successfully met. Progress made in this respect and significant milestones crossed have been discussed throughout this report.

AN ANALYSIS OF THE PROFITABILITY OF STATE BANK OF PAKISTAN 1999-00 TO 2002-03

Introduction

It is a well accepted fact that Central Banks do not direct their operations with the prime motive of earning profit s. However, by virtue of their sole right of issuing notes and being custodian of Government's Cash balances, Commercial Banks reserves and the country's foreign exchange reserves, Central Bank generally hold enough income earning assets in their possession. SBP also carries out its affairs on the same pattern and in the course of conduct of its business, it sometimes makes surplus profit which is transferred to the Government for budgetary support.

The Bank's income mainly consists of earnings in the form of interest on Securities and on loans/advances to Government and Banks, Discount on Market Treasury Bills issued for replenishment of Debit Balance of Federal Government, Exchange gains/losses on sale and purchase of foreign currencies and commission on management of Public Debt of the Central and Provincial Governments. The main items of expenditure include pay and allowances of SBP's staff, Agency Charges paid to National Bank of Pakistan for transacting Government business on SBP's behalf at places where SBP does not maintain a direct presence, printing charges for Bank Notes and other security documents etc.

1999-00 to 2002-03 "A period of varying profitability"

The country's economy underwent significant changes during the last few years having wide ranging effects on a number of economic and financial areas including the profitability of the State Bank. A number of such developments have impacted SBP's profitability in recent years, which varied from Rs. 36,088.9 million earned for the year 1999-00 (Table I.I) to an amount of Rs 243.1 million earned for the year 2002-03. Primarily, there were two heads of accounts affecting the Bank's profitability viz. a) Discount on MTBs and b) Gains/Losses on Foreig n Exchange. Year-wise position of these accounts for the period 1999-2003 along with other relevant information impacting SBP's profitability may also be referred in the above table. The economic rationale behind the changes in profitability is explained in the next section.

Private Capital inflows: With the initiation of efforts to curb Hundi/Hawala channels, significant volumes of foreign exchange inflows were realized in the form of increasingly high volume of remittances from overseas Pakistanis. Such remittances increased from less than a billion dollars in 1999-2000 to a historic record level of over four billion dollars in 2002-03 (Table 1.2). This increased supply reversed the downward movement in the exchange rate and the rupee started gaining strength rapidly.

Exchange Rate Appreciation: The steep rise in the value of Pak rupee has perhaps been the most significant development on the economic front during the last few years. In the post 9/11 scenario, Pak rupee saw rapid exchange rate appreciation, in sharp contrast with a continuously depreciating exchange rate for the past many decades. A glance at table 1.2 identifies year 2001-02 as the turning point when the traditionally weak rupee began its upside journey.

SBP's Profitability 1999-00 to 2002-03

No.	Description	1999-00	2000-01	2001-02	2002-03
1	SBP's holdings of MTBs	458,525.4	487,297.5	199,690.3	105,439.8
2	Rate of Discount on MTBs (Min - Max)	7.0925% - 10.3554%	7.0926% - 12.8756%	5.6450% - 2.8756%	1.6389% -6.4045%
3	**Discount Income on MTBs**	**39,531.5**	**45,940.7**	**26,640.3**	**7,339.5**
4	Exchange Rate 1$ = PKR (July to June)	51.60 - 52.30	52.30 - 63.98	63.98 - 60.02	60.02 - 57.81
5	Exchange Rate (Appreciation/Depreciation) %	(1.40)	(22.4)	6.2	3.7
6	**Exchange Gain/(Loss)**	**(13,890.7)**	**(49,168.2)**	**9,033.0**	**(11,809.4)**
7	**Other Income (Return/Mark-up on PLS Basis etc., Dividend, commission & other operating income)**	**18,575.6**	**31,355.3**	**7,737.0**	**15,237.0**
8	**Gross Income (3+6+7)**	**44,216.4**	**28,127.8**	**43,410.3**	**10,767.1**
9	**Expenditure & Provisions**	**8,127.5**	**12,460.2**	**17,941.3**	**10,524.0**
10	**Profit by SBP (8 - 9)**	**36,088.9**	**15,667.6**	**25,469.0**	**243.1**
11	**Amount transferred from/(to) Reserve Fund**	**(5,000)**	**5,600**	**3,000**	**(14.5)**
12	**Surplus Profit transferred to Govt.**	**31,088.9**	**21,267.6**	**28,469.0**	**228.6**
13	Reserves Level - (USD)	991	1,677	4,333	9,525
14	Foreign Currency Liabilities - (USD) *(FCAs, Central Bank's Deposits, IMF)*	4,726	3,833	2,536	2,036
15	Net Foreign Assets/(Liabilities) (14-15)	(3,735)	(2,156)	1,797	7,489
16	Foreign Exchange Purchases by SBP - (USD)	1,633	2,157	3,859	4,957

(TABLE 1.1)

Year	Exchange Rate	Home Remittances[1]	Exports[1]	Interest Rates[2]
1999-00	52.30	984	8,569	7.22
2000-01	63.98	1,087	9,202	12.88
2001-02	60.02	2,389	9,135	6.28
2002-03	57.81	4,237	11,160	1.66

[1] In millions of US Dollars. **(Table 1.2)**

[2] Last Cut-off rate in MTBs auction as on 30th June.

Foreign Exchange Reserves: While there were benefits of a strong rupee, a swiftly appreciating exchange rate would have entailed the risk of placing country's exports at a disadvantage. To keep exports competitive, SBP had to mop up excessive liquidity from the foreign exchange market resulting in a continuous accumulation of the country's foreign exchange reserves. Consequently, the foreign exchange reserves of the country reached a historic level of approximately 9.53 billion dollars (Table 1.1) as on June 30, 2003. This was a phenomenal increase in comparison to the past when the country was faced with chronic shortages in its reserve volumes. Pak rupee witnessed an appreciation of approximately 3.70% during the year ending on June 30, 2003.

While there are several benefits of maintaining a high volume of foreign exchange reserves, it has its own repercussions on the profitability of the State Bank. The foreign exchange reserves held with SBP are carried at the cost at which they were purchased from the market. Subsequent changes in the exchange rate affected SBP's profitability when the balances were revalued on a mark-to-market basis as per the International Accounting Standards. Previously when the rupee was depreciating, SBP realized exchange gains on its Gross Foreign Assets although due to the the fact that bank's Foreign Liabilities far exceeded the Net Foreign Assets, the net impact on bank's profitability remained negative in the form of a net exchange loss.

However, when the rupee took a reverse turn and started appreciating sharply, SBP as per the requirements of international accounting standards had to book revaluation losses on its Gross Foreign Assets since the prevailing exchange rate in the market at the year end was less than the rates at which purchases were made. Moreover, the Net Foreign Assets position of the Bank also remained positive due to the unprecedented increase in the foreign exchange reserves held, adding further to the net exchange loss. On the other hand, interest rates in the international foreign exchange market continued a declining trend and SBP's income on its investments of foreign exchange assets was therefore significantly lower .

YEAR	Net Exchange Income/(Loss)	Net Profit	Surplus Profit transferred to Federal Government
1999 - 00	(13,890.6)	36,088.9	31,078.9
2000 - 01	(49,168.2)	21,267.6	21,257.6
2001 - 02	9,033.0	28,469.0	28,459.0
2002 - 03	(11,809.4)	243.1	218.1

Table (1.3)

In the year 2000-01, the aggregate exchange loss of Rs.49 billion (Table 1.3) was incurred due to provision of forward cover on Foreign Currency Accounts - Exchange Risk Coverage Scheme (Rs 31.3 billion), open market operations including currency swaps (Rs 20.1 billion) and revaluation of net foreign assets (Rs 8.6 billion). These were partially offset by Rs 10.9 billion earned as forward cover fees charged on the foreign currency accounts. In the year

2001-02, there was a gain of Rs 8.2 billion on cover provided against foreign currency accounts, a much lower loss on market transactions of Rs 0.6 billion and a lower loss on revaluation (Rs 5.2 billion) due to lower stock of foreign currency accounts. These were somewhat compensated by the forward cover fee charged of Rs 6.6 billion. In 2002-03, the exchange loss has taken place due to appreciation of Rupee against US dollar. Contrary to popular perception, a strong and appreciating rupee will lead to exchange loss when the value of foreign reserves (net of liabilities) are positive and translated into rupees. During the earlier years when foreign exchange reserves at SBP, net of own liabilities, were negative and the rupee was depreciating, SBP had to incur a translation loss due to revaluation of its reserves. However, when the reserves had improved significantly, State Bank still incurred a revaluation loss due to appreciation of the rupee. To further illustrate the point, consider the foreign reserves (net of liabilities)at the end of the FY-2002-03 being at $ 7.5 billion which would translate into rupees 450 billion assuming a conversion rate of Rs 60 to a dollar. An appreciation of the rupee to 58 would cause the same level of net reserves to be depicted at Rs 435 billion causing SBP to incur a loss of Rs 15 billion in its accounts for the year. Similarly, assuming a depreciation of rupee to 62 to a dollar, the same net reserves will be valued at Rs 465 billion causing SBP to record a translation gain of Rs 15 billion. On the other hand, the position is reversed when SBP reserves (net of liabilities) are negative as in the years before 2001-02. Taking the net reserves at negative $ 3.7 billion as of June 2000 and assuming depreciation of rupee from 60 to 62 to a dollar, SBP would incur a loss of Rs 7.4 billion while an appreciation in rupee from 60 to 58 would cause SBP to record a gain of Rs 7.4 billion.

Availability of sufficient foreign exchange reserves alleviated the country's vulnerability on the external sector. The adoption of a market based exchange rate regime also justified maintenance of a high volume of reserves which he lped in keeping the speculative traders at bay to put undue pressure on the exchange rate. However, the cost of maintaining a high volume of reserves was borne by SBP in the form of revaluation losses and low return on investments resulting in declining overall profitability.

Monetary Policy Implications

The foreign exchange purchases made by SBP also had their impact on the rupee liquidity in the market as the banks selling foreign exchange to SBP were paid in Pak rupees. The massive foreign exchange purchases made by SBP from interbank market resulted in injection of huge volumes of rupee liquidity in the money market. This increased rupee liquidity had significant implications over the conduct of monetary policy as excessively high money supply can potentially create inflationary pressures. To avoid such happening SBP had to sterilize the additional rupee liquidity from the market through frequent auctions of Govt. securities and Open Market Operations.

The increased money supply forced interest rates in the money market to come down rapidly (Table 1.2). The government took advantage of the low interest rates scenario by retiring its expensive debt held with SBP with borrowing from market sources at a low cut-off rate. During the year 2002-03 the government retired debt held with SBP to the tune of Rs. 213 billion (Table 1.4).

Position of Government Securities and T.Bills				**(Rs. in millions)**
	30-06-00	**30-06-01**	**30-06-02**	**30-06-03**
Total T. Bills	647,428	737,776	557,807	516,268
Schedule Banks	103,790	123,889	231,507	411,254
SBP[1]	540,133	595,990	318,602	104,617
Non-Banks	3,505	17,897	7,698	397

[1] **Also includes Ad-hoc T-Bills**

Table 1.4

The sharp decline in SBP's holdings of government securities significantly affected SBP's profitability. In fact, the decline in SBP's holdings of government Securities and the drop in the rates of return are the prime reasons behind the sharp decline in SBP's income during 2002-03. However, the reduction in SBP's income should rather be deemed a trade off against reduced cost of borrowing for the government as the income earned by SBP is ultimately transferred to the government's account. So while the SBP is faced with a drop in its income mainly because of reduced income from investment in government securities, the government at the same time is able to find fiscal space through reduced cost of borrowing. According to government's own estimates, the debt servicing payments during the year 2002-03 were 207.8 billion as against the budget estimate of Rs. 264.0 billion. The savings on domestic interest payments in the budget caused by low T-bill rates were thus higher than the expected profits from the SBP. In net terms, the Government was better off in FY 03 compared to what it had assumed at the time of budget formulation.

Conclusions

Based on the above analysis, it can be clearly seen that the profitability of the State Bank is dependent upon the following factors:

a) Private Capital flows
b) Reserves Level
c) Exchange rate movements
d) Interest rates

If the private capital flows are low resulting in a low level of Reserves; interest rates are high and the rupee is depreciating, the probability of SBP earning profits would be high. Whereas, SBP on the other hand is likely to incur losses if the private capital flows are high resulting in a high level of Reserves; interest rates are low; the rupee is appreciating and SBP is undertaking sterilization to keep money supply under control. As explained earlier, the scenario described later remained applicable for most of the years under review.

Although the overall impact of SBP's policies during 1999-00 to 2002-03 resulted in a decline in its profitability; as a consequence of these policies, the economy has been able to reap benefits in the form of competitive exports; reduced cost of government borrowing; stability in exchange rate and most importantly a significant rise in the foreign exchange reserves of the country. Besides, the reduced cost of borrowing for the government has actually set off the potential financial impact of SBP's reduced profitability on government budgetary support.

Annual Accounts