

FINANCIAL SECTOR REGULATION AND POLICIES

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State Bank's policies and regulatory directives have a major impact on the evolution of the banking sector and their financial health. A number of initiatives were taken during the year under review, which are summarized below.

FINANCIAL DEEPENING AND SOUNDNESS

A. CORPORATE BONDS

Debt financing constitutes one of the major sources of funding for corporate entities. In Pakistan however, the corporate bond market is still in its infancy where financial institutions act as the major source of financing long-term debt in the shape of loans & advances with minimal reliance on market based debt. Since multilateral agencies have now stopped funding NBFIs, particularly DFIs & the leasing companies, these institutions have not been able to develop attractive alternate sources of funding which has adversely affected their lending and investment capabilities. Consequently, some of the major companies, particularly leasing companies, have increased reliance on TFCs for additional term debt funds.

Banks, who have been the major repository of national savings have not been able to assume a significant role in the development of corporate debt market. Recently, State Bank has allowed the banks to enter domestic capital market as issuers of TFCs/Bonds. Banks can now raise funds from the capital market in the form of rated and listed subordinated debt instruments (like TFCs/Bonds), which can also be included in the banks' supplementary capital. However, in order to be eligible for inclusion in supplementary capital, the instrument needs to be fully paid up, unsecured, subordinated as to payment of principal and profit to all other indebtedness of the bank while not being redeemable before maturity without prior approval of SBP. This step would not only strengthen the financial markets but would also play an important role in financial deepening, promotion of good corporate governance and bringing further market discipline in the banking industry. Ability of banks to tap the market for longer-term funds through these instruments provides an additional venue for matching of long term assets such as mortgages and project finance. The TFC market has been buoyant and 53 issues worth face value of Rs 27.784 billion have been floated through K.S.E.

B. INCREASED PAID UP CAPITAL REQUIREMENTS

In order to facilitate the financial institutions to strengthen their competitive ability and consolidate equity structure to a level considered adequate assurance towards protection of depositors' interests as also to encourage economies of scale & economies of scope, SBP revised the applicable minimum paid up capital requirements. Banks were required to enhance their net paid up capital to the minimum level PKR 1,000 million in two stages by 1st January 2003. Banks not able to comply with the requirement faced conversion of their status into Non-Scheduled Bank (NSB) with restrictive activities. Such NSBs, if any, were permitted to only operate in the inter-bank market, make investments in government securities, and finance import/export businesses within such limits as may be specified by State Bank, on case-to-case basis. It was also provided that State Bank, upon request made, may consider allowing such a banking company to continue accepting deposits from their corporate/institutional depositors only up to the limit of lower of the total deposits mobilized as of 30th November or 31st December, 2000. As a result of this stipulation, almost all banks, excepting a handful likely to merge or exit, have attained the new capital requirement.

C. GREATER DISCLOSURE

In line with the requirements and recommendations of the International Accounting Standards, existing formats of financial statements needed a revision to make them more informative and user friendly. The need was also felt for further broadening the scope of prevailing disclosures under these statements. Accordingly, in collaboration with Institute of Chartered Accountants Pakistan & Pakistan Banks Association, a suitably revised format was devised & circulated to banks.

The entailing enhanced disclosure requirements are expected to add further to the market discipline and improve corporate governance in the industry.

D. IMPROVED CORPORATE GOVERNANCE

To achieve the goal of good corporate governance, augmenting safe and sound banking practices, it is imperative that the 'Board of Directors' assumes its role and responsibilities independent of the influence of the line management. Members of the Board must fully appreciate the nature of their mandate and the enabling powers, in clear terms. Further, it must also be ensured that the focus of the Board of Directors remains on providing strategic direction, policy guidelines along with the overall supervision and monitoring of the affairs, while delegating the role of managing day-to-day operations to the management of the bank. In continued recognition of the importance of corporate governance, State Bank has taken a number of steps to raise the bar of governance standards in the industry. A separate Prudential Regulation was issued outlining the responsibilities of a financial institution's Board of Directors.

The process also included formulation & implementation of "Fit & Proper Test" for the appointment of President/Chief Executive and filling of the vacancy of Directors on the Board by issuance of Prudential regulation XXIX on Responsibilities of Board of Directors. Similar instructions were also issued by SBP for assessing the fitness & propriety of key executive positions in April 2003. State Bank's clearance for appointing a person as chief executive or a member on the Board of Directors of a bank/DFI has been made mandatory. The eligibility criteria for appointment of chief executives and members of the Board of Directors have also been made more stringent. The moneychangers, members of stock exchanges or brokerage houses or companies owned or controlled by them or persons directly or indirectly associated with the business of stock market/money changers have been prevented from becoming directors on the board of a bank/DFI. Recently, the State Bank has also outlined eligibility criteria for appointments at banks for the core functions. On similar lines, banks were also directed through a circular to appoint "Compliance Officer" who would be responsible for coordinating with the regulatory authorities and compliance of laws, regulations & instructions issued from time to time. In addition, to facilitate depositors & various other stakeholders in reaching informed judgment, it is now mandatory for all banks to get themselves evaluated by credit rating agencies. These ratings are also disclosed to general public by SBP and disseminated to Chambers of Commerce and other trade bodies. Such public disclosures would allow the stakeholders to make more informed choices among the competing banks.

E. COMPLIANCE WITH INTERNATIONAL CODES AND STANDARDS

In recent years, serious efforts have been made at the State Bank to achieve full compliance of various international codes and standards. The core principles (CPs) for Effective Banking Supervision have become the most important global standards for prudential regulations and supervision. A vast majority of countries have endorsed the core principles for implement. State Bank had conducted a self-assessment of compliance with core principles and the exercise affirmed our compliance with most of the CPs. Apart from strict enforcement of the capital adequacy requirements prescribed under Basel Capital Accord of 1998, the annual financial

statement of banks as also the State Bank's own annual financial statements are required to be prepared in line with the international Accounting standards. These efforts have contributed in further establishing credibility of the country and its financial system with international financial institutions and central banks.

F. EXPORT FINANCE SCHEME

The Export Finance Scheme, which is the major source of export credit for eligible commodities on soft terms, has been in operation since 1973, when SBP introduced it as "Refinance Scheme for Non-Traditional and Newly Emerging Exports". Since then, the scope of the scheme has continuously been enlarged and now it covers almost all items of exports excluding only some of the basic & primary commodities/raw materials.

All the scheduled banks are providing credit facilities to exporters under Export Finance Scheme (EFS). As SBP provides refinancing facility to banks, in respect of the funds disbursed, it replenishes the liquidity of the banking system. Since EFS is a market-driven product, it is modified whenever there is a need to do so in order to facilitate the end users. Some of the recent modifications envisage:

- ❑ Reduction in documentation requirements
- ❑ Greater role for commercial banks
- ❑ Reengineering the role of SBP.
- ❑ Revised simpler procedure for refund of fines under EFS

Under the new system the role of SBP has been transformed from micro management to overall monitoring of banks under explicit guidelines.

G. LIBERALISATION OF BRANCH OPENING AND CLOSING

The SBP has been historically preoccupied with the consideration and approval of every single bank branch in the country. This has led to evasion of sound business decisions by the banks in expanding their network. With a view to liberalize the existing regulations, prior approval of State Bank for opening or closing a branch has been dispensed with. Instead, a very flexible Annual Branch Expansion Policy has been introduced, which allows banks to take decisions on their branch portfolio based on business requirements.

H. CREDIT INFORMATION BUREAU: UPGRADING AND GOING ONLINE

The banking system is dependant upon fair and accurate credit reporting. Inaccurate credit reports directly impair the efficiency of banking system and undermine public confidence, essential for sustainability of the banking system. Credit data is also an important supervisory/regulatory tool, through which central banks regulate and monitor the credit and monetary policy. Realizing the importance of credit data, State Bank of Pakistan established Credit Information Bureau (CIB) in 1990. The sole purpose of CIB was to collect credit information from banking companies and make such information available to facilitate the process of credit appraisals.

Presently, CIB collects credit information on monthly basis from banks/NBFIs including Leasing Companies and Modaraba Companies in respect of borrowers having credit exposure of Rs. 0.5 million and above.

In order to enhance CIB's capacity to deal with the growing demand for consumers/micro credit and to bring it on-line, CIB has switched its systems from Unix based Informix on DEC-Alpha Server to Window based Oracle on Acer Altos 21000 Server.

In addition to maintaining Credit database, CIB has also started maintaining a database for Non-Performing Loans of Banks. With regard to provision of CIB facilities on-line, work on the project has been completed and banks/NBFIs can now access Credit Reports on-line from the Bureau. Elevating CIB to the level of real time online service has been a joint initiative with the banking industry and all possible measures have been taken to build firewalls around the systems that hold and disseminate online information.

I. ANTI MONEY LAUNDERING MEASURES

State Bank of Pakistan, being the regulatory and supervisory authority, has been initiating measures to prevent the use of banking channels for the purposes of money laundering. These measures include issuance of Prudential Regulations, initiating promulgation of AML law and participation in regional efforts against Money Laundering.

The focus on prevention of money laundering has sharpened in the recent past and State Bank has adopted a two-pronged strategy to tackle the issue. Firstly, a comprehensive money laundering law for the country was formulated for issuance under the auspices of the Ministry of Finance. A Working Group on Money Laundering was set up at the MOF, in which SBP has been an active member, to formulate the Anti-Money Laundering law that is comprehensive and covers all major aspects of AML. Under this law, NAB, FIA and Anti-Narcotics Force shall have full authority to investigate and prosecute under the existing special courts. A National Financial Intelligence Center (NFIC) shall also be set up. The purpose of NFIC would be to collect and analyze data on suspicious transactions. A “confiscated Assets Funds” shall also be created. Secondly, embarking upon the path of upgrading its own capacity and expertise in the area, SBP undertook the following measures:

- a. **Membership of Asia Pacific Group on Money Laundering (APGML):** Pakistan has also obtained membership of APGML, a regional AML organization, and several SBP officials have also participated in APGML’s conferences and workshop. The main objective was to keep abreast of the global developments and to provide an opportunity to interact with regional partners in the AML area.
- b. **Instructions to comply with Prudential Regulations XI and XII:** In early June 2002, SBP issued a directive to all banks advising them to put in place appropriate procedures to ensure that all branches of the banks strictly follow requirements of “Know Your Customers”.
- c. **Guidelines for appointment of Compliance Officer:** SBP through BPD Circular No. 16 of 2003 issued guidelines for appointment / designation of Compliance Officer, in terms of which, banks / DFIs have been advised to appoint / designate a ‘Compliance Officer (CO)’ , so as to ensure that the activities of banks / DFIs are in compliance with the relevant laws and regulations, especially with regard to Know Your Customer (KYC), and other anti money laundering laws, rules and regulations. COs will, inter alia, primarily be responsible for banks / DFIs effective compliance relating to (a) guidelines for KYC (b) anti money laundering laws and regulations, (c) timely submission of accurate data / Returns to regulator and other agencies and (d) monitor and report suspicious transactions to president / CEO of the Bank / DFI and other related agencies.
- d. **Freezing of Accounts:** SBP, under various UN Conventions, has met the responsibility of freezing bank accounts of entities that were so specified.
- e. **Training of Supervisory Staff:** In order to develop expertise in this area, adequate training (local and foreign) is being imparted to the concerned supervisory staff.

J. INTRODUCTION OF GUIDELINES FOR NON-PERFORMING LOANS (NPLS) AT BANKS/DFIS- BALANCE SHEETS RECONFIGURATION

One of the major problems faced by banking industry was the high level of NPLs. In order to help banks to clean up their balance sheets and realize maximum recoveries, State Bank developed a set of guidelines entitled “New Guide Lines on Write-offs”. These guidelines were finalized after detailed deliberations with the representatives of five big commercial banks and trade bodies so as to make them practical. While direct impact of the scheme as of 30-06-03 has been recoveries & restructuring of NPLs of PKR 18 billion, its aggregate impact may extend considerably once banks settle all the referred cases.

K. ISLAMIC BANKING

In December, 1999, Shariat Appellate Bench (SAB) of Supreme Court of Pakistan upheld the judgment pronounced earlier by the Federal Shariat Court, declaring Riba as un-Islamic while disposing off government appeal there against and held all laws and/or provisions which provide for interest as repugnant to injunctions of Islam which shall cease to have any legal effect. This judgment was reviewed by the SAB in a petition filed by UBL and the case was remitted on June 24, 2002 to Federal Shariat Court for fresh determination.

Measures taken after the Supreme Court Judgment: As directed by the Supreme Court, a Commission for Transformation of Financial System and Task Forces in the Ministry of Finance and Ministry of Law were established in February 2000. A Committee on Development of Financial Instruments and Standardized Documents was also set up by the Commission in SBP to review existing products and services of banks and other financial institutions, develop new financial instruments and draft standardized documents for submission to the Commission for final approval.

The Commission presented two interim reports to the Government in October 2000 and May 2001. In these reports, Commission recommended various measures to implement court orders, identified the major Shariah compliant modes of financing, their essentials, draft seminal law captioned as ‘Islamization of Financial Transactions Ordinance, 2001’, model agreements for major modes of financing, and guidelines for conversion of products and services of banks & financial institutions. Earlier in April 2001, Committee on Development of Financial Instruments and Standardized Documents had presented its Final report to the Commission while in August, 2001 the Commission submitted its final report to the Government after consolidation of the above mentioned two reports.

In pursuance of the recommendations and preparatory work done, State Bank of Pakistan had adopted a three-pronged strategy for promotion of Islamic banking by:

- ❑ Allowing opening of a full fledged Islamic commercial banks in the private sector
- ❑ Allowing existing banks to establish subsidiaries for Islamic banking
- ❑ Allowing existing banks to open separate branches for Islamic banking

In December 2001, SBP issued detailed criteria for establishment of Islamic commercial banks in the private sector. Al-Meezan Investment Bank Limited applied for the license and permission to convert into an Islamic commercial bank. Consequently, a license in the name of Meezan Bank Limited was issued to operate as the first full-fledged Islamic bank in January 2002.

In order to allow existing banks to open subsidiaries for Islamic banking, a draft amendment in section 23 of Banking Companies Ordinance, 1962 has also been approved by the Ministry of Finance. A scheme for allowing existing banks to open exclusive branches for Islamic banking operations was prepared keeping in view the underlying issues and international practices in this regard. Consequently, five banks have so far been granted permission to establish nine standalone

Islamic Banking branches and one such branch is already operational. While a number of issues related to Islamic Banking including statutory liquidity requirements have been suitably resolved, work is underway for resolution of remaining the issues such as Accounting Standards to be followed, Shariah Audit, Shariah Board and a separate set of Prudential Regulations governing Islamic Banking. Here in order to provide level playing field to the Islamic banks in comparison to the other conventional banks, Refinance Division of Banking Policy Department in coordination with its ex-Islamic banking division carried out designing of export refinance scheme. The scheme also incorporates views of Meezan Bank taken on the scheme in its capacity as a stakeholder. SBP has also formulated and introduced, Islamic Export Refinance Scheme (Part I & II) taking into account the feedback of stakeholders such as Meezan Bank and considered views of the Shariah scholars.

L. REVIEW & UPDATING OF FINANCIAL INDUSTRY LAWS

Most of the existing laws were framed in the early 60's and 70's with modifications made as considered appropriate from time to time. However, the basic orientation of the laws remained unchanged. It has been State Bank of Pakistan's endeavor to have in place a coherent and simplified legal framework for the financial sector, which encourages banking business on one hand and plugs the regulatory loopholes on the other. In this regard State Bank has been proposing various amendments in existing laws pertaining to the financial sector.

A number of amendments were made in Banking Companies Ordinance, 1962 during the last two years, so as to promote consolidation of the financial institutions (Amendment in Section 3A, section 47 & 48), protect the depositors' interest in case of liquidation (substitution of section 54 and 58), to remove certain lacunas and inconsistencies occurring over time, bring the deposits denominated in other currencies under purview of the unclaimed deposits, promote Islamic Banking (addition of new subsection 'aa' in section 23(4), tackle the Corporate Governance issue and to implement the strategic decisions like shifting of supervisory responsibility of NBFIs to Securities and Exchange Commission of Pakistan (amendment in Section 3A). Above aspects have been given effect through amendments in BCO through various Ordinances.

With the development of a large number of innovative financial products and strides in telecommunication technology, it was decided to undertake a comprehensive review of the existing legal framework and make necessary revisions and modifications in the banking laws. On the initiative and recommendations of SBP, Federal Government constituted Banking Laws Review Commission in April 2000. The Commission was mandated to survey the legal problems and legislative needs of financial institutions and propose amendments in existing legislation including drafting of new laws. The Commission drafted and recommended the new Recovery Law viz. "The Financial Institutions (Recovery of Finances) Ordinance, 2001" promulgated by Federal Government on 30th August 2001 vide Ordinance No. XLVI of 2001. The law contains additional provisions and positive features for recovery of finances through speedy legal recourse.

Currently the Commission is in the process of drafting an insolvency law, which has been named by the Commission as Corporate Rehabilitation Ordinance. The Commission has also decided to take up Banking Companies Ordinance after completion of work on Corporate Rehabilitation Ordinance.

M. MANDATORY CREDIT RATING

For promoting self-discipline in the financial markets, all banks/NBFIs were required to get themselves credit rated by June 30, 2001 from the approved credit rating agencies. The objective was to provide another yardstick to the market participants and stakeholders for informed decision making, to promote healthy competition and induce financial institutions to improve their financial condition.

N. REVISION OF THE PRUDENTIAL REGULATIONS

The PRs for banks and DFIs were designed to regulate a banking sector which was dominated (up to 80% of the market) by nationalized banks. Furthermore, these PRs were geared more for Wholesale / Corporate Banking. Therefore, with the changing composition of the banking sector (now 60% with the private sector, increasing to 80% once HBL is privatized), there was a need to revise the PRs. Firstly, these have been disaggregated into PRs specifically for Corporate, SME financing, Consumer, Micro finance and for Infrastructure. Secondly, these have been liberalized to allow bankers to use their discretion in many areas. These new PRs, which have been developed after both extensive and intensive consultations and feedback of external stakeholders like PBA and other trade bodies and associations, will be introduced shortly. Thirdly, Risk Management Guidelines have also been developed and introduced to prepare the banks for Basel II Accord. It is expected that as banks improve their readiness to better manage their risk, the PRs will be gradually withdrawn and Risk Management Guidelines will only remain.

O. ALLOWING FORMATION OF NBFCS

An in-depth review of the Non Bank Financial Institutions (NBFIs), carried out by the State Bank of Pakistan indicated a number of deficiencies and problems that needed policy intervention. Although suitable steps were taken by SBP in respect of DFIs including restructuring, the rest of the NBFIs, including 47 Modarabas, 32 leasing companies and 15 investment banks and other companies, continued to suffer from a general malaise of low profitability, low return on equity and high cost of funds. Clearly, a redesigned module was required for NBFIs to address the issues involved while also promoting mergers and consolidations within this segment of the financial sector. In conjunction with SECP, a new model of Non-Bank Financial Companies (NBFC) has been developed, whereby NBFCs shall be allowed to undertake all financial services except banking functions. The portfolio of related services may therefore range from corporate advisory services, leasing, housing finance, venture capital, investment advisory for managing closed-end mutual funds to asset management for open-end mutual funds.

POVERTY TARGETED POLICIES

A. PROMOTING MICRO FINANCE

The micro finance Sector in Pakistan is at an evolutionary stage with low outreach, narrow institutional base, limited retail capacity, and a perception of micro finance as more of a social service than a commercially viable financial proposition. Commercial banks, in general, are neither structured nor geared to extend their micro finance exposure beyond experimental forays while the segment does not form a part of the target market for Development Finance Institutions (DFIs). Non-government organizations (NGOs) have shown appreciation for the nature of micro finance demand emanating from poor through effective targeting, participatory approaches, capacity building, and gender sensitivity. However, their micro finance operations are unlikely to attain financial self-sufficiency with limited capacity to reach a larger segment of the population.

While recognizing the importance of micro finance towards poverty alleviation and considering the ongoing banking & financial sector reforms, government has formed a comprehensive Micro Finance Sector Development Program (MSDP) with the assistance of Asian Development Bank (ADB). The Program aims at creating a conducive policy environment, developing appropriate financial infrastructure, promoting and strengthening micro finance Institutions (MFIs) and providing institutional development support.

A legal framework for establishment of MFIs in the private sector, known as MFIs Ordinance 2001 has been enacted, which inter alia stipulates the functions, capital requirements, ownership

structure, terms & conditions for establishing micro finance Banks/Institutions in the country, audit & disclosure requirements and winding up procedures. It allows establishment of three categories of MFIs i.e. MFIs having operations on the national level, MFIs operating in a province and those operating in a specified district with minimum capital requirements of Rs.500 million, Rs.250 million and Rs.100 million respectively. The prospective MFIs are required to be incorporated as limited liability companies under the Company Law, before applying to State Bank of Pakistan for an MFI license. SBP, being the only regulatory and supervisory agency for all deposit taking institutions, has been entrusted the responsibility of regulation and supervision of MFIs.

Related regulatory framework has been developed by SBP in consultation with all the stakeholders and the support of both domestic and international Micro Finance experts and practitioners.

SBP has already issued two licenses to Khushhali Bank (KB) and The First Microfinance Bank in the private sector to operate as countrywide Micro finance Institution. KB has established an extended branch network of 35 branches spread all over the country while First Microfinance Bank established in January 2002 has also been allowed to open 10 branches during the year 2003. While KB and First Microfinance Bank are expected to play an important role in development of the sector, a number of other institutions would also be allowed to operate as MFIs to increase the outreach of micro finance services and fill the existing gap between demand and supply of related services.

B. DEVELOPMENT OF PRUDENTIAL REGULATIONS FOR SMALL & MEDIUM ENTERPRISES

A healthy and robust SME sector can play an important role in economic development of the country. In Pakistan most of the SMEs are in the informal sector and lack proper documentation and other important records. They are also not able to comply with the requirements of existing Prudential Regulations like audited accounts, efficacy of securities, etc. Resultantly access to funding from formal channels was an issue for most SMEs and a major hurdle in their growth.

Realizing the importance and potential of SME sector, State Bank of Pakistan has developed draft Prudential Regulations after extensive consultation and feedback from SME Bank, SMEDA and PBA. The new set of Prudential Regulation would primarily focus on a mix of asset backed as well as cash flow based lending. Financial Institutions are also being encouraged to play a proactive role, work closely with management of SMEs and act as partners (in advisory capacity) rather than just as lenders. It is expected that introduction of new set of Prudential Regulations for SMEs within this year would result in a reasonable increase in financing to SMEs and play a pivotal role towards development of this sector in Pakistan.

C. WOMEN EMPOWERMENT

In addition to providing enabling regulatory environment for growth and development of micro and SME sectors, concerted efforts have been made by SBP, substantially increasing flow of financial resources to women entrepreneurs. First Women Bank Limited (FWBL) has been mandated to work for the development of female segment of the population by providing financial resources as well as undertaking direct efforts to develop related human resource base. FWBL operates three "Business Centers" for acquisition / enhancement of technical skills of women to enable income generating economic activity through employment or self-employment for which financial resources are also made available.

In order to create the desired awareness, targeted media campaigns are undertaken by the bank whereby female clientele is informed on the availability of bank's free financial advisory services and existing empowerment schemes. The bank also supports female entrepreneurs in carrying out feasibility studies of their proposed projects in consultation with SMEDA. In its efforts to channel funds for poverty alleviation, collaborative arrangements have been made with international agencies like the ILO, UNDP and CIDA. These agencies identify and evaluate female entrepreneurs for financing feasible income-generating project funded through the bank. These international agencies have also been instrumental in providing funds for training of bank's own staff and infrastructure facilities necessary for performance and achievement of desired targets.

D. WIDENING THE SCOPE OF AGRICULTURAL CREDIT

In view of the enhanced focus on the agriculture sector, State Bank of Pakistan has taken a number of initiatives to encourage channeling of more credit to this sector. One of the most significant moves was to eliminate the mandatory agricultural credit targets and encourage credit flows to the whole value chain from procurement of inputs to processing, storage and retail operations. The emphasis has been shifted from managing shortages to surpluses of major crops and also to non-crop sub-sections. This measure has already led to an upsurge of 24% in the agriculture credit disbursement by the five big banks for the first time.

E. ALLOWING WHEAT PROCUREMENT BY PRIVATE SECTOR

As part of the efforts to extract the Government out of the high-transaction businesses such as wheat procurement and reduce rent-seeking opportunities at the same time, the private sector was initially allowed to procure wheat stocks at the accommodative lending rate of 12%, enabling further reduction later through advice to banks to determine the same on market realities by linking the same to the prevalent T-bills rate.

F. STORAGE AND MARKETING LOANS

A policy decision at the governmental level in 2001 provided for private sector's increased involvement in the procurement / import of essential commodities including local wheat procurement and storage. As the private sector did not have the requisite resources especially for procurement and storage of wheat, SBP has issued enabling guidelines to Banks/DFIs aimed at creating private sector's related capabilities. While initial year financing of related projects by banks were agreed at 12 percent, for the subsequent period, the borrowing rate was linked to the 6 months treasury bill rate which is currently at a historical low. Besides, in order to enhance the wheat storage capacity in the private sector, banks / DFIs are to provide funds for a period of 7 years at normal lending rates for construction of silos and other structures that can serve as a storage area for wheat. For proper ongoing assessments, banks / DFIs have been advised to continue direct interaction with the borrowers as well as Flour Mills Association in mitigation of the entailing credit risk.

It is expected that over a period of time, availability of such facilities would facilitate localized procurements at relatively higher prices for the farmers with the added option of availing direct storage for future gainful disposal of produce.

G. STUDENT LOAN SCHEME

State Bank of Pakistan spearheaded the launch of Students Loan Scheme to help those who qualify on merit but are unable to finance education in better universities and colleges. This scheme has been launched in collaboration with the five major commercial banks of Pakistan (i.e. NBP, HBL, UBL, MCB and ABL). Under the Scheme, financial assistance is provided by way of

Interest Free Loan to the meritorious students for scientific, technical and professional education within Pakistan. The Scheme, which is administrated by National Bank of Pakistan under the supervision of SBP, operates under the oversight of an Apex Committee, headed by Deputy Governor (Management) of SBP. A PKR 500 million-endowment fund exists for meeting the funding requirements of the scheme.

CATERING TO THE NEEDS OF THE MIDDLE CLASS SEGMENT

Sustainable and equitable economic growth can take roots if an environment conducive to the spread of middle class is nurtured and fostered. Access to credit by the middle class has been limited and therefore the banking sector has followed an uneven path. While it has mobilized savings from the middle income group, as is evident from 24 million deposit holders in the banking system, it has been remiss in developing new loan products and services to cater to their needs. The banking sector remained focused on large corporate, public sector, government paper and trade financing. Recent moves to liberalize the financial sector, pursuing an accommodative monetary policy that leaves ample liquidity in the banking system, reduced demand for credit from the government and public sector enterprises and a healthy competition among the banks have forced the banks to rethink their strategic approach. Consequently, the SBP is working closely with the industry to diversify asset base, introduce new products and services, intensify electronic banking and meet the credit needs of the middle-income groups and middle market. As significant progress has been made in recent years towards improving the health and soundness of the banking sector, there is an active interest towards new areas of financing.

The various initiatives aimed at offering improved banking services and products to the middle-income clientele include:

- A - Consumer Financing:** Consumer financing has strong forward and backward linkages with the industrial and trading activities in the country. In order to promote such financing, banks have been allowed to provide facilities for purchase of consumer durables. Moreover, the scope of consumer financing has also been broadened to include all consumer durables. The positive experience of auto financing supports the expectations that the middle class in the country would benefit considerably from these policies by having greater access to funds for acquisition of consumer durables through banks. This would also provide the needed boost to the local manufacturers of TVs, air-conditioners, VCRs, washing and drying machines, deep freezers etc. in the country. It is encouraging to note that banks have made significant progress toward developing and introducing consumer products while the larger banks have established separate business groups catering to specific banking requirements of the consumer segment.

- B - Housing Finance:** With a burgeoning population, the housing market in Pakistan has always had great potential. One of the constraints in its growth was the non-availability of housing finance. State Bank has addressed this issue by promoting the concept of Housing Finance. A special Housing Finance Window has been created for refinancing to banks at concessional rates while the commercial banks are being encouraged to introduce new housing finance products. Activity on this front has already picked up and almost all the major commercial banks in Pakistan have launched related products. This initiative would provide continued support to the national economy, as there are nearly forty industries, which are likely to be positively affected by greater demand for related inputs and allied services. In this regard, the requisite decisions were taken in respect of restructuring of the beleaguered House Building Finance Corporation (HBFC) where induction of a new management team has not only improved the outlook of the institution but also resulted in development of specialized products for promotion of housing schemes. SBP has also relaxed the debt-equity permissible ratio up to 80:20 while enhancing the maximum borrowing limit to PKR 7.5 million. Tax deductibility of mortgage interest payments and other incentives announced in the federal budget for 2003-2004 will provide a boost to housing finance in the country. The ensuing eligibility of greater number of aspiring borrowers is expected to help provide the much needed growth in the sector.

- C - **Personal Loans:** Several commercial banks have actively launched credit cards and personal loans targeted at the middle class in general and the salaried classes in the public and private sector, in particular.
- D - **Evening Banking:** In order to meet the persistent demand of the banks for removal of restrictions on timings for provision of banking services to the general public, banks have been allowed to conduct business up to 8.30 p.m., at their option. This policy decision has obvious implications in terms of competitive positioning of banks while providing further flexibility to the customers of the banks.
- E - **Easier Ways to Pay Utility Bills:** In the interest of General Public & to provide facility to the customers of utility companies, installation of Electronic Collection Machines for collection of Utility bills have been allowed. Moreover, commercial banks have also been encouraged to authorize more branches to receive bill payments and develop innovative IT based solutions such as online bill payment systems.
- F - **More ATMs:** In order to facilitate access to general banking services round the clock, such as withdrawal of cash, checking of account balances, deposit of cash or payment of bills or credit card payments, State Bank has directed all commercial banks to join one of the two Automated Telling Machine (ATM) networks existing in Pakistan and to offer their customers this facility at convenient locations. This has not only reduced inconvenience to customers, but also enabled the banks to make better use of information technology and reduce operational costs. Moreover, SBP has adopted a more liberal policy with regard to installation of ATMs outside the branch premises and depositing of cheques & cash through ATMs.
- G - **Senior Citizens Services Facilitation:** In order to give relief to senior citizens, instructions were issued to banks/NBFIs vide BSD Circular Letter No.17 dated 12th June, 2000 to ensure extension of special assistance and due care to senior citizens, disabled & handicapped persons as far as possible in meeting their genuine banking needs/services to alleviate hardship. The banks/NBFIs were further advised that instructions may be circulated down the line for its implementation in letter & spirit.

AN OVERVIEW OF OTHER BANKING & FINANCIAL SECTOR DEVELOPMENTS

The period ending with fiscal Year 2002-03 witnessed State Bank of Pakistan pursue its agenda of change—both within the institution itself and the financial industry at large, with greater fervor and a heightened sense of urgency. This quickening of the pace of reforms was to sustain and enhance the momentum gathered during the previous years and also to send a signal to the market that State Bank of Pakistan is committed to continue the reforms agenda.

The thrust of the Financial Sector Reforms being implemented by the State Bank of Pakistan is toward strengthening the financial industry, by providing an enabling environment for its development at large and the banking sector in particular. This is being achieved through a strategy of liberalization and provision of a market-driven framework for financial institutions, elimination of duality and ambiguity of regulatory controls, strengthening of corporate governance, nurturing a consultative process for policy formulation and introducing measures for

financial deepening of the market. At the same time, the regulatory framework is being strengthened to make it more dynamic in outlook, firm yet fair and transparent in its operation and flexible enough to allow adaptation to market changes. Specifically, the following actions were taken:

- a. Privatization of Nationalized Commercial Banks (NCBs):** The task of restructuring of the banking sector revolves to a great extent on the privatization of the NCBs. SBP's stance on this issue has consistently emphasized on such a rationalization. As a result, UBL has been successfully transferred to private strategic investors; complete divestiture in MCB and Bank Al-Falah has been achieved; while 20% shares of National Bank have been offloaded in the market through a public offering. The process of privatization of HBL is underway through the Privatization Commission. State Bank, on the other hand has been entrusted the responsibility of restructuring and eventual transfer of ownership of ABL to a private sector strategic partners while in respect of IDBP, State Bank is currently evaluating various options and shall in due course be recommending to the Federal government the best options available on a cost-benefit basis. It is envisaged that the affairs of these institutions would be streamlined during the current year, giving further clarity to the stakeholders and adding to market efficiency and transparency.
- b. Consolidation of Banks and Financial Institutions:** As part of the exercise to rationalize the financial sector, State Bank has taken a number of steps to encourage financial institutions to opt for mergers / acquisitions and emerge as stable and financially strong institutions helpful for economic growth and productivity. SBP has also issued guidelines on mergers and acquisitions for banks / financial institutions, which included local incorporation of branches of foreign banks. As a result of these efforts, while a number of Commercial Banks / Financial Institutions have merged since July 2000, a list of which may be referred at Annexure-C.
- c. Restructuring of DFIs and Specialized Banks:** In parallel, efforts were expended to restructure the Development Finance Institutions (DFIs), NDFC was merged with National Bank, which while saving the poorly managed organization from total collapse also achieved the goal of retaining depositors' confidence. Similarly, RDFC and SBFC were merged and a new bank, the SME Bank was created to cater to the growing needs of the SME sector specifically. Federal Bank for Cooperatives has been liquidated; ADBP has been transformed into a Joint Stock company while IDBP, subsequent to a complete restructuring and change of management, is being considered for transfer of ownership to the private sector suitors.
- d. Elimination of Regulatory Duality:** Effective December 01, 2002, SECP has assumed the role of sole regulator for all Non-Bank Financial Institutions (NBFIs) including investment banks, modarabas, venture Capital companies etc. This step has been taken to remove the duality of regulatory functions, simplify procedures for business, and reduce high transaction costs faced by the NBFIs.
- e. Reserve Management:** The Bank's foreign exchange reserves were never large enough to warrant attention towards finding optimal reserve management solutions. Today, with reserves in excess of USD 10 billion and buoyant expectations from increasing exports and inwards remittances, this has been an area where SBP has focused its attention. A reputable international consulting firm has been selected to advise and assist SBP in effective management of foreign exchange reserves with the inherent

objective of developing in-house capacity for future unassisted decision-making in the area.

- f. Risk-Based Audit:** As part of the efforts to improve supervision of banking industry and to develop an Early Warning System so that problems could be identified and addressed in a proactive manner, SBP has introduced the concepts of risk-based examination and IT Audits of the banking sector. This is expected to vastly improve evaluation, monitoring and control mechanisms and allow for closer monitoring of problem banks and for timely and appropriate remedial measures.
- g. Securitization:** Development of the concepts of asset securitization in the financial sector in Pakistan is essential for enhancement of institutional lending capacities and diversification of risk. Enhanced innovation in the area not only provides business and industrial enterprises another source of obtaining funds, it is also a tool for the banks to diversify their asset portfolio while optimally utilizing bank's capital. To begin with, banks and DFIs have been allowed to securitize their assets under lease, mortgage and infrastructure financings while other assets may also be securitized with prior approval of the State Bank. To enable banks to proceed in the area in a structured manner, State Bank has issued comprehensive guidelines for asset securitization in November 2002.
- h. Commercial Paper:** The guidelines on commercial paper have been finalized in consultation with all the major stakeholders have been issued. This will be an important step toward developing primary and secondary markets in the commercial paper. On a case-to-case basis, State Bank had already initiated the process of granting permission to banks and DFIs for investing in Commercial Paper. An alternate funding source will thus be increasingly available to corporate entities for meeting their working capital requirements while development of Commercial Paper as an alternate source will also be instrumental in broadening of the money market in Pakistan.
- i. PRs for Infrastructure Projects Relaxed:** Availability of private sector funding for infrastructure projects is considered essential for the private sector to come forward in support of government's objectives of generating increased economic activity. To encourage banks to actively finance infrastructure projects, as also to enable them to use the available excess liquidity for productive purposes, the debt to equity ratio for infrastructure projects has already been relaxed from 60:40 to 80:20. In order to further facilitate related lending in a prudent and transparent manner, comprehensive guidelines being developed.
- j. Payment System:** Being a core central banking function, SBP's focus has remained on the stability and efficiency of the payment system and implementation of a Real Time Gross Settlement System (RTGS) was a step toward that end. In order to cope with the emerging challenges, a fresh look was taken at the available organizational support in the area. Payment Systems Policy Group was established under the chairmanship of DG (Management) with membership from all related areas. Payment Systems Department was established with clearly defined functions. Benchmark positions for the department were evaluated/ approved and job descriptions finalized. Concurrently, RTGS Project Management Office was also established for the desired level of follow through. A seminar was held in March for the bankers in which information was disseminated regarding institutionalization of focus on payment systems and RTGS Project. Also a training module on payment systems has been developed and delivered to 34th

International Central Banking Course held at NIBAF. All future SBOT and other central banking courses will include this module. Commissioning of RTGS at the State Bank is expected to drastically change banking in Pakistan by adoption of technology and moving towards electronic banking.

The design for RTGS Systems for SBP was finalized with the assistance of foreign RTGS Consultant and extensive consultation internally and externally with the banking sector. The implementation of RTGS will involve extensive re-engineering of existing business processes in the area of settlements of large value inter-bank payments and interfacing with both GLOBUS and SWIFT. Also, a legal firm's proposal is being evaluated for appointment as Consultant for creation of enabling legal framework for operation of RTGS.

Monitoring system for existing payment and settlement systems has been designed and instituted from July, 2003 for collection of statistics on quarterly basis. The first Census on Electronic Banking was conducted by PSD and results consolidated and disseminated to the banking sector in June, 2003. Director PSD is to act as Secretary of ECH Task Force, which will continue to serve as a platform for consultations with the banking sector on automation. Fast pace growth in E-banking has been achieved in Pakistan with number of ATMs having more than doubled and their transactions and online branch network having more than tripled since 2000.

- k. **E-Banking:** The results of State bank's focus on automation of banking sector, through formation of ECH Task Force and mandating of connectivity of banks with one of the two ATM switches, are very encouraging. Although cash and checks largely dominate the local banking system, electronic transactions have experienced a phenomenal growth over the last couple of years. Use of ATMs, credit and debit cards is increasing at a rapid pace coupled with the expansion of the infrastructure supporting them. This growth is depicted in the statistics related to E-banking and confirmed by the recent Census conducted by State Bank. The trend in increasing credit card usage is confirmed as the average monthly transactions using credit cards, which have increased by 60% in the 1st quarter of 2003 as compared to 2000. In terms of volume the increase is 80% in the same period. The trend is steeper for ATM transactions. The average monthly transactions on ATMs increased by almost 316% in the 1st half of 2003 compared to 2000. In terms of volume, the increase is even higher i.e. about 369%. Further, the banks are trying to provide more and more services through electronic means. In addition to issuing debit cards, some banks enable their customers to do accounts management electronically and are also providing phone-banking services to their clients.

The above trend of increasing confidence on electronic transactions is fully supported by the growth in the electronic banking infrastructure. ATMs have more than doubled to 444 by end of 1st half of 2003 from only 207 in December, 2000. Banks, which are connected to one of the two ATM switches, have increased to 20 recently. And for the first time in the banking history in this country, the on-line bank branch network is about to cross the milestone of thousand branches in 2003 (994 by 30th June, 2003), which is over three times its level in December, 2000 (317 branches). On the cross border front, almost all banks in Pakistan have now obtained connectivity to SWIFT, which has made them part of the most credible international network, enabling quick and reliable transfer of funds possible to and from around the globe. This huge investment in technology demonstrates

a major shift in the strategic thrust of the banking sector of Pakistan, most likely, due to competitive circumstances and technological opportunities.

The trend of fast past increase in ATM transaction is expected to get a further boost as the State Bank is currently encouraging the two Switch providers to achieve connectivity between the two Switches by end of February, 2004 allowing the clients to access their accounts from ATM operated by any participating bank.

- 1. Primary Dealers:** A broad based auction system of Government securities was introduced in 1991 whereby all banks and NBFIs were eligible to participate in the auction. Primary Dealers system was introduced in the year 2000 to provide for sale of Government paper through financial institutions selected within the approved parameters for onward distribution as well as to create its secondary market. The parameters for selection of Commercial banks, investment banks and listed brokerage houses include a minimum capital level of Rs 500 million while they are expected to have in place necessary infrastructure with Reuters dealing system, experienced personnel in treasury area and must have been an active participant in the government securities market. PDs deal in government securities i.e., Market Treasury Bills of 3, 6 and 9 months maturity and Pakistan Investment Bonds of 3,5 and 10 years tenor.

Objectives:

- To facilitate government borrowings direct from the market
- Develop medium / long term bench marks for capital market
- Introduce price making mechanism for the government securities market
- Deepen secondary market trading
- Strengthen market intelligence system for SBP

The eleven PDs, currently operating, include five local banks, four foreign banks and one DFI and brokerage house. Their selection entails the obligation to quote two-way price, underwrite 3.5% of each tenor target of long term paper in each auction and may short sell government securities of long term paper to the extent of each tenor target in each auction.

The PDs system has been further revamped in 2003 to

- Make it more broad based so that institutions other than banks may also become PDs
- Activate secondary market trading that is currently not up to the mark
- Provide further and easy access to the non bank investors to get the government paper
- Eliminate pass through bids to make the bond pricing realistic

Provide non competitive bids for the corporates to ensure their participation

PERFORMANCE REVIEW OF BANKING SYSTEM

Supervisory authorities around the world are striving to ensure safety and soundness of their respective financial systems so as to play an essential supporting role in achievement of economic development objectives. In order to keep the stakeholders well informed about the health and stability of the banking system of Pakistan, State Bank has started to carry out in-depth performance review. The Quarterly Performance Reviews on banking system are now published regularly for wider dissemination and strengthening of the framework for disclosure of information on the performance of the banking system.

URDU TRANSLATION OF PRs

A clear and unambiguous understanding of applicable regulations is essential for efficient service delivery of products and services by the banks as well as for a fully convergent understanding of the rules of the game, to avoid unnecessary future disputes. A project has been initiated for an Urdu version of the PRs. This initiative would go a long way, especially in serving the interests of the participants from the micro-finance & SME sectors.

FORMULATION OF HELP DESKS

The concept of Electronic Help Desk has been introduced in Banking Policy & Supervision Department to provide all the possible assistance toward early clarification and resolution of issues being faced by the financial institutions. This would help improve the quality of services being offered by the central bank and contribute to efficient functioning of the banking sector.