2 Financial Sector Reforms During 1990s

By the end of 1980s, it was evident that the pervasive monetary and credit policies followed over the years had given way to the repressed financial system, affecting adversely the growth and efficiency of the financial sector. It was in this perspective that at the end of 1989, a reform program was initiated to reduce the market segmentation, instill competition, and switch over to market-based and relatively more efficient monetary and credit mechanism. However, this reform process gathered momentum since 1997, when a crucial set of reforms aiming at institutional strengthening, restructuring of banks and DFIs, and improvement in regulatory framework was introduced.

2.1 Institutional Reforms

The government ownership of commercial banks resulted in political intervention into credit allocation and loan recovery decisions besides other institutional inefficiencies. As a result, infected loans increased sharply, financial institutions suffered losses, and quality of services plummeted. In order to address these issues, a number of policy reforms were undertaken to encourage the participation of the private sector, such as transferring management and control of NCBs to the private sector, and permitting it to open banks and NBFIs. These measures were designed to improve the level of competition and efficiency in the financial system.

2.1.1 Financial Liberalization

Privatization

To facilitate the privatization process, the Banks (Nationalization) Act, 1974 was amended in 1990, empowering the Federal Government to sell all or any part of the share capital of NCBs. In a subsequent amendment, the government was allowed to suspend the provisions of the Banks (Nationalization) Act, in cases where 26 percent shares of any NCB were sold to the private sector. Furthermore, an NCB would fall outside the ambit of the Banks (Nationalization) Act, 1974 when 51 percent of the share capital was taken up by the private sector.

Accordingly, 26 percent shares of Muslim Commercial Bank (MCB) were sold to the private sector in April 1991. By January 1993, further 49 percent shares of MCB were disinvested in addition to transfer of its management and control to the buyer. In September 1991, 26 percent shares of Allied Bank Limited (ABL) were also disinvested under the Employee Stock Ownership Plan and the management and control of the bank was handed over to Employee Management Group. Further 25 percent shares were sold to private sector in August 1993. In the same year, the government decided to sell 26 percent shares of United Bank Limited (UBL) and transfer its management to the private sector. Although initial attempt to privatize UBL failed because of various technical reasons, privatization of NCBs remained a key element in government agenda.

Opening of New Banks

With a view to encourage private sector participation, enhance efficiency and promote competition among banks, the Banks (Nationalization) Act, 1974 was amended during 1991, allowing private sector to open banking companies. Subsequently, in August 1991, ten new Pakistani commercial banks were permitted to commence their operations.[1] In later years, eleven new banks were allowed to start commercial banking.[2] Moreover, two provincial banks, namely, the Bank of Khyber and the Bank of Punjab, were declared as scheduled banks in 1994.

[1] These banks included: Bank Al-Habib Limited, Soneri Bank Limited, Union Bank Limited, Mehran Bank Limited, Indus Bank Limited, Prime Commercial Bank Limited, Askari Commercial Bank Limited, Bolan Bank Limited, Capital Bank Limited, and Republic Bank Limited. Of these, last two banks did not begin their business activity.

[2] These included: Metropolitan Bank Limited, Habib Credit & Exchange Bank Limited, Schon Bank Limited, Faysal Bank Limited, Platinum Commercial Bank Limited, Prudential Commercial Bank Limited, Gulf Commercial Bank Limited, Bank Al-Falah Limited, Bank of Ceylon, Oman International Bank, and Trust Bank Limited.

In order to avoid the mushroom growth of banks a moratorium was imposed in 1995 and no new bank was allowed to open thereafter. However, the branch policy for both the domestic private banks and foreign banks was eased; this was done to provide the opportunity for existing banks to grow. On the contrary, nationalized banks were prevented to open new branches in December 1996 and asked to close unprofitable ones in 1997.

2.2 Institutional Strengthening of NCBs and DFIs

2.2.1 Strengthening of Self Governance

In order to strengthen self-governance, various amendments were made in Banking Companies Ordinance, 1962. More specifically, section 27B was inserted to curtail and make punishable disruptive union activities; according to a new section 83A, dishonest removal or disposal of goods (pledged as security for the payment of any debt or loan) was made liable for punishment; and extension of any financial facility to a borrower on verbal instructions was considered an offence. Furthermore, amendments were also made to empower the SBP to frame guidelines for recovery of bad or doubtful loans by giving incentives to borrowers for making repayments within a specified time. At the same time, SBP was also authorized to publish a list of defaulters after notifying and hearing from them in advance.

2.2.2 Restructuring ofBanks and DFIs

Since NCBs had focused more on increasing their branch network to far-flung areas of the country, their efficiency began to decline with rising cost and oversized workforce. These, together with growing non-performing loans rapidly offset the initial benefits of nationalization. The more important concern was the increase in intermediation costs that translated into lower returns on deposits and higher lending rates.[3] The resulting stress on their profitability made it clear that without a significant restructuring, these banks would continue to pose systemic risks to the financial system. Keeping this in view, NCBs were asked to prepare restructuring plans to rationalize their work strength and size.

In September 1997, three NCBs, two specialized banks and two privatized banks introduced various separation schemes for employees besides chalking out plans for branch closure. With the help of golden handshake schemes, in a two-year period, these banks were able to reduce the size of their workforce from 99,954 to 81,079 as on end December 1999. In terms of branch closure program, an earlier criterion, which ensured that no area was rendered un-banked,[4] was changed and banks were allowed to close their branches entirely on commercial considerations. This resulted in a reduction of 718 branches from end June 1997 (8,673 branches) to end June 2000 (7,955 branches).

2.2.3 Strengthening of Prudential Measures

The rapidly deteriorating governance and credit discipline (especially in NCBs) not only aggravated structural problems, but also led to worsening level of non-performing loans. This necessitated mustering of efforts to strengthen prudential measures, focusing on capital adequacy, adequate provisioning and effective loan recovery mechanisms, and legal procedures.

In 1994, the capital adequacy requirements for NCBs and two large specialized banks (i.e., ADBP and IDBP) stood at 3 percent of call and time liabilities. This resulted in over-lending by these banks and weakening of capital base, thereby making them vulnerable. In FY96, all NCBs, foreign banks and

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[3] Although this could not be substantiated with data, intermediation costs were rising but largely concealed in distorted lending and deposit rates, due to presence of elements of mandatory and concessionary credit and ceilings and floors on lending rates.

[4] A place/area is deemed to be un-banked if no branch of any other bank is operating within a radius of 5 km. Ref: BSD circular No.11, dated 17th March 2001 (branch licensing policy).

NBFIs were instructed to adopt the system of risk-weighted capital, in line with the Basle Accord. Consequently, effective from 31st December 1997, banks were required to maintain capital and unencumbered general reserves of not less than 8 percent of their risk-weighted assets. In addition, banks had to achieve a minimum paid-up capital of Rs 500 million by end December 1998. In December 2000, this minimum capital requirement has been doubled to Rs 1,000 million, with half of the increase i.e. up to Rs 750 million to be achieved by end December 2002 and the remaining till end December 2003. A banking company failing to meet the above requirement shall stand converted into a non-scheduled bank.

Since credit rating is considered as one of the measures of transparency, steps were taken to institutionalize the credit-rating process. Accordingly, in April 1995, all NBFIs were required to have themselves rated by one of the approved agencies. A similar condition was placed for all banks from June 2000 with a view to safeguard the interests of prospective investors, depositors and creditors.

In order to provide a level-playing field between banks and NBFIs, besides consolidating the supervisory role of SBP over NBFIs, a one percent cash reserve requirement (CRR) was imposed on NBFIs effective from January 7, 1996 besides statutory liquidity requirement (SLR) of 15 percent, which was imposed on January 1, 1992. In addition, the provisioning rules and interest suspension were imposed on DFIs from the end of the accounting year 1996.

Furthermore, in January 1997, SBP allowed banks to offer fund management and other investment advisory services by forming subsidiary companies. Consequently, banks meeting liquid assets requirement and other credit disciplines during the immediate 52 preceding weeks would be eligible to set up such subsidiaries. Such organizations, however, would not be permitted to invest in real estate or grant any form of credit. In April 1999, SBP amended this regulation, specifying minimum paid-up capital of Rs 100 million for subsidiaries formed for investment banking and fund management.

2.2.4 Strengthening of Loan Recovery Process

State Bank, during its periodic inspections of banks, classified, wherever necessary, loans and advances into three categories, namely, sub-standard, doubtful, and loss on the basis of assessment of risk to banks. However, in February 1989 banks were directed to classify themselves loans and advances in accordance with the detailed guidelines issued by SBP.[5] These guidelines were further strengthened in August 1992, whereby the determinant for the category of Other Assets Especially Mentioned (OAEM) was changed from 180 days or more to 90 days or more.

In November 1993, SBP asked banks to set quarterly recovery targets, submit progress reports, and form strategies to improve future recovery process. At the same time, minimum conditions for borrowers were also established to ensure that defaulters were not provided fresh loans. In this connection, banks were also required to furnish a list of defaulters to SBP, having a total borrowing of Rs 1 million and above, together with details of rescheduled and restructured loans. In order to clearly identify defaulters, SBP required banks to obtain information from Credit Information Bureau of SBP about total outstanding liabilities (to banks and other financial institutions) of any applicant seeking loans of Rs 0.5 million or more. In August 1997, SBP revised disclosure standards and banks were asked to submit their annual accounts on new formats in line with international accounting practices.

In 1993, the government increased the number of banking tribunals from three to eleven for non-interest bearing loans i.e. mark-up based loans, whereas for interest bearing loans, this was raised to fourteen. All financial institutions were also instructed not to accommodate defaulters unless

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[5] These guidelines were laid down in BID circular No. 3 dated 20th February 1989.

rescheduling or restructuring of outstanding liabilities are completed to the satisfaction of lending institution. In December 1996, government restricted NCBs from making new project loans till June 1997.

In June 1997, SBP took a lead by launching a three-pronged loan recovery drive which comprised of: (1) an amnesty scheme, encouraging defaulters and sick units to settle their overdue/loans; (2) default cases of borrowers, who did not avail amnesty program by 5th September 1997 were to be filed with the new banking courts; and (3) asset recovery departments of the NCBs and DFIs were to be strengthened and placed under new management. In April 1998, SBP's prudential regulation for loan classification was rationalized, thereby requiring banks to make qualitative evaluation of their credit portfolios for risk assessment on the basis of adequacy of security, cash flows and credit worthiness of borrower.

By 15th November 1998, total cash recovery amounted to Rs 34.7 billion, or a quarter of total defaults. In October 1999, the military government issued a one-month deadline to defaulters for clearing of outstanding dues. Under this loan recovery drive, a total of Rs.13.5 billion were collected during October to December 1999.

2.3 Institutional Strengthening of SBP

The initiation of financial liberalization required the apex institution to work with more diligence and authority to achieve its objectives. Hence, in order to strengthen SBP's regulatory and supervisory authority, a number of policy and institutional measures were introduced.

2.3.1 Restructuring

In order to address core financial issues (such as non-performing loans, creation of marketable government securities, monitoring of NBFIs, strengthening of on-site and off-site surveillance, and enhancing the capacity of SBP), a process of internal SBP restructuring was initiated. With the purpose of monitoring leasing companies, modarabas, housing finance companies, investment banks and DFIs, the NBFIs Regulation and Supervision Department was setup. This department, which became functional from 1st January 1992, issued 'Rules of Business', requiring all NBFIs to submit periodic returns for evaluation of their performance.

Securities Department was setup in December 1990, to launch an auction system of public debts and develop a secondary market for government securities. In 1991, the Credit Information Bureau (CIB) was established to maintain record on all borrowers with liabilities, overdues and defaults of Rs 1 million and above, to any financial institution under SBP's Jurisdiction. Subsequently, in FY95 all information was computerized to minimize delay in information transmission to banks.

More importantly, the SBP Act was amended in February 1994, giving full autonomy to the Board of Directors of the Bank in all matters relating to administration and conduct of business of the Bank within the provisions of SBP Act, 1956. This act was amended again in 1997 to further enhance SBP's responsibilities (see **Section 2.6.1**).

Information from early warning system, off-site surveillance and on-site inspection was integrated and focused on risk analysis. At the same time, a system was put in place whereby performance of each bank and NBFI was evaluated under CAMELS and CAELS system. Exchange and Debt Management Department was established in FY00 by merging the Securities Department and the Foreign Exchange Dealing Room established in 1998. This paved the way for coordinated operations in foreign exchange and Pak Rupee denominated securities. This facilitated the free float of Pak Rupee achieved in FY01.

2.3.2 Consolidation of Regulatory Functions

The restructuring process received a major boost in May 1997 with the amendment of the SBP Act, 1956 and the Banking Companies Ordinance, 1962. These changes vested authority to SBP to regulate and supervise banks and the financial institutions, to conduct an independent monetary policy, and to set limit on government borrowings from the central bank. Besides, the Banks (Nationalization) Act 1974, was also amended, dissolving Pakistan Banking Council, and requiring SBP consultation in matters relating to appointment of chairman/president and members of the board of all government owned banks and DFIs. Private banks were also required to seek SBP approval to such appointments.

In April 1997, services of an international consulting firm --Arthur Andersen-- were acquired to undertake an in-depth review of the banking supervisory system and monitoring techniques. The firm assisted in modernizing and re-orienting inspection process besides providing training to SBP officials. More importantly, on their recommendations, a risk-based inspection of financial institutions and CAMELS system of off-site surveillance were introduced.

In February 2000, a Concept Paper outlining the future direction of SBP with the objective of transforming it into a highly professional, efficient and modern institution was approved by the Central Board of SBP.[?] To help achieve this objective, important measures were undertaken, including, increased emphasis on direct recruitment (which started in mid 1990s) at senior and middle management level on the basis of merit through open competition; strengthening of National Institute of Banking and Finance (NIBAF) -- the training wing of SBP; identification of core and non-core functions; and the introduction of an Early Retirement Incentive Scheme which was later converted into a permanent feature for employees with 25 years of service. Moreover, as a step towards decentralization of authority, administrative and financial powers were delegated to lower levels of hierarchy.

2.3.3 Computerization

Although the process of computerization was initiated in FY94 with the creation of Computer Services Department, a major step was the setting out of "Information System Strategy Plan" in FY99. The plan envisaged setting up of an intranet facility and the installation of in-house application software. SBP also launched its own website that hosts valuable information which are being regularly updated. Furthermore, in order to ensure greater security and efficiency in payment system, SBP acquired membership of Society for Worldwide Inter-bank Financial Telecommunication (SWIFT), which is operational since June 5, 2000.

2.4 Debt Management Reforms

The debt management reforms were initiated with a view to: reduce the segmentation in government debt market; rationalize the cost of raising long-term government debt; establish a market-based rate of return structure for government securities; and pave the way for implementation of monetary policy through instruments of indirect monetary control (see **Section 1.4**).

2.4.1 Replacing Tap System with Auction Based System

Realizing the negative repercussions of tap system of debt management, Government of Pakistan introduced a short-term paper in April 1989. Although these six-month debt instruments, also known as "Government of Pakistan Market Treasury Bills", were to be sold by SBP on behalf of government through an auction system, this experience was not very successful.[6] Consequently, Securities

[?] The concept paper was prepared by Dr. Ishrat Husain, Governor, SBP.

[6] It is important to note that up to June 1989, in each of the total three auctions, all bids were rejected as quoted rates were considered too high. During 1989-90, out of 26 auctions, 17 were abandoned either due to lack of interest or high offered

Department was set up in December 1990 to launch auction system of public debt, and develop a secondary market for government securities. This was supported by an end to issuance of three-month T-bills and GTDRs sold through tap. In addition, following the introduction of 3-Day Repo facility in February 1992 the discount window was closed down in the same month. The system of credit ceilings was replaced in August 1992, by a relatively flexible control through fixing of Credit Deposit Ratio (CDR) in each quarter. However, this system was also abolished in September 1995, thereby encouraging scheduled banks to extend credit to the private sector through market-based mechanism, and helping SBP in managing its monetary policy through indirect control.

In terms of long-term government debt instruments, securities available to banks and NBFIs included, 'Market Loans', which were a kind of government bond sold through subscription at par with fixed rates of interest. However, they were not allowed to invest in CDNS schemes, which were available to individuals at very attractive returns with the option of premature encashment. More importantly, none of these securities were priced at market rates. In view of ample demand for a market based, long-term government paper by banks and NBFIs, Federal Investment Bonds (FIBs) of 3, 5 and 10-year maturities were introduced. These were fixed coupon bonds offering 13, 14, and 15 percent annual return respectively. First auction of FIBs was conducted on 30th March 1991. Although the market response quickly picked up, it failed to retain its attractiveness after reaching peak in FY93, as cut-off decisions did not match market expectations on pricing (see details in **Section 5.1.3)**.

2.4.2 Promotion of Secondary Market

The development of a secondary market depends on a variety of factors, including capability and skills of dealers in market making, privileges provided by the central bank that allow dealers to carry out their obligations, quality of the payment system in terms of efficiency and ease, spectrum of alternative government and non-government debt instruments available to investors, and saving behavior of economic units in the country.

System of Approved Dealers

The reorientation of money market, particularly following the introduction of auction system, required efficient primary dealers (PDs). For that purpose, in December 1990, the former Secretary's Department of the SBP, sought applications for PDs from scheduled banks and DFIs.[?] The prospective PDs were not only required to maintain a minimum capital of Rs 100 million, but also obliged to follow SBP rules and procedures, participate actively in all issues of government securities, distribute their securities holding as broadly as possible, make efforts for secondary market development, provide two-way market prices, and report periodically to SBP. In return, SBP intended to provide certain privileges, including, extension of a market facility to provide liquidity support in case of shortage of funds, access to auctions and open market operations, access to SBP's book-based clearing and settlement system and access to the inter-dealer broker network as and when introduced.

However, in February 1991, to widen the scope of participation in auctions all banks were allowed to participate directly, thereby creating a category of 'Approved Dealers'. Although the selection criteria for PDs was articulated much later in the end of 2000, financial institutions were quickly granted the status of Approved Dealers, if they had a current account with SBP. Institutions, not having a current account, were required to enclose a letter from their bank, authorizing SBP to deduct the required amount from their balance to settle the accepted bids. Despite drawbacks, this system succeeded in firmly establishing the primary market of T-bills and FIBs.

rates, and only Rs 4,250 million worth of T -bills were sold. In the next year, 16 auctions were held and all were abandoned due to similar reasons.

[?] Secretary's Department was named as such because its Director served as Secretary to the Central Board of Directors of SBP. This department was renamed as Corporate Affairs Department in FY92.

Book Based System of Government Securities Settlement

In order to promote secondary market activities, the facility of Subsidiary General Ledger Account (SGLA) was extended to NBFIs in March 1991. The system, which was further streamlined in June 1991, allowed the issuance of government securities without any physical movement. In this system, while settlement was accomplished via an entry in SGL (representing the ownership of the investor), the transfer of ownership required simultaneous debits and credits to respective accounts of holders. This system allowed two layers of accounting: (1) between SBP and banks/NBFIs with current accounts at SBP, known as SGLA, and (2) between banks/NBFIs and their clients, called "Investors' Portfolio of Securities". This system greatly eased the clearing and settlement of primary as well as secondary market transactions in T-bills and FIBs.

2.4.3 Measures Relating to National Savings Schemes

Since Khas Deposit Certificates (KDCs) were offering very high returns, these carried the largest share in unfunded debt.[7] These certificates were discontinued in February 1990 due to their costly nature. At the same time, three other instruments (Special Savings Certificates, Registered and Bearer, and Special Savings Accounts) were introduced.

Interestingly, despite lower returns on new instruments, these were still very attractive. In fact, contrary to reform objectives, these schemes were made more attractive overtime by administratively increasing their yields, which together with underlying tax incentives, further intensified the market segmentation. However, in FY99 the interest rate structure was rationalized to some extent, when compound annual average return on Defense Savings Certificates (DSCs) was reduced by two percentage points in May 1999, which were followed by further one percentage point cuts in FY00 and FY01, successively (see **Table 4.15**).

2.4.4 Measures Relating to Bearer Instruments

In order to tap finances from informal sector, one registered and two bearer instruments were introduced in mid 1980s. More specifically, Special National Fund Bonds (SNFBs) were zero-coupon two-year registered bonds with a yield of 5.6 percent and offered to individuals and corporate bodies; Bearer National Fund Bonds (BNFBs) were of one, two and three-year maturities, carried yields in the range of 8.7 to 13.2 percent, and Foreign Exchange Bearer Certificates (FEBCs), which were denominated in Pak Rupees but issued against foreign exchange, carried rates of return in the range of 14.5 to 15.0 percent. All these instruments were exempted from income tax. Furthermore, SNFBs provided the immunity from probe by tax authorities. This immunity was also given to FEBCs if these were encashed in Pak Rupees.[8]

To mobilize foreign exchange, US Dollar Bearer Certificates (DBCs) were introduced in February 1991. Five Year Foreign Currency Bearer Certificates (FCBCs) denominated in US Dollar, Pound Sterling, Deutsch Mark and Japanese Yen were initiated in March 1992. Their outstanding level peaked in FY97, however these were discontinued from January 1998. Three-year FCBCs denominated in US Dollar and Pound Sterling were introduced in February 1998 and discontinued in December 2000. Outstanding stock of these certificates was reported in domestic debt, because of Pak Rupee counterpart implications for budget.

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[7] Out of the total unfunded debt of Rs 113 billion as on end June 1989, KDCs share was 71.6 percent, followed by Defense Saving Certificates (22.5 percent) and other instruments like National Deposit Certificates/ Accounts, Premium Savings Certificates and Savings Accounts (5.9 percent).

[8] SNFBs, which were offered on tap for first two months of FY86, succeeded in raising Rs 15.1 billion, whereas BNFBs continued till 1992 and their rollover was allowed till 1998. At their peak in FY 92, their outstanding level was Rs 43.9 billion. On the other hand, FEBCs (which were made more attractive in FY 93) were discontinued on December 15, 2000. At their peak in FY 95, their outstanding level was Rs 13.5 billion.

2.5 Monetary Management Measures

Prior to financial sector reforms, monetary management was based on instruments of direct controls, such as administratively set interest rates, credit ceilings, directed and subsidized credit and direct involvement of government in formulation and implementation of monetary policy. Therefore, following measures were undertaken with the objective of addressing these structural weaknesses.

2.5.1 Reorientation of Monetary Policy Instruments

Besides the introduction of auction-based government debt management, a flexible system of Credit-Deposit Ratio (CDR) was initiated in August 1992, which replaced ceilings for allocation of credit. Under this system, commercial banks were required to extend credit to the private sector within limits worked out on a quarterly basis in relation to CDR. This system was gradually liberalized and eventually abolished altogether in September 1995 (see **Section 2.4.1**).

A major shift in monetary management came about in January 1995 with the introduction of open market operations (OMOs), which have now become the major instrument of monetary policy. Since then, SBP has been using Market Related Treasury Bills (MRTBs) as the primary tool for conducting OMOs and, hence controlling inter-bank market liquidity. In order to ensure transparency and regularity, it was decided to follow a fixed schedule from 15th April 1999 for conducting auctions and open market operations.[9]

In February 1992, the rediscount facility was replaced with SBP 3-Day Repo facility against T-bills; later, banks were allowed to also use FIBs when accessing this facility. However, in order to limit any misuse, the procedure for acquiring this facility was amended in May 1993, and banks were directed to provide sufficient justification to SBP for using this source of funding. In addition, banks were also required to report all inter-bank call money and repo transactions to SBP.

The special cash deposit ratio (as a percentage of either total demand and time liabilities or outstanding credit) is effectively a statutory cash reserve requirement (CRR) with the difference that they are remunerated at some given interest rate. After the start of reforms program, this condition was first imposed on 9th October 1991, when banks were required to maintain 7 percent of their outstanding credit in addition to the CRR. However, this requirement was dropped from 15th January 1992. Again, on 9th February 1995, banks were directed to maintain 1.5 percent of their total demand and time liabilities (in Pakistan) as special cash deposit with SBP. This ratio was further enhanced to 3.5 percent of the total demand and time liabilities (excluding foreign currency accounts) from 11th December 1995 -- before abolishing it from 1st July 1996.

Since then, emphasis was placed more on cash reserve requirement (CRR), which normally stood at 5 percent on weekly average basis. Apart from that, banks were also required to maintain a given percentage of their demand and time liabilities in government securities as the statutory liquidity ratio (SLR). As a part of reforms, this ratio was gradually reduced from 45 to 35 percent in October 1993 and further to 25 percent in March 1994. At present, the ratio stands at 15 percent, set in June 1998.

2.5.2. Rationalization of Subsidized Credit Schemes

In order to eliminate the subsidy element and the attendant financial market distortions, the lending rates on special financing schemes including locally manufactured machinery (LMM) and export finance were gradually raised. At present, returns payable on special financing schemes are close to market rates, except for export finance and export sales of LMM. In addition, to ensure that financial institutions are not burdened with subsidized credit, all new schemes involving concessional finance were capped.

[9] Fixed schedule for OMOs was abandoned in July 2001. However it is still continuing for auctions.

Export finance scheme experienced a major change in 1992 when scheduled banks were asked to maintain an interest bearing Special Deposit Account with SBP, using the amount of refinance provided by central bank. In practice, this squeezed the banks' ability to expand credit and contained credit expansion in the system. Hence, in April 1997, this scheme was restored to its original.

2.5.3 Interest Rate Rationalization

As a major step towards market-based monetary management, caps on maximum lending rates of banks and NBFIs for trade related modes of financing (except for LMM and export finance scheme) were removed in March 1995. Subsequently, caps for project financing were also lifted in October 1995. Floors on minimum lending rates, for project and trade related financing were abolished in July 1997. Accordingly, banks and NBFIs were able to set their lending rates in relation to the demand/supply conditions in the market.

2.6 Banking Law Reforms

During 1990s, a number of amendments were made in the SBP Act, 1956; the Banking Companies Ordinance, 1962; the Banks (Nationalization) Act, 1974; the Banking Companies (Recovery of Loans) Ordinance, 1979 and the Banking Tribunals Ordinance, 1984. The key objectives of these changes were: to pave the way for privatization of NCBs; to enhance competition by allowing private sector to establish new banks; to increase the autonomy of SBP in formulating and implementing monetary policy; to consolidate its role as regulator of banks and non-bank financial institutions; to strengthen the internal governance of these institutions; and to improve the framework for recovery of loans.

2.6.1 Reforms in SBP Act, 1956

The Act was amended in February 1994 to increase autonomy of SBP in regulating the monetary and credit system. Accordingly, the Central Board of Directors of SBP was enlarged to accommodate full representation of provinces and economic sectors, and enhance its responsibilities in matters relating to administration and conduct of business. Meanwhile, an amendment in BCO empowered SBP to change CRR and SLR for scheduled banks. The amendment in SBP Act also institutionalized a framework for the coordination of monetary, fiscal, foreign trade and exchange rate policies by establishing a Monetary and Fiscal Policies Coordination Board.

In January 1997, section 46B was also inserted in SBP Act, 1956 to prohibit governmental or quasi-governmental bodies from issuing any directives to banking companies or other financial institutions regulated by SBP. Furthermore, the Central Board was entrusted to formulate monetary and credit policies consistent with targets and the recommendation of the Monetary and Fiscal Policies Coordination Board with respect to macroeconomic policy objectives. The Central Board was further assigned the responsibility to determine and enforce limits on SBP credit to the federal/provincial governments and their agencies; approve credit requirements of the private sector; submit a quarterly report to the Parliament on the state of the economy; and advise the federal government on economic policy issues.

The major responsibilities of Monetary and Fiscal Policies Coordination Board included: to coordinate between fiscal, monetary and exchange rate policies by ensuring consistency among macroeconomic targets; to determine government borrowing from commercial banks on the basis of liquidity expansion determined by the Central Board; to review the consistency of macroeconomic policies on quarterly basis and revisit initial limits/targets depending on developments in the economy; and to review expenditures incurred on raising of loans and government borrowing. This also required the Planning Commission and the Ministry of Finance, to periodically inform the Board about the impact of monetary policy on investment, growth and balance of payments. Similarly, the Ministry of Commerce was ordained to provide feedback to the Board regarding the impact of monetary policy on trade.

The aforesaid amendments triggered a process of institutional capacity building within SBP through restructuring of its departments, induction of professionalism, and development of its human resource base (see **Section 2.3**). This process took a definitive shape and direction in FY00 with the implementation of the 'Concept Paper' approved by the Central Board of SBP. This will continue in coming years with more vigor to enable SBP to assert and exercise greater autonomy already provided legislatively.

2.6.2 Amendments in Banks (Nationalization) Act, 1974

In 1997, an amendment in the Banks (Nationalization) Act further consolidated the regulatory functions of SBP. Accordingly, Pakistan Banking Council was dissolved; exclusive right of the government and its corporations to establish a bank were withdrawn; consultation with SBP was made necessary in the appointment of chairman, chief executive or any other member of the board of directors of NCBs and DFIs; and these boards were vested with respective superintendence of banking business and policy. Earlier in 1990, important changes were also made in this act, when government was empowered to privatize NCBs. In addition, DFIs were brought under the purview of PBC. In 1991, the government was allowed to permit the establishment of banks in the private sector.

2.6.3 Reforms in Banking Companies Ordinance, 1962

The consolidation of SBP's supervisory role also required amendments in BCO. Under Section 40A, SBP was made responsible to systematically monitor performance of every banking company to ensure their compliance with the applicable statutory criteria and banking rules and regulations. In case of non-compliance, SBP was authorized to take remedial steps in accordance with the law, and periodically report shortcomings or violations to the federal government. Section 41D empowered SBP to direct prosecution of a director or chief executive, who had knowingly caused loss to depositors' money or to the income of banking company.

Furthermore, sections 82A-G institutionalized the system of banking ombudsman (mohtasib), who had powers to investigate and adjudicate on complaints of banking malpractices; perverse, arbitrary or discriminatory actions; violations of banking law; inordinate delays or inefficiency, corruption, nepotism or other mal-administration. In addition, mohtasib could facilitate the amicable resolution of complaints, or report its recommendations to SBP for implementation. Provision of appeal to SBP by aggrieved parties was also made on orders of mohtasib, with finality in SBP's decision.

2.6.4 Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997

This Act was enforced to consolidate and re-enact the Banking Companies (Recovery of Loans) Ordinance, 1979 and the Banking Tribunals Ordinance, 1984. This allowed establishment of banking courts to expedite recovery process for stuck-up loans. Besides disposing of suits within ninety days or asking defaulters to furnish security hereafter, these courts were allowed to pass interim decrees in respect of undisputed claims. In addition, an effective mechanism was also laid down, envisaging attachment before judgment and appointment of receiver, and allowing the bank to take over the possession of property (in case where it was authorized to do so) without filing a suit. These courts were authorized to dispense with, by passing a preliminary decree relating to suits based on mortgages, and pass final decree for foreclosure or sale. The Act also provided for recovery of loans written off on or after 1st January 1990, on basis other than bonafide business considerations.

2.7 Exchange and Payment Reforms During 1990s

The process of exchange and payment reforms, initiated in 1991, was intended to facilitate rapid industrialization by creating an environment conducive to domestic and foreign investment, trade and foreign exchange resource mobilization. Although this process received a serious set back due to the unsustainable balance of payments position following nuclear detonation, this was by no means an end to reforms. Instead, the resulting restrictions were gradually lifted as soon as economic conditions improved. Given this, the liberalization process can be divided into two periods: 1) February 1991 to May 1998, and 2) May 1998 to December 2000.

2.7.1 Reforms During February 1991 - May 1998

Promoting Intermediation

With a view to attract funds held abroad by Pakistanis, the resident Pakistanis were allowed to open foreign currency accounts (FCAs) with banks in Pakistan, which were freely transferable abroad, exempted from income and wealth tax, and no question was to be asked about the source of foreign exchange. Persons holding FCAs could also obtain Rupee loans against such accounts.

Encouraging Foreign Investment

In order to encourage foreign investment, restrictions on capital inflows and outflows were liberalized. More specifically, not only foreign investment in all industries (particularly in services, infrastructure, and agriculture sector) was allowed without prior approval, investors were also permitted to purchase up to 100 percent of the equity in industrial companies on repatriable basis. Furthermore, investment shares (issued to non-residents) could be exported and remittance of dividend and disinvestment proceeds was permissible without prior approval of SBP.

In terms of corporate financing, branches of foreign banks in Pakistan, foreign controlled investment banks incorporated in Pakistan, and non-residents were allowed to invest in registered corporate debt issues, like TFCs etc. through public offerings and secondary market purchases. Other than liberalizing procedures for issue and transfer of securities, non-residents were also allowed to trade freely in the shares quoted on the stock exchanges in Pakistan. However, for that purpose, they were required to open a 'Special Convertible Rupee Account' (SCRA) with any authorized dealer (AD) in Pakistan, which could be fed by remittances from abroad and dividend payable to non-residents, whereas balances could be freely transferable abroad. In terms of royalty and technical fee, ceilings on these payments to non-residents were abolished. For domestic borrowings, rules intended for foreign controlled companies (for working capital and fixed investment) were streamlined. Further, private sector entrepreneurs were allowed to obtain long-term foreign currency loans from abroad subject to certain conditions.

Facilitating Forex Transactions

In this regard, the outward remittance facility available to publishers of newspapers and magazines, and for correspondence courses was extended. In addition, upper limit on remittance for membership of the educational, technical and professional organizations, and examination fee payable to foreign professional institutions was abolished. More importantly, restrictions on foreign exchange for education abroad were removed, procedures for the release of foreign exchange for living expenses/ renewal of exchange permits were relaxed, and facility of back-to-back remittances was allowed.[10] Besides, Pakistani nationals and resident companies/firms were licensed to work as money changers on payment of prescribed fee. These money changers were allowed to sell and purchase foreign currency notes and coins at their own exchange rates.

Promoting International Trade

On the export side, besides permitting exporters to retain the amount of commission (not exceeding 5 percent of FOB value of goods realized) in their special FCAs, they were allowed to use foreign currency balances for surrendering export proceeds to ADs. In addition, individual firms/organizations participating in international trade fairs/exhibitions were allowed to obtain foreign

[10] Back-to-back remittance facility permits ADs to issue TCs/MTs/TTs and drafts, without limit against surrender of equivalent amount in the shape of foreign currency notes.

exchange without prior approval. Moreover, upper ceiling on export of trade samples during a calendar year was raised. On the import side, the condition of obtaining import license from Chief Controller of Import & Export (CCI&E) was done away with. Importers, registered with EPB, were permitted to make imports up to US$10,000 (or equivalent in other currencies) without opening letters of credit or registering the indents/proforma invoices or orders with the ADs.

Liberalizing Forex Market

A milestone was achieved in July 1994, when the government accepted the obligations of Article VIII, sections 2, 3 and 4 of the IMF Articles of Agreement. Consequently, the Rupee was made convertible on current international transactions. Other major changes in exchange rate regime were introduced in February 1998 when ADs were permitted to determine their own exchange rates for currencies (other than US dollar) in terms of Rupee depending upon demand and supply position of the market. The exchange rate of US Dollar against Pak Rupee continued to be determined by SBP. However, the SBP's buying/selling spread for the US Dollar was widened from 0.5 percent to 1.0 percent of buying rate, and ADs were allowed to fix their own buying/selling rates for US Dollar within this band.

2.7.2 Measures Undertaken During May 1998 - December 2000

The economic sanctions by certain donor countries and multilateral institutions following nuclear detonation by Pakistan on 28th May 1998, created a state of uncertainty, especially regarding Pakistan's ability to meet its external obligations. In terms of inflows, remittances fell drastically, and foreign and programmed loans from IFIs dried up. On the other hand, constancy of claims on limited resources was bound to deplete the meager liquid foreign exchange reserves in a short time. The resulting balance of payments crisis was addressed by extensive controls on foreign exchange transactions.

Freeze of FCAs

In view of impending huge forex liability, withdrawal in hard currency from FCAs, certificates of investment issued by NBFIs and encashment of foreign currency instruments (FEBCs, FCBCs and DBCs) was suspended. However, these could be converted into Rupees at prevailing exchange rate.[11] In addition, exemptions on FCAs from tax and *zakat* deduction were withdrawn to encourage their conversion into the Rupees. Furthermore, holders of FCAs were also offered Special US Dollar Bonds against the foreign exchange in their accounts. These Bonds were later made more attractive by reducing the minimum maturity period from 5 to 3 years and raising the maximum rate of return from LIBOR +2 to LIBOR + 4 percent. In June 1998, a new FCA scheme was initiated, which had no surrender requirement for banks and no forward cover facility from SBP. However, in June 1999, banks/NBFIs were directed to keep these deposits within Pakistan only. At the same time, they were allowed to deposit such funds with the central bank.

Introduction Of Multiple Exchange Rate Regime

In the exchange rate regime, a new mechanism was introduced in July 1998, comprising of: a) official exchange rate, and b) floating inter-bank exchange rate (FIBR). While the official exchange rate was fixed by SBP, FIBR was determined in the inter-bank market. The composite of the two rates was applicable to all transactions, except for certain specified categories, which were subject to official exchange rate.[12] Subsequently, the share of FIBR in the composite exchange rate was gradually increased from 50 to 80 percent in December 1998, and further to 95 percent in March 1999. Finally, the market-based unified exchange rate system was adopted with effect from 19th May 1999, and FIBR became applicable to all foreign exchange transactions. In addition, the requirement on ADs to surrender all foreign exchange receipts to SBP was abolished. At the same time, forex demand for all

[11] Withdrawal of incremental deposits after July 1, 1998 was allowed in foreign exchange.
[12] The composite was initially defined as 50 percent official and 50 percent FIBR.

approved purposes was to be met from the inter-bank market. However, by the end of May 1999, an unofficial cap on the Rupee trading was imposed in the inter-bank market due to undesirable volatility. This cap remained effective for over one year, before its final removal on 21st July 2000 when the Rupee was put to a complete float, which was a major achievement in the area of exchange rate management.

Preventing Speculative Activity in Inter-bank Forex Market
In order to prevent speculative activities in the inter-bank market, ADs were prohibited from buying and selling foreign exchange from/to other ADs unless such purchase/sale was backed by permissible transactions with their customers. In addition, forward transactions of ADs with customers for tenure of less than one month were not permitted. ADs were further advised to ensure that Special Convertible Rupee Accounts (SCRAs) of non-residents are not used for speculation in respect of exchange rate of Rupee.

The operations of forex market were rationalized by replacing the system of Net Open Position with an aggregate foreign exposure limit for each bank. Furthermore, reporting system was strengthened and ADs were directed to report daily all forex transactions (ready, forward, take-ups, cancellation, adjusting entries etc.) creating exposure in any currency to the SBP. To ensure stability and transparency in the market operations, ADs were asked to revalue their books daily on mark-to-market basis.

Discouraging Capital Outflows
With a view to discourage capital outflows, some of the powers of ADs (relating to outward remittances) were withdrawn; the scope of back-to-back remittances was restricted and later this facility was withdrawn; and the release of foreign exchange by ADs for all travel purpose was prohibited. However, with improved economic conditions, most of these restrictions were relaxed.

Containing Import Demand
Besides doing away with the facility to import through contracts/purchase orders/proforma invoice/ indent etc., the minimum cash margin requirements were also used to contain imports. However, both of these restrictions were removed later with improvement in forex reserve position of the country.

Discouraging Overdue Export Bills
In order to eliminate incentives available to exporters for maintaining overdue export bills, it was decided that in case where an exporter does not repatriate export proceeds within three days of the due date or within 4 months of the shipment date, whichever is earlier, he shall be entitled to export proceeds at the rate of exchange prevailing on the due date or at the rate prevailing on the date of realization of export proceeds whichever is lower.

2.8 Capital Market Reforms
Capital market reforms were an integral part of overall financial sector liberalization program. The objective was to enable equity market to channel investment funds to the most productive uses. This was to be achieved through creating a favorable policy environment that instills competition and level playing field for investors, and by broadening the market base. The emphasis was also given on the strengthening of governance, institutions, regulation, and supervision. Furthermore, several steps were taken for the improvement and modernization of market infrastructure. Another target area of these reforms was the corporate debt market, which envisaged promotion of Term Finance Certificates (TFCs).

2.8.1 Privatization of State-owned Enterprises
The government policy to sell its share in large state-owned enterprises (SOEs) through stock exchanges was of great significance in development of the equity market. Increased supply of

securities such as the Pakistan Telecommunication Corporation (PTC) and the Muslim Commercial Bank (MCB), and the large issue of a power project, namely the Hub Power Company (HUBCO), which has been actively traded, had considerably increased the market depth.

2.8.2 Opening of Capital Market to Foreigners

Exchange and payment reforms (see **Section 2.7.1**) proved to be of great significance in the development of capital market. Through these reforms, foreigners and oversees Pakistanis were allowed to make investments without prior approval except in few specified industries. This resulted in large inflows of foreign funds. Furthermore, the permission to retain 100 percent equity by foreign investors in a company with no obligation to go public helped improve their confidence in Pakistani markets. Other important steps in this regard were: the permission to bring in any amount of foreign currency and to take it out freely; treatment of foreign private investment with regard to taxes on income, at par with those applicable to similar investment made by citizens of Pakistan; and relief from double taxation in cases of those countries with which Pakistan had treaties for avoidance of double taxation.

2.8.3 Creation of SECP

One of the items in reform agenda was the creation of an autonomous body that would replace Corporate Law Authority. This step was aimed at establishing a professional agency that would improve the regulation and supervision of securities market. Hence, in December 1997, Securities and Exchange Commission of Pakistan (SECP) replaced Corporate Law Authority through Act No. XLII of 1997. After its establishment, SECP played a proactive role in streamlining activities of capital market and protecting the interest of retail investors.

An important step taken by CLA was the easing of restrictions on pricing of new issues. More specifically, CLA repealed the Capital Issues (Continuance of Control) Act, 1947 and consequently abolished controls on pricing of new issues; and introduced the "Companies (Issue of Capital) Rules, 1996" via a notification on 8th February 1996, to encourage promoters' contribution, broaden public participation, and prevent premature projects from going to the public. This had a positive impact on initial public offering, subscriptions and private placements.

Another noteworthy step was the creation of the Central Depository Company of Pakistan Limited (CDC) in 1993 to facilitate electronic transfer of stocks. The CDC commenced its operations in September 1997. This depository company was established by stock exchanges in collaboration with the IFC, Citibank, leading commercial banks and DFIs. This greatly encouraged market activity and streamlined the settlement process.

The incorporation of the Pakistan Credit Rating Agency Limited (PACRA) and the DCR-VIS Credit Rating Co. Ltd considerably enhanced the market transparency.[13] Furthermore, automation of all three stock exchanges and their revised rules and regulations also helped in improving investors' confidence and led to increased trading activity.

2.8.4 Other Measures

The rationalization of interest rates in late 1990s facilitated the capital market growth. In addition, the ban on institutional investment in National Savings Schemes (NSS) in FY00, and launching of Pakistan Investment Bond (PIB) has created a huge potential for the development of corporate debt market. Tax incentives like exemption of income tax on bonus shares, abolition of wealth tax and capital gains tax exemption on conversion of individual membership into corporate membership of exchanges, helped in reshaping capital market structure in Pakistan.

[13] PACRA was established as a joint venture between IFC, IBCA limited of England, and Lahore stock Exchange. DCR-VIS Credit rating Co. Limited was established in association with Duff and Phelps Credit rating Co.