# 7 Future Direction of Reforms

The country has made a significant progress in implementing financial sector reforms and achieved a more competitive market structure with the expanding market share of private and foreign banks, and the privatization of two nationalized commercials banks. There are also significant gains in the form of better supervision and regulation of financial market and institutions. Nevertheless, there are still some major weaknesses in the financial sector, particularly with respect to efficiency of the banking sector. Thus, further reforms in main areas are required to achieve an efficient, sound and competitive banking system. The subsequent sections discuss the future direction of financial sector reforms in Pakistan that has emerged from the analysis provided in earlier chapters.

Future direction should be focused to achieve four broad medium to long-term objectives: improvement in soundness of financial system; strengthening the efficiency of supervision; increasing the effectiveness of monetary policy; and deepening the financial system and services.[?]

## 7.1 Soundness of Financial System

Soundness of financial system requires its constituent institutions to be efficient, having an optimal size and relatively healthy portfolio; and the financial system itself of being the optimal size. These requirements call for renewed efforts for privatization, drastic restructuring of DFIs, a more effective tackling of the problem of bad debts, and the elimination of fragmentation, and thereby consolidation of financial system.

### 7.1.1 Remaining Agenda for Privatization

Chapter 3 shows that the state-owned banks continue to dominate the financial sector, despite the entry of new private and foreign banks during 1990s. The commercial banking system is still dominated by the three nationalized commercial and two partially privatized banks. The deteriorating governance and credit discipline, especially in the state-owned banking sector had eroded their capital, which has largely been compensated through capital injections by SBP. Privatization of the nationalized commercial banks (NCBs) and large development finance institutions is the key to overcome these structural problems. These banks should be sold, as being done currently, through competitive bidding and through listing on Stock Exchanges. This would bring in transparency in the process, fetch a realistic price to the government exchequer and enhance sale proceeds, which should be used for high priority purposes such as national debt retirement and poverty reduction. In addition, it would also deepen the strength of the capital market.

It must be realized that the size of these institutions, given the absorbing capacity of the private sector, demands a carefully designed process of privatization with absolute transparency. A vigilant restructuring of these institutions, making them a manageable and profitable avenue to attract the hitherto lukewarm attention of the foreign investors, is required. In addition, the high tax rate on banks' profits is also perceived negatively by the potential buyers of state-owned banks. Though a reduction in tax rate from 58 percent to 50 percent for banks has been made in FY02, a further reduction is also required so that the general corporate tax rate is applied to banks as well. Moreover, the current drive to recover the defaulted loans also needs to be accelerated. The privatization of NCBs could be further promoted by staff reduction and branch rationalization.

### 7.1.2 Restructuring of DFIs

Although the government implemented various reforms to improve the efficiency of the financial sector, but only a little attention has been given to reform the development finance institutions (DFIs).

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[?] This chapter draws extensively from " Financial Sector in Pakistan: Future Strategic Direction" by Dr. Ishrat Husain, Governor, State Bank of Pakistan.

Current distressed state of DFIs is clearly described in chapter 4. These institutions are characterized by a common set of problems, which includes a very high ratio of non-performing loans and infected portfolios, serious shortage of new financial resources, a low level of institutional efficiency and overstaffing with a high level of demoralization. The distressed state of DFIs is an outcome of political intervention by different governments in the 1980s and 1990s, which has perverted the credit allocation and loan recovery decision. DFIs in Pakistan have failed not only in reaching the targeted sectors but also in achieving sustainability mainly because of large defaults.

Thus, attention should be paid to reform and restructure the DFIs. The ultimate objective of reforms should be: (a) to provide diversified variety of financial products and services at economical costs to the various segments of the economy including micro and small enterprises/individuals; (b) to contribute to enhancing the domestic savings rates; and (c) to allocate resources on the basis of economic merits of investment proposals. In this respect, restructuring of DFIs may be done with the objective of making them operationally efficient, financially viable and sustainable. To achieve these objectives, the DFIs' institutional structure needs to be rationalized, streamlined and consolidated with a view to minimizing the number of public sector DFIs, attaining economies of scale, enhancing clarity in their roles and promoting efficient delivery of services to targeted sectors.

DFIs account for about 11 percent of the total assets of the financial sectors. They are mainly owned by the government with mandate to provide directed and subsidized long-term financing to industry, credit to the agricultural sector and loans for house building. Although government intervention has created distortions in the market, a calculated government intervention is justified in view of the fact that the financial market in Pakistan is not yet well developed to meet the long-term financing needs of the economy. Keeping this in view, the government has already started restructuring of DFIs in 2000. Bankers Equity Limited (BEL) has already been liquidated, while National Development Finance Corporation (NDFC) amalgamated with National Bank of Pakistan (NBP). The Small Business Finance Corporation (SBFC) and Regional Development Finance Corporation (RDFC) have already been merged into a new entity--the SME Bank--to cater to the needs of the small and medium scale enterprises. Public sector shares (46 percent) of Pakistan Industrial Credit and Investment Corporation (PICIC) are to be sold to the private sector. The NIT and ICP mutual funds management has been proposed to be contracted out to the private sector through the Privatization Commission under the Capital Market Development Program with the assistance of Asian Development Bank. ADBP will be retained, with institutional strengthening so as to make it more effective. Federal Bank for Cooperatives (FBC) is in the process of liquidation and its financing functions will be transferred to ADBP. House Building Finance Corporation (HBFC) is being restructured and its institutional capabilities are being upgraded substantially to provide housing finance.

### 7.1.3 Arresting Bad Debts

Chapter 3 and 4 show that although, a number of prudential measures have been taken to arrest the bad debts, the non-performing loans as percent of total advances increased from 21 percent in 1993 to 25 percent in 2000, which clearly reflects that earlier efforts to arrest the bad debts were not enough. To address the problem in a more systemic way, the government has established the Corporate & Industrial Restructuring Corporation (CIRC) in September 2000 to assume non-performing loans and assets of state-owned institutions (HBL, UBL, NBP, NDFC, IDBP and ADBP) with the aim of promoting revitalization of the economy by reviving sick industrial units. The corporation has been empowered to take over the non-performing loans of Rs 30 million or more of the nationalized commercial banks (NCBs) and development finance institutions (DFIs), make arrangements to revive the sick units and ultimately liquidate non-performing loans and stuck up loans. The Corporation has so far resolved outstanding loans of Rs 3.2 billion by selling 30 non-performing loans, while 138 non-performing loans with outstanding amount of Rs 33 billion are under resolution.

While progress of CIRC has been limited so far in arresting the bad debts, a comprehensive strategy is needed to address the issue, which requires rationalization of the whole financial sector and considering bad debts as a subset of a larger issue. Any comprehensive program of arresting bad debt will have to cover the following areas: (a) a well functioning legal framework without any loop-holes; (b) strengthening and improving regulatory framework; (c) strengthening and widening the scope of Corporate and Industrial Restructuring Corporation; (d) strengthening the role of Credit information Bureau and credit rating agencies; (e) improving the quality of project evaluation by institutions before disbursing loans, and (f) privatization of nationalized institutions, and reduction in the number of banks and DFIs through merger/amalgamation. It is noteworthy that while the first four steps are of continuous nature, the time frame for last one is necessary to avoid the moral hazard problem.

### 7.1.4 Consolidation of Financial Sector

Chapter 3 and 4 also show that there are too many small and under-capitalized private financial institutions in different categories, resulting in fragmentation and smallness mainly due to the legal and regulatory framework that sets the limits of the business areas and minimum capital requirements. Absence of economies of scale and scope, failure to upgrade technology, and lack of quality human resource base do not allow these institutions to compete effectively with large banks. Consolidation of smaller institutions into bigger units is required to enhance competition and efficiency. This can be done by focusing on the legal and regulatory framework, the mode of funding by institutions, and deregulating their business operations. The aims should be to integrate the market as much as possible from the viewpoint of customers of financial services.

The following actions should be taken to trigger the consolidation in a smooth manner: (a) raising the capital required for each type of institution to a certain level; (b) facilitating consolidation deals; and (c) in case of commercial banks, further liberalizing branch opening and closing to promote natural growth and mergers. In fact, all scheduled banks have already been required by SBP to raise their capital to Rs 1,000 million by 1$^{st}$ January 2003, in a graduated manner by first enhancing it from Rs 500 million to Rs 750 million by 1$^{st}$ January 2002.

In the long-term, the financial system should be well served by a three-tier structure. Top tier would consist of strong universal banks providing credit and financial services to large-scale industries and other corporate clients; catering to consumer financing needs; and having a global network. This tier would be mainly private sector owned and also encouraged to reach out to small and medium enterprises.

Second tier would consist of specialized and other private sector banks, in addition to microfinance institutions in public and private sector. The focus of this tier would be to provide credit and financial services to micro, small and medium enterprises, besides meeting specialized credit requirements for exports, agriculture and rural sectors.

The third tier is envisaged to consist of private non-bank financial companies resulting from the consolidation of existing fragmented NBFIs. These institutions would rely on borrowing and contributions funding their asset growth. They would undertake equity underwriting, merger and acquisition, asset management, corporate bond issues, securities trading, leasing, venture capital etc. This tier would be governed and supervised by the Securities and Exchange Commission of Pakistan (SECP).

## 7.2 Efficacy of Supervision

Strengthening of supervisory and regulatory capabilities of governing institutions (SBP and SECP) not only requires enhancement of their own skills but also those of institutions being supervised. This requires instillation of good governance, placement of effective legal infrastructure, and clear demarcation of supervisory responsibilities in case of multiplicity of supervisors.

### 7.2.1 Improving Corporate Governance

For good corporate governance a four tier structure is desirable, viz management, board, external auditors and self-regulation. A good progress in this respect has been made towards the end of 1990s. The banks/NBFIs incorporated in Pakistan have been mandated to get the clearance of the State Bank prior to appointment of their Chairman, Chief Executive and members of the Board. The management of public sector banks has already been drawn from private sector, and their boards have been re-constituted and appropriate persons of repute from private sector have been inducted. Under the provisions of Banks (Nationalization) Act, 1974 the appointments of Chief Executive of public sector banks/DFIs have to be made out of a panel of professional bankers maintained by SBP. The SBP requires not only a continuous strict scrutiny but also strict adherence to the defined criteria in this regard to prevent intervention by the government and politicians.

Good corporate governance is also aided by a system of external auditing. In this respect, SBP has recently revised the appointment criteria for selecting panel of auditors to make it more realistic, transparent and according to international standard. The criteria will also help SBP to determine the professional capability and competence of external auditor. The guidelines for submission of special report to State Bank by the external auditors are also being revised. A vigilant monitoring and updating of these issues will be required by the State Bank to improve the corporate governance.

Self-regulatory bodies like Financial Markets Association of Pakistan (FMAP) and Pakistan Banks Association (PBA) also have to become more active to enforce ethical and sound market practices. The need for close liaison between self-regulatory bodies and supervisory authorities will also increase in future and likely result in better regulation and supervision.

### 7.2.2 Strengthen Legal Infrastructure

Although legal and judicial reforms have facilitated financial contract dispute resolution, implementation of court judgments is still ineffective, partly due to remaining weaknesses in the law and its enforcement. The law could be further strengthened by enabling financial institutions to foreclose on collateral without the intervention of courts. Financial institutions could be facilitated by providing required resources of the state to implement out-of-court foreclosure. Simultaneously, the implementation of court judgment could be facilitated by providing courts with adequate resources to effect loan recovery. Furthermore, SBP Act, Banking Companies Ordinance 1962, Banking Nationalization Act and DFI Act could be revised to enable the operation of these institutions on commercial considerations without bureaucratic and political influences.

### 7.2.3 Enhance Capabilities of Supervision

State Bank of Pakistan has already taken important initiatives to strengthen off-site surveillance and on-site inspection. A set of manuals was developed for on-site examinations, off-site surveillance, early warning system, and problem bank management. On-site examination process was modernized to provide reliable, clear and timely information regarding banks' financial conditions, performance and future prospects; and serves as the basis for effective corrective action. In this respect, development of sustainable practical training programs for supervisory staff are essential not only to enhance the quality of SBP inspectors but also to keep pace with modernization of financial institutions.

### 7.2.4 Demarcation of Supervision and Regulation Responsibilities

The proposed three tier financial system, requires a clear demarcation of supervision and regulation responsibilities for strengthening the efficacy. SBP and SECP have redesigned the non-bank financial institutions (NBFIs) to offer a whole variety and range of financial products, tailored to the needs of customers through one window operation; these institutions will be called as Non-bank Financial Companies (NBFCs). Duality in supervisory role for NBFIs between SBP and SECP will no longer exist as supervisory/regulatory functions of NBFIs are going to be transferred to SECP after making necessary amendments in Banking Companies Ordinance 1962 and a framework containing rules for supervision of NBFCs. Continuous coordination is envisaged between SECP and SBP to ensure consistent and effective supervision over the entire financial sector.

Redesigned NBFCs will bring together all non-banking services such as leasing, investment banking, housing finance, venture capital, asset management, discounting services and investment advisory services under one umbrella. This consolidation will not only help in greater cost effectiveness for customers, but also improve the effectiveness of supervision stemming solely from SECP.

## 7.3 Effectiveness of Monetary Policy

Independence of central bank is a sine qua non for effectiveness of monetary policy. It further requires existence of deep and efficient financial markets. In addition, a market based term structure of interest rates is a precondition for the realization of an active money and government securities market. Furthermore, monetary policy changes are transmitted more effectively if both money and foreign exchange markets are free of segmentation.

Proper signaling of monetary stance also plays a vital role in the effectiveness of monetary policy, which necessitates the signals to be interpreted by market players in the direction intended by the central bank. This requires not only a clear enunciation of dissemination of Annual Credit Plan but also an enhanced communication with the market. SBP has already started a detailed explanation of its monetary stance in its Quarterly Reports. This practice will be further strengthened in future.

### 7.3.1 Ensuring Autonomy of SBP

The SBP was granted autonomy in 1997 in the management of monetary policy but it remained an institution devoted to the financial need of the government, although in recent years fiscal prudence was broadly observed. Ensuring SBP full autonomy in devising and applying its monetary policy requires establishing legal limits to the amount, established in terms of clause (b) of Section 9A of SBP Act, 1956, that it can advance to the government.

### 7.3.2 Rationalization of Interest Rate Structure

Government has created distortions in resource mobilization through the national saving schemes (NSS) by setting very high yields on medium and long-term saving certificates. As shown in section 6.4, these high rates have put pressure on public finances as the domestic debt servicing costs have risen disproportionately, thus widening the fiscal deficit. On the other hand, they have diverted deposits from banking sector to non-banking sector and resulted in lower deposit base for banks. As a result, the NSS instruments have grown at twice the rate of bank deposits and now equal half of bank deposits. Thus, government has crowded out the private sector from the long-term markets through the NSS.

Although in the recent past, the profit rates on NSS have been rationalized to avert the diversion of banks deposits to non-banking sector, the government financing mechanism needs to be made more conducive to overall financial sector development. To achieve this goal, it is important to set the rates on NSS marginally lower than those of government securities available to banking sector. This is necessary in view of premature encashment facilities available on various certificates of NSS. Consequently, it will require the strengthening of existing weak link between the return on a ten-year DSC with that of market determined Pakistan Investment Bond (PIB). Unless this happens, dis-intermediation episodes will continue to haunt the financial system.

### 7.3.3 Unification of Foreign Exchange Market

Present foreign exchange market is segmented into an official inter-bank foreign exchange market, fed by export receipts, official remittances and other inflows for ultimate use by imports and other payments, and a kerb market fed by unofficial remittances for ultimate use by any buyer. Kerb market has been increasingly used by SBP for purchasing hard currency to enhance reserves. The premium between the two markets has remained within a range of 4 to 5 percent over an extended period of time. Merging of these markets will remove the segmentation and increase the efficiency. Merger is proposed to take place by 1st July 2002 through transformation of existing licensed money changers into Exchange Companies with enhanced regulation. This unification is expected to significantly increase the inflow of foreign exchange in the country through official channels.

### 7.3.4 Development of Secondary Market for Long-term Government Paper

Although the secondary market for short-term government paper is active and efficient, the market for long-term government papers is yet to be developed. Initial steps in this regard have already been taken through the selection of primary dealers (PDs) and the introduction of PIBs. The PDs were chosen on the basis of their treasury expertise and infrastructure, past performance as market players, and capital adequacy. These players are given the explicit responsibility of developing an active secondary market by supplying non-PDs and institutional investors with PIBs. The resulting shortlist of PDs include: (1) ABN-AMRO Bank, (2) American Express, (3) Citibank, (4) Habib Bank Limited, (5) National Bank of Pakistan, (6) Standard Chartered Grindlays, and (7) Union Bank.

It is imperative to give the long-term instruments a more conducive environment through a shift in mindset of players from a buy-and-hold strategy to a strategy of active participation in secondary market trading. This will depend mainly on how effective the PDs are in undertaking their obligations that will lead to effective market making.

## 7.4 Deepening of Financial System and Services

Financial depth requires that financial transactions should encompass a broader range of economic and financial agents. This in turn calls for limiting the role of government and promoting that of the private sector. Furthermore, outreach of financial institutions should not be confined to the large few, but also touch micro level enterprises. An outdated and inefficient payment system can result in promotion of informal financial activities and constrain the system to remain shallow. Moreover, in the age of globalization, enhancement of financial services will go a long way in attracting global capital.

### 7.4.1 Minimizing the Role of Government

As shown in peer country comparison (**section 6.8**), larger shares of banking sector credit to government are associated with shallowness of financial sectors. Therefore, it is necessary to reduce the role of government and public sector institutions through curtailment of its borrowing from the banking system. This can only be done if not only the ownership of government in financial institutions is reduced through privatization, but a meaningful restructuring of public sector enterprises is undertaken as well.

### 7.4.2 Promote Micro-finance Institutions

Low level of financial depth indicated in high currency and low M2 to GDP ratios is largely due to the inability of present formal financial structure to cater to the needs of micro, small and medium enterprises, which are currently outside the formal sector, and as such unable to expand the scope of their economic activities. As discussed earlier, proposed three-tier structure of financial system is expected to go a long way in deepening and widening of financial activities.

### 7.4.3 Modernization of Payment System

Considerable progress has been made during 1990s towards achieving speedy and automated clearing of cheques. However, progress on modernization of government securities settlement system was limited to establishment of a book-based manual system for only three government securities (T-bills, FIBs and PIBs). Nevertheless, a landmark achievement was the establishment of Central Depository Company for automated settlement of corporate securities.

Establishment of an automated and efficient payment settlement system is necessary not only to increase the volume of financial transactions within the country, but also to tap the international capital searching for viable financial investment. Growing cross-border interdependence between payment and settlement systems has led to a number of international initiatives to develop the payment systems in accordance with the Core Principles for Systematically Important Payment Systems (SIPS). The SBP is examining various options to implement a Real Time Gross Settlement System (RTGS). Once operational, it will significantly enhance the volume of financial transactions in the country. Furthermore, in order to curtail the delay in foreign currency transfers within the country, establishment of a non-Rupee clearing house is also under consideration.

### 7.4.4 Enhancing Financial Services

The financial sector around the world is opening to the foreign markets. Globalization brings in both opportunities and threats. Economies that want to get benefit from this trend must be proactive in adopting the optimal policies. World Trade Organization is an important forum for promoting international trade in goods and services and Pakistan is a member of WTO and a participant in GATS (General Agreement of Trading in Services). State Bank will be actively involved in promoting policies and strategies to export financial services. Presently, Pakistan's commitments in financial services address important issues of branch licensing, ownership of banks and financial institutions, asset management and financial advisory services, employment of foreign nationals, setting up of locally incorporated subsidiaries by foreign institutions, and commitments related to leasing and insurance. Further liberalization of financial services has to be undertaken under TRIMs (Trade Related Investment Measures) agreement with WTO. Therefore, the State Bank as a regulatory authority will have to reposition itself to cope with these challenges.

## 7.5 Conclusion

State-owned banks and DFIs are still faced with the problems of large non-performing loans, high administrative costs and low efficiency reflected in high spread between lending and deposit rates. Thus, key to solution lies in the privatization of state-owned banks and DFIs. To privatize these institutions, a watchful restructuring is required to make these institutions manageable and profitable avenue to attract the attention of foreign investors. To remove distortions in resource mobilization, the government financing mechanism needs to be made more conducive to overall financial sector development. To arrest the bad debts a comprehensive strategy should be envisaged, which requires rationalization of the whole financial sector along with a well functioning legal framework without any loop-holes; strengthening and improving regulatory framework; strengthening and widening the scope of Corporate and Industrial Restructuring Corporation; privatization of nationalized banks; and merger of small banks and reduction in the number of DFIs. Consolidation of smaller institutions into bigger units is also required to enhance efficiency and promote competition. Implementation of these reforms would result in self-sustained and commercially viable financial institutions.