Executive Summary

Pre-reform Structure in 1990

Financial landscape of the country was significantly altered in early 1970s with nationalization of domestic banks and expansion of public sector development finance institutions. By the end of 1980s, it became quite clear that the national socio-economic objectives sought to be achieved by nationalization, were not being met. Instead, the pre-dominance of public sector in banking and non-bank financial institutions, coupled with the instruments of direct monetary control, were becoming increasingly responsible for financial inefficiency, crowding out of the private sector, deteriorating quality of assets and rising vulnerability of financial institutions.

Dominance of public sector financial institutions, at the end of FY90, was apparent with a share of 93.8 percent in total assets. Similarly high shares existed for deposits, advances and investments. Within the banking sector, share of public sector was 92.2 percent in total assets, while the rest belonged to foreign banks as domestic private banks did not exist at that time. Structure of non-bank financial institutions was more skewed with a hefty share of development finance institutions (all in public sector) at 78.6 percent. Share of investment banks, leasing and modaraba companies remained small, despite their inception from early to mid 1980s. With these characteristics, financial structure at the end of FY90 did not provide a level playing field for competition and growth.

Besides the uneven ownership of financial system towards the public sector, a serious distortion was being caused by the presence of National Savings Schemes. Relatively higher returns on these schemes were causing dis-intermediation and worsening the crowding out of the private sector, already squeezed under the system of financial repression exercised largely through direct monetary controls on the banking system. National economy was taking a double hit because of these schemes. First, domestic debt was mounting rapidly, with rising servicing costs and second, the investment potential of the economy was being constrained due to misallocation of credit.

Not only the financial system was becoming more stressful, supervisory system was also losing its effectiveness. SBP's role, as a central bank, had considerably been weakened due to the presence of Pakistan Banking Council (PBC), which acted as a holding company of nationalized commercial banks and also exercised supervisory control over them. Duplication of supervisory role was diluting SBP's enforcement of its regulations over nationalized commercial banks. Not only the supervisory capabilities of SBP were becoming ineffective, it was also not allowed to formulate and implement the monetary policy independently. In addition to this, non-bank financial institutions were practically unsupervised because of lack of autonomy and multiplicity of supervisory agencies over them that included Corporate Law Authority, Monopoly Control Authority and Controller of Capital Issues, all attached directly with the Ministry of Finance.

Structure of financial markets was determined by the type and size of its participants. With the government as the main player in the arena, supported by the passive supervisors and a few large-sized nationalized banks and DFIs, private sector participants were only watching the mobilization of financial savings from the households and consequent diversion to the government and priority sectors. There were hardly any markets in the true sense of the word, i.e., markets where players' interaction resulted in pricing and clearing. Financial markets, after nationalization of commercial banks, were not equating the supply of funds according to their demand, rather a set of distortions was being imposed through the system of financial repression characterized by credit rationing and other controls.

The foreign exchange market was highly regulated by SBP through a system of exchange control over suppliers and users of foreign exchange. Only two of the several financial markets that had competitive characteristics were call money market and the market for corporate equities. However, the competitiveness of call money market was largely irrelevant for the financial and real sectors as a whole, because of their inability to transmit interest rate signals due to the absence of a proper monetary transmission mechanism. Activities in the equity market were mainly confined to Karachi Stock Exchange with limited turnover of shares and market capitalization. Corporate debt market was almost non-existent except for a few bonds of public sector enterprises. Market of mutual funds was, consequently, also very limited.

In short, the financial structure at the end of 1980s was hardly conducive for meeting the growing financial needs of the economy. Although the nationalization of banks in early 1970s resulted in a rapid expansion of branch network within the country, the system of credit ceilings, interest rate controls, subsidized loans, directed credits and high government borrowing both from banks and non-banks (through national savings schemes) were adversely affecting the banking system.

Weaknesses in the supervisory system and lack of governance in state-owned institutions were worsening the quality of services being delivered. Inefficiencies due to over-staffing and over-branching were continuously adding to the administrative cost of public sector institutions. Spread between lending and deposit rates was concealing the intermediation inefficiencies due to the system of caps and ceilings on interest rates. Data disclosure standards were not resulting in conveying full picture of financial health of institutions. In short, the financial health was deteriorating fast, but largely concealed in opaque balance sheets of banks and NBFIs.

Financial Sector Reforms During 1990s

Realizing the inherent weaknesses of the financial structure that emerged after nationalization, government initiated a broad based program of reforms in the financial sector. Objectives of reforms were to create a level playing field for financial institutions and markets for instilling competition, strengthening their governance and supervision, and adopting a market-based indirect system of monetary, exchange and credit management for better allocation of financial resources. Reforms covered seven important areas: financial liberalization, institutional strengthening, domestic debt, monetary management, banking law, foreign exchange and capital market.

Banking sector was liberalized by permitting private banks to operate and compete with nationalized commercial banks. Competition was promoted by privatization of MCB and ABL. Initially at the start of 1990s, ten new banks were permitted to operate, of which eight started functioning. A couple of new banks joined later in the private sector. Governance of financial institutions was strengthened by insertion of new sections in Banking Companies Ordinance, 1962. Loan recovery process was streamlined by issuing clear guidelines for loan classification and requiring banks to submit regular reports on recoveries. A number of state-owned banks and DFIs were downsized and restructured through golden handshake and branch closure programs in later half of 1990s. Prudential measures were strengthened at the same time to ensure capital adequacy and disclosure of financial data reflecting true conditions of banks.

Several steps were taken to enhance effectiveness of SBP: a Credit Information Bureau (CIB) was established to keep credit records; an NBFIs Regulation and Supervision Department was established that subsequently issued 'Rules of Business' to supervise them; autonomy was granted to SBP in matters related to administration and conduct of business, that was later expanded to include formulation and implementation of monetary policy; regulatory function of SBP was consolidated through dissolution of Pakistan Banking Council; and supervisory role was further enhanced by placement of CAMELS and CAELS frameworks and extensive training of SBP officers on off-site surveillance and on-site inspection.

Domestic debt management underwent one of the most significant reform processes during 1990s. A primary market of treasury bills was established through auctions that replaced earlier tap system. Secondary market activities were promoted by replacing the discount window with SBP 3-Day repo facility. A system of approved dealers was established to widen the participation in auctions. A long-term auctionable government paper was also introduced in 3, 5 and 10-year maturities. Establishment of a book-based system of government securities settlement greatly enhanced the volumes of repo transactions in the secondary market. An important step was also taken with regard to national savings schemes; Khas Deposit Certificates, with very high returns, were discontinued.

Various monetary management measures were initiated to dismantle the system of financial repression and establish a market-based mechanism of monetary control. Bank-by-bank credit ceilings were abolished and replaced with credit deposit ratio that too, was subsequently removed. In addition to this, caps on lending rates of banks and NBFIs were eliminated to pave the way for implementation of monetary policy indirectly through signals of liquidity and short-term interest rate changes.

Banking laws also underwent significant changes during 1990s in order to provide a supportive legislative framework for the reform process. Important amendments were made in all the relevant banking laws including SBP Act, 1956; Banking Companies Ordinance, 1962; Banks (Nationalization) Act, 1974; and Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997. The most important of these were the amendment in SBP Act, 1956 that provided for its full operational autonomy in conjunction with the dissolution of PBC in 1997.

Another important set of reforms, related to exchange and payments, was initiated in early 1990s, and quickly resulted in promotion of bank intermediation, encouragement of foreign investment, facilitation of forex transactions and enhancement of international trade. These steps in conjunction with capital market reforms helped in attracting foreign portfolio investment. Capital market saw an establishment of a central depository for automated trading of corporate equities and bonds. Further measures included establishment of credit rating agencies and transformation of Corporate Law Authority into an independent Securities and Exchange Commission of Pakistan, with full supervisory powers over capital market and non-bank financial companies.

Performance of Commercial Banks During 1990s

Growth trend of commercial banks during the decade seemed to indicate a structural break at the end of 1997. Assets of banks grew from Rs 426 billion in 1990, at a compound average growth rate of 17.8 percent per annum, to Rs 1,339 billion in 1997. Later on, compound average growth slowed down to 7.0 percent per annum, with assets reaching Rs 1,641 billion at the end of decade. Deposits of commercial banks showed a similar trend during this period. Up to 1997, average annual growth rate was in double digit (17.9 percent), decelerating to a low single digit (5.6 percent) in the later period of the decade. Deposits in terms of GDP increased from 41.4 percent in 1990 to 45.7 percent in 1997, later eroding to 41.6 percent in 2000.

Evaluation of banks under the CAMELS framework revealed important insights about their soundness and vulnerabilities. Commercial banks, for analytical purpose, were grouped into three categories: state-owned banks, private banks and foreign banks. Performance of overall banking sector mirrored that of the state-owned banks due to their large share in total assets. Nevertheless, the assets share of state-owned banks declined drastically from 92.2 percent in 1990 to 54.0 percent in 2000 (if MCB and ABL are excluded). This development is a firm reflection of growing competition in the banking sector from new private banks that did not exist in 1990.

Capital erosion was witnessed in the state-owned banks, in terms of capital to liability ratio, for the first seven years of the decade. Capital to liability ratio was at the lowest level in 1997 when two large banks suffered huge losses for two consecutive years. However, injection of capital by SBP in these banks improved their capital adequacy. Capital to risk-weighted assets ratio (CRWA) also increased from only 0.6 percent in 1997 to 9.5 percent in 2000, well above the minimum benchmark of 8 percent set by the Basel Committee. For the foreign banks, capital adequacy ratio remained very strong throughout the decade indicating their soundness; their CRWA ratio was 18.0 percent in 2000. Private banks, which commenced their operations in early 1990s, naturally experienced a decline in their capital to liability ratio because of expansion of their deposits from nil position. Their CRWA ratio also declined from 15.5 percent in 1997 to 11.1 percent in 2000, but remained comfortably above the minimum required, indicating much better health than that of state-owned banks. Banking industry, as a whole had a CRWA ratio at 11.4 percent in 2000.

Asset quality of state-owned banks had declined, both in terms of earning assets to total assets and NPLs to gross advances during the decade. However, the deterioration was mostly observed up to 1997.[1] This is because of the reason that the most important set of banking reforms were undertaken late in the reform process -- mostly towards the end of 1997. Enhanced disclosure requirements by SBP, with consolidated supervisory powers after the dissolution of PBC in May 1997, forced the banks to reveal true pictures of their balance sheets by incorporating full provisioning. That alone resulted in 'reported' increase in non-performing loans that already existed but seldom declared as such. Furthermore, after the freezing of FCAs in May 1998, all banks faced deposit erosion, liquidity squeeze, liquidation of investment and consequent erosion of earning assets.

Foreign banks again stand out as the best performers in terms of asset quality. Although they had experienced a sharp decline in the ratio of earning assets to total assets in 1999 in the aftermath of FCA freeze, they were successful in turning it around in 2000. Their NPLs to gross advances had not only remained stable since mid 1990s, these had actually declined from early 1990s. Private banks also remained in comparatively better position than state-owned banks, although their NPLs to gross advances had been rising since 1997 and compared poorly with those of foreign banks.

Management soundness indicators revealed a mixed picture for state-owned as well as private banks. Expenditure to income ratio remained stubbornly high for state-owned banks during 1990s, even if the value for 1997 was ignored due to extraordinary expenditure on golden handshake schemes. As discussed earlier, higher provisioning in these years was the prime reason behind this. This higher cost is also depicted in rising trend of their interest rate spread. Private banks displayed a sharper rising trend in expenditure to income ratio than those of state-owned banks. With the better quality assets, lower expenditure to income ratio for foreign banks was expected. Surprisingly, their interest rate spread had been higher than that of state-owned banks. However, this was due more to the inefficiencies of state-owned banks, than of foreign banks.[2] Higher spread helped foreign banks in earning above normal profits, while state-owned banks were primarily maintaining this to cover their inefficiency cost.

Earnings and profitability indicators of state-owned banks showed steep decline in 1996, 1997 and 1999, due to losses suffered mainly by two of the large state-owned banks. However, this had been arrested after injections of capital in these banks by SBP. Although profitability remained positive for private banks, a declining trend was witnessed in these indicators. Similar trend existed for foreign banks, with an accentuated decline after 1998; this is understandable due to larger exposure of foreign banks to FCAs. Indicators of liquidity and sensitivity to market risks showed a declining trend for all groups of banks, mainly due to the conscious policy of SBP in reducing SLR from 45 percent in

[1] From thereon, although the ratios increased, signs of stabilization became visible after 1999. Furthermore, this increase should be viewed in relation with increasing focus of SBP on declaring true value of NPLs under strict supervision.

[2] This is largely due to the two factors: better quality of assets of foreign banks, and predominance of FCAs in their deposits that pay lower returns.

December 1992 to 15 percent in December 2000. However, ratio of liquid assets to total assets remained higher in case of foreign banks, showing their voluntary holding of excess government securities and comparative reluctance in undertaking credit extension.

In terms of the health of the banking industry, very small improvements, or arrests in earlier declines, could be discerned in some of the CAMELS indicators after 1997. These improvements should be seen in the context of various negative factors that affected the banking industry after 1997. While SBP in that year required banks to enhance capital adequacy, strengthen asset quality, improve management, increase earnings and reduce sensitivity to various market risks, the freezing of foreign currency accounts in May 1998 instilled new pressures of weakening capital, deposit erosion, and dis-intermediation in the financial system. Persisting environment of low economic growth had also added a dampener to demand for credit, and at the same time the supply of the credit was negatively affected due to over-cautious attitude of banks following the drive for accountability and loan recovery that began in October 1999.

Performance of NBFIs and CDNS During 1990s

Assets of NBFIs grew very rapidly from Rs 133.9 billion in 1990, at a compound average growth rate of 17.3 percent per annum to Rs 410.3 billion in 1997. Growth trend reversed thereafter, with assets falling to Rs 351.7 billion in 2000 at an average rate of decline of 4.9 percent per annum. In terms of GDP, assets of NBFIs increased from 15.6 percent in 1990 to 16.7 percent in 1997, but later declined to 11.0 percent of GDP in 2000. The decade saw an upsurge in mobilization of funds through national saving schemes from Rs 131.9 billion in 1990, (at a compound average growth rate of 17.0 percent per annum) to Rs 633.8 billion in 2000. In terms of GDP, outstanding investment in NSS rose from 15.4 percent in the beginning of decade to 19.9 percent at the end. The tremendous growth came at the back of very high returns on NSS, and resulted not only in mounting debt and servicing burden, but significant dis-intermediation in the financial system as well.

Health of NBFIs weakened rapidly during the decade mainly due to deteriorating management of DFIs. Asset composition of these groups was altered significantly during the decade. Share of DFIs declined from 78.6 to 57.0 percent; investment banks increased from 1.8 to 12.0 percent; leasing companies from 4.7 to 11.1 percent; modarabas from nil to 4.3 percent; housing finance companies declined from 12.3 to 6.3 percent; and mutual funds increased from 1.9 to 8.6 percent. Discount houses and venture capital companies constituted less than 1 percent towards the end of decade.

Declining health of DFIs was visible from the beginning of decade. Capital to liability ratio not only declined continuously throughout the decade, it became negative as well during the last two years of the decade due to severe erosion of capital in some of the large DFIs. Poor asset quality, serious management problems, low earnings and profitability, and squeezed liquidity position of public sector DFIs combined with weak macroeconomic environment, played havoc with the capital of DFIs especially NDFC, one of the largest DFI whose equity showed a hole of Rs 16.6 billion towards the end of decade.[3] Rising number of sick industrial units during mid 1990s passed on a heavy size of NPLs to public sector DFIs that had the main exposure in project financing. In addition, increased competition to mobilize deposits by offering unrealistically high rates of return, discontinuation of credit lines from international finance institutions and freezing of foreign currency deposits aggravated their problems. Criminal mismanagement of BEL led to its liquidation towards the end of decade. However, these problems were confined to public sector DFIs. Foreign sponsored DFIs remained healthy and expanded their activities prudently during the decade.

Investment banks grew very sharply with their assets rising from 2.4 billion in 1990, (at a compound annual average growth rate of 33.2 percent) to Rs 42.1 billion in 2000. Speedy growth of investment

[3] NDFC was subsequently merged with NBP on 30th October 2001.

banks was aided by the boom in stock exchanges in early 1990s and mobilization of foreign exchange through certificates of investment. However, with the freezing of foreign currency deposits, investment banks were severely affected and their assets declined in 2000, after reaching Rs 48.7 billion in 1999. Structure of investment banks was also skewed, as only two out of sixteen investment banks jointly held around two-thirds of total assets.

CAMELS indicators of investment banks showed a mixed bag of performance. Capital to liability ratio remained stable, roughly within a band of 13.0 to 16.0 percent during FY93 to FY00, after declining first from a very high level during their formative years. Asset quality indicators showed increasing stress, both in terms of earning assets to total assets and NPLs to gross advances. Ratio of earning assets to total assets declined from 82.9 percent in the beginning of decade to 74.1 percent at the end, while the ratio of NPLs to gross advances climbed from a negligible value to 15.7 percent. Indicators of management soundness showed an increasing trend in expense to income ratio after 1994. Earnings and profitability indicators showed mixed trends, while the liquidity management indicators showed improvements.

Leasing companies had been the best performers amongst the eight groups of NBFIs. They had maintained not only a solid, steady and high growth trend but also a well-balanced and prudent performance in terms of financial indicators. Their assets increased from Rs 6.3 billion in 1990 (at a compound annual average growth rate of 20.1 percent) to Rs 39.1 billion in 2000. Capital adequacy in terms of capital to liability ratio remained stable during the decade at a comfortably high level of over 25 percent. Asset quality in terms of earning assets to total assets ratio, also remained at high levels. Their advances constituted more than 85 percent of earning assets throughout the decade.

Modaraba companies did not display the success of leasing despite their rapid growth in late 1980s and early 1990s. Their tax-free status, that seemed to have generated this growth, was withdrawn in 1992. Assets of modaraba companies grew from Rs 11.8 billion in 1994, (at a compound growth rate of 4.0 percent per annum) to Rs 15.0 billion in 2000. This was one of the lowest annual average growth rates during the decade amongst the eight NBFIs groups, even lower than that of DFIs. In terms of available indicators, it was difficult to reach specific conclusions about modaraba companies. However, the fact that modarabas significantly lost values, for a majority of their shares, added credence to their weak performance.

Group of Housing Finance Companies, like DFIs, was also at the losing end. However, the weaknesses stemmed entirely from HBFC, the largest among this group of only four, with 95 percent assets. Total assets of HFCs grew from Rs 16.5 billion in FY90 (at a compound annual average growth rate of only 3.0 percent) to Rs 22.3 billion in 2000. The group surprisingly showed increasing adequacy of capital in terms of capital to liability ratio. However, the asset quality indicators showed an alarming and deteriorating picture. Ratio of NPLs to gross advances had increased from 4.3 percent in FY90 to a very high level of 69.3 percent in FY00.

Mutual funds and their management companies came under severe pressure during the second half of the decade. Initially their total assets jumped from Rs 20.1 billion in 1991 (at a compound average growth rate of 278.9 percent per annum) to Rs 78.5 billion in 1994. After touching this peak, the total assets declined to Rs 23.7 billion in 1999, at an average rate of 19.1 percent per annum. Later, some respite was seen with assets going up to Rs 30.4 billion in 2000.

Discount houses and venture capital companies despite remaining profitable almost throughout the decade were not able to carve any significant share in the activities of NBFIs. Their share remained less than one-half of one percent throughout the decade. Discount houses were able to maintain steady profits, but venture capital companies showed high volatility in their profits, from the beginning of decade, that increased markedly towards the end.

Transformation of Financial Markets During the Reform Process

Reforms, that were initiated in late 1980s and continued in the 1990s, started to transform the financial markets rapidly from FY91. Structure of a well functioning money market quickly developed with the introduction of auctioning process of short and long-term government securities. Capital market activities expanded very quickly in response to opening up of equity markets to foreigners. Activities in foreign exchange market also expanded after residents were allowed to open foreign currency accounts in addition to granting licenses to money changers.

Pre-reform system of tap treasury bills at a fixed yield of 6 percent, quickly gave way to establishment of auctioning process and promotion of secondary market activities made possible by the inception of SBP 3-Day Repo facility. The reforms transformed the passive primary market of treasury bills into an active and competitive one within two months in just four auctions. Bidding pattern of participants demonstrated a quick adjustment to market pricing mechanism within this short period. The bid spreads decreased sharply during the first four auctions, indicating a quick move towards competitive pricing. Similar success was also witnessed in the auctions of newly introduced long-term government paper, the Federal Investment Bond (FIB) of 3, 5 and 10-year maturities, that also helped in establishment of a full spectrum yield curve of marketable government securities. Repo transactions made their way rapidly in the secondary market of T-bills and FIBs, and firmly established themselves as a fairly unregulated but orderly instrument of money market for the first time in South Asia.

With the establishment of money market, and emerging of short-term interest rates to be effectively used as signals of monetary policy changes, SBP dismantled almost all the direct controls of monetary policy. Abolishment of credit ceilings first gave way to a more flexible, albeit direct, mechanism of credit deposit ratio, which was subsequently removed in late 1994. Caps imposed on maximum lending rates for banks and NBFIs were also removed during that time to pave the way for effective use of open market operations (OMOs) as a major indirect instrument of monetary policy, in conjunction with SBP 3-Day Repo Rate and the cash reserve requirement. Though initial OMOs were not successful, subsequent learning process enabled both SBP and banks to participate efficiently therein.

Initially, SBP focused only on one-way OMOs mainly concerned with the objective of draining the excess liquidity from the commercial banks to restrain their credit expansion within the limits of credit plan. Later, in October 1997, SBP also started injecting short-term funds for liquidity management through OMOs. However, operational objective of this liquidity management was to control the reserve money rather than the overnight inter-bank rate that continued to exhibit considerable volatility in the inter-bank money market. Hence, the weighted average yield of six-month T-bill became the main benchmark for banks and NBFIs, because of its lower volatility, for setting their lending rates. Consequently, efficacy of the interest rate, in the transmission mechanism of monetary policy began to take root.

Capital market showed remarkable growth triggered by the inception of exchange and payment reforms undertaken in early 1990s, which allowed non-residents to trade in shares at the domestic stock exchanges and freely repatriate investment and profits. These reforms initiated a large mobilization of funds into the equity market, thus contributing to the growth of stock exchanges of the country. Market capitalization at the Karachi Stock Exchange rose very quickly from Rs 90.0 billion, or 8.8 percent of GDP in FY91 to Rs 218.4 billion, or 18.0 percent of GDP in FY92.

By the end of 1991, International Finance Corporation (IFC) ranked Pakistan as one of the leading emerging markets in the world. Consequently, a number of offshore funds were established in foreign countries and listed on foreign exchanges for investment either in Pakistan or in other emerging markets. In addition, increased supply of securities due to the privatization of large state-owned enterprises such as the Pakistan Telecommunication Corporation (PTC) and the Muslim Commercial Bank (MCB), and the large issue of a power project HUBCO (Hub Power Company) had increased the depth of the market.

Market capitalization further increased to Rs 405 billion in FY94. Increased interest of international investors also enabled Government of Pakistan to raise US$ 150 million from Euro Dollar Market in FY95, through its first ever, sovereign bond of 5-year maturity. However, the political and economic instability of the country during most of 1990s brought volatility in the capital market. Market capitalization, after reaching a peak level of Rs 496 billion in FY97, fell to Rs 391.9 billion, or 12.3 percent of GDP in 2000. Year to year developments in equity market mostly reflected the political uncertainty brought about by frequent change of governments and sanctions imposed on Pakistan following nuclear detonation in 1998.

A market for corporate paper began to develop after private companies were allowed to issue Term Finance Certificates (TFCs) in FY95 to raise resources. Establishment of Pakistan Credit Rating Agency (PACRA) also provided a supporting infrastructure in terms of rating process. Progress was slow in the beginning due to presence of bonds with very high coupon rates, issued by some public sector enterprises, and carrying the guarantee of the federal government.[4] However, after the decline in short-term rates, and consequently in long-term yields, market for TFCs picked up with four new issues in 1999 alone. Two important policy changes aided in promoting TFC market. First, NSS rates were reduced in mid 1999 and again in 2000. Second, institutional investment was banned for NSS from March 2000. Five new issues of TFCs came to market in 2000 and with the launching of Pakistan Investment Bonds (PIBs) in December 2000, it is expected that TFC market will flourish further as pricing becomes easier with PIB benchmarks.

Structure of foreign exchange market did not transform quickly because the process of liberalization, initiated in early 1990s, was mainly concentrated in areas other than exchange rate regime. Permission to open resident foreign currency accounts started to contribute visibly in the deposit mobilization and credit expansion from commercial banks. Mobilization of FCAs was fuelled initially by the absence of any forward cover fee in the initial phase of the scheme. Later in July 1992 when fee was imposed,[5] its level was set on lower side with high implicit subsidy, that continued to attract increasing volume of foreign exchange in these accounts, mostly through dollarization made possible by the inception of money changers in early 1990s. Total foreign currency deposits mobilized by banks and NBFIs increased from $ 2.6 billion in June 1991 (at a compound average growth rate of 21.6 percent per annum) to $ 11.2 billion in April 1998, a month before the nuclear detonation by Pakistan to match the Indian initiative.

Although the reforms specific to foreign exchange market were started from March 1998, permitting authorized dealers to fix their own buying/selling rates for US dollar within the band widened from 0.5 to 1.0 percent, the reform program went off-track due to the balance of payments and confidence crisis triggered by nuclear detonation and subsequent freezing of foreign currency accounts. Major structural change came with the introduction of multiple exchange rate system in July 1998, which was gradually unified and transformed to a free-floating exchange rate regime.

Transformation to the free float was achieved first by the introduction of a floating inter-bank rate (FIBR) determined by market forces, side by side with the official SBP rate fixed initially at Rs 46 per

[4] For example, Wapda Bond which carried government guarantee besides offering coupon rates as high as 19 percent per annum.
[5] This fee was initially imposed only on US$ denominated FCAs in July 1992, but later extended to other currency denominations FCAs in December 1993.

US dollar while the former usually set by the market at comparatively depreciated levels. The pre-specified ratio (originally being 50:50) of these two rates determined their weighted average, known as composite rate. Subsequently, role of the FIBR was gradually enhanced by changing this ratio to 20:80 in December 1998, 5:95 in March 1999, and finally to 0:100 on 19th May 1999 when FIBR started covering all transactions. However, after only a few days an unofficial cap was imposed on FIBR, which remained in place for almost a year. The cap was revised upward twice in June 2000 and subsequently removed on 20th July 2000 giving way to the free-floating exchange rate regime.

Impact Analysis of Financial Reforms

As stated earlier, objectives of the reforms were to create a level-playing field for instilling competition in financial institutions, strengthening their governance and supervision, and adopting a market-based system of monetary, exchange and credit management for better allocation of financial resources. Specific achievements were expected in terms of greater ownership of private sector in financial institutions; increased financial depth, intermediation and efficiency; reduced interest rate spread; better management of domestic debt in terms of cost and sustainability; reduced segmentation in government debt market; reduced distortion in term structure of interest rates; reorientation of monetary policy from direct to indirect control; enhanced efficacy of monetary transmission; and increased effectiveness of SBP in supervising banks.

In terms of private sector ownership, financial sector witnessed a radical shift in the banking sector towards decreased control of government. Assets share of public sector banking companies fell from 92.2 percent in 1990, after establishment of new private banks and privatization of MCB and ABL in early 1990s, to 54.0 percent in 2000. Combined share of private, privatized and foreign banks, consequently rose from 7.8 percent in 1990 to 46.0 percent in 2000. Public sector ownership in overall financial sector (including banks, NBFIs and CDNS) declined from 94.7 percent in 1990 to 70.0 percent in 2000.

In terms of financial deepening, a one time jump was witnessed in the ratio of M_2 to GDP during FY93 from 41.7 to 44.4 percent, which increased the average ratio of 39.2 percent observed in the pre-reform 1980s to 43.5 percent during 1990s. However, this increase was largely brought about by the opening of resident foreign currency accounts that later caused serious balance of payments problems. When compared with peer countries, financial depth in terms of M_2 to GDP ratio improved only marginally in Pakistan during 1990s. In India, the ratio went up from 42.7 percent in 1990 to 56.9 percent in 2000. In Philippines, depth increased from 34.2 to 62.5 percent, Malaysia from 64.4 to 102.6 percent and in Turkey from 23.9 to 44.6 percent during the same period. Pakistan was at the mid of peer group of countries in terms of financial depth in 2000.

The extent of financial intermediation could be assessed by the currency to deposit ratio, with lower value indicating relatively higher level of intermediation. The ratio declined from 51.4 percent in 1990 to 34.3 percent in 2000, indicating substantial improvement in intermediation. The same trend was also observed in currency to GDP ratio that decreased from 14.7 percent to 12.9 percent during the same period. However, among the selected group of six peer countries Pakistan had the highest currency to GDP ratio. Besides, it was the only country excepting India with double digit value, showing the presence of large informal sector in their economies.

Financial efficiency could be gauged by interest rate spread.[?] It increased from 3.9 percent in 1990 to 4.7 percent in 2000, indicating decreased efficiency. Spread between weighted average lending and deposit rates widened much further, from 2.4 percent in 1990 to 8.1 percent in 2000. However, the latter should be interpreted with caution. In the pre-reform period, interest rates were controlled from both sides, with floors on deposit rates and ceilings on lending rates. Therefore, their widening

[?] It is the difference between effective return on assets and interest expense on interest paying liabilities.

indicated the change from repressed to a liberalized interest rate regime. Moreover, compared with the interest rate spread, the spread between weighted average lending and deposits rates is an inferior indicator of efficiency. This is because the former takes into account lending as well as investment activities, whereas the latter does not. Nevertheless, the fact remained that reforms could not succeed in increasing the efficiency of banking sector, when measured in terms of interest rate spread.

Admirable improvement was, however, witnessed in terms of increase in credit allocative efficiency. The share of concessionary and mandatory credit in total private sector credit declined from 44.2 percent in FY90 to 31.4 percent in FY00. Sectoral distribution of credit did not show significant change in 1990s, except for the increase in share of manufacturing from 42.5 per cent in the first half to 50.9 percent in second half, and a decrease for agriculture from 20.4 percent to 14.7 percent in the corresponding periods. Some inroads were, nevertheless, made in bringing down the share of credit to the government from 48.5 percent in 1990 to 41.8 percent in 2000. Performance of Pakistan was also admirable in this regard when compared with peer countries. Share of credit to government went up in Bangladesh, Philippines and Turkey during this period. Whereas, it fell in case of India, Sri Lanka and Malaysia. However, the level of share in Pakistan in 2000 was still very high compared with the peer country average of 29.5 percent.

Debt management reforms were expected to stabilize the level and cost of domestic debt to a sustainable level in the long run. However, interest costs as well as debt levels continued to rise at a fast pace in post-reform decade, albeit at a pace lower than that observed in pre-reform decade. It must be acknowledged at the outset, that the domestic debt burden was already very high when reforms started. Annual average rate of increase in nominal debt during 1980s was 20.4 percent, with unfunded debt comprising NSS at 28.3 percent. Some of the measures like discontinuation of costly Khas Deposit Scheme in February 1990 (with annual profit rate of 13.4 percent per annum and 68 percent share in NSS) did succeed in decelerating the interest costs, but others like the introduction of FIBs with high coupon rates and increase in yield of replenishment T-bills from 0.5 percent to market-determined weighted average yield, worked in opposite direction, together with the introduction of SSCs, RICs and subsequent increase in their profit rates and those of DSCs.

Reforms did result in a favorable impact in the first half of 1990s in decelerating the nominal as well as real debt levels. The pre-reform decade of 1980s witnessed a per annum growth rate of 20.4 percent, whereas post-reform decade of 1990s registered 15.7 percent per annum. However, the deceleration was not enough to make the earlier pace sustainable, due largely to effective reversal of reforms that again increased the profit rates of NSS and created new dis-intermediation pressures. Consequent impact on government budget was astronomical. Interest expenditure as percent of total revenue rose from 29.4 percent in FY90 to 49.5 percent in FY00. Interest expenditure in terms of GDP rose from 4.7 percent in FY90 to 8.1 percent in FY00.

Improper sequencing together with weaknesses in design of debt management reforms were both possibly at fault for the mounting debt burden as well as dis-intermediation of the financial system. Premature liberalization of government debt market in developing countries seldom lead to fiscal restraint, rather it became easier for these countries to get into trouble through rapidly rising interest expense on domestic debt. Thus, fiscal reforms should have preceded the financial reforms. However, the opposite sequencing was followed, probably because the fiscal reforms were the hardest to implement. Even within the financial reforms, debt management reforms were implemented first in early 1990s, instead of the banking institutional reforms, that should have been implemented first but had to wait till 1997.

Despite failing with regard to the objective of achieving domestic debt sustainability, debt management reforms succeeded in providing the necessary infrastructure and supporting environment for reorientation of monetary policy, away from instruments of direct control towards market-based monetary management. Once SBP was empowered to change the basic monetary instruments like CRR, SLR and SBP 3-Day repo rate, establishment of primary and secondary markets of T-bills and FIBs prepared the arena for implementation of open market operations, after the abolishment of credit deposit ratio and caps on maximum lending rates of Banks and NBFIs.

Monetary transmission mechanism of the pre-reform period that allocated the credit through quantitative rationing, quickly changed and firmly established the credit channel through increasing efficacy of short-term interest rates as price signals. Transmission of monetary policy changes began to impact the money market immediately in terms of very quick changes in short-term money market rates, and with some lags, on banks' lending rates on fresh advances. However, the transmission mechanism through the traditional interest rate channel is still not very effective due to lack of a home mortgage market and absence of consumer financing of durable goods. Exchange rate channel that was already present through its effects on imports, exports and inflation, got also linked with the short-term interest rates after establishment of free float regime.

One of the most crucial sets of reforms that would continue to influence the financial sector, was the banking sector reforms implemented in late 1997. These encompassed not only the institutional strengthening and restructuring of nationalized banks and DFIs, but also those of supervisory authorities. Effectiveness of SBP supervision over banks was strengthened significantly after adoption of CAMELS framework, revision of disclosure requirements for banks and NBFIs in conformity with international standards, prescription of risk-weighted system of capital requirements and increasing compliance in adopting Core Principles of Effective Banking Supervision formulated by the Basel Committee. SBP is now fully or largely compliant in twenty-two out of twenty-five core principles and progress is underway to achieve full compliance. Furthermore, human resource quality of SBP officers has considerably been improved through extensive training in off-site surveillance and on-site inspection.

Future Direction of Reforms

Although Pakistan's financial sector has achieved a more competitive market structure with the expanding market share of private and foreign banks, there are still some major weaknesses particularly with respect to the efficiency of the banking sector. These include a highly infected loan portfolio and higher administrative cost reflected in widened spread between lending and deposit rates. These problems stemmed from a failure of governance and a breakdown of prudent credit culture. Thus, there is a great need to improving the environment in the banking sector for the required good governance and credit discipline, which are essentials for an efficient, sound and competitive banking system.

The reforms program should aim at the privatization of the state-owned commercial banks and larger development finance institutions, the enhancement of the authority and capacity of the State Bank to supervise and regulate the banks effectively, and the improvement of the legal and judicial processes for enforcing financial contracts. To arrest bad debts, a comprehensive strategy is needed which requires rationalization of the whole financial sector and coverage of four main areas: 1) a well functioning legal framework without any loop-holes; 2) strengthening and improving regulatory framework; 3) strengthening and widening the scope of Corporate and Industrial Restructuring Corporation to assume non-performing loans and assets and; 4) privatization of nationalized banks, merger/amalgamation of smaller banks and reduction in the number of DFIs.

For good corporate governance, the State Bank requires not only a continuous strict scrutiny but also strict adherence to the defined criteria for appointments of Chief Executive of public sector banks/DFIs to prevent intervention by the government and politicians. Ensuring SBP full autonomy in devising and applying its monetary policy requires establishing legal limits to the amount that it can advance to the government. To remove distortions in resource mobilization, the government financing mechanism through NSS needs to be made more conducive to overall financial sector development. To remove the segmentation and increase the efficiency, merger of official and kerb markets of foreign exchange is required through transformation of existing licensed money changers into Exchange Companies with enhanced regulation.

To enhance competition and efficiency, consolidation of small institutions into bigger units is required which can be done by focusing on the legal and regulatory framework and on the mode of funding by institutions and deregulating the business side. Consequently, in the long-term, the financial system should be well served by a three-tier structure. Top tier will consist of strong universal banks providing credit and financial services to large-scale industries and other corporate clients, consumer financing, in addition to operating internationally. 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 micro-finance institutions in public and private sector. The focus of this tier will be to provide credit and financial services to micro, small and medium enterprises, in addition to meeting specialized credit requirements for exports, agriculture and rural sectors. The third tier is conceived to consist of private non-bank financial companies resulting from the consolidation of existing fragmented NBFIs. They will undertake equity under-writing, merger and acquisition, asset management, corporate bond issues, securities trading, leasing, venture capital etc. This tier will be governed and supervised by the Securities and Exchange Commission of Pakistan (SECP). Implementing these reforms would result in self-sustained, sound and commercially viable financial institutions in Pakistan.