



Governor's Message

The Annual Performance Report of State Bank of Pakistan (SBP) provides an opportunity to take stock of institution's performance and offer report of accountability to all stakeholders and public at large. Like a number of central banks, SBP has legal mandate to perform multiple functions. The principal mandate, however, is to secure monetary and financial stability and foster a dynamic and sound financial system so as to achieve sustained and equitable economic growth in the country.

In delivering these responsibilities, SBP has steadily transformed and strengthened itself over the years to adapt modern approaches and modalities and international best practices in all principal areas of its policy mandate and operations. In the annual report, SBP management and staff have also attempted to capture the broad direction of structural reforms and policy debates underway in the central bank as well as banking industry to serve better the economic and social requirements.

Qualitative Changes in Monetary Management

Serving its legal mandate of achieving price stability, while promoting sustainable economic growth, SBP's monetary policy has helped contain core inflation. In the last year, SBP brought about substantive changes in the formulation, management and conduct of monetary policy. To further strengthen monetary policy framework, SBP has streamlined formulation, synchronization and implementation of monetary policy and is reviving financial programming and macroeconomic modeling to help feed in broader economic developments in monetary policy making process while ensuring consistency in monetary and macroeconomic framework. SBP Central Board invoked Section 9A of the SBP Act, 1956 and imposed annual ceiling on government borrowings and has also communicated to the Government its quarterly borrowing limits. These changes in debt policy, leading to reduction in reliance on central bank borrowing, should augur well for easing the monetary pressure, though ultimately scaling down of Government borrowings from banking system would be more desirable and would minimize crowding out of private credit.

Besides using standard tools, like adjustment in reserve ratios and increase in policy discount rate, SBP has proactively pursued Open Market Operations (OMOs) to mop up excess liquidity from the banking system. Monetary tightening yielded results while the aggregate demand pressures were contained and the core inflation (refers to non food non energy inflation) declined from 7.1% to 5.7%. Despite the high and rising level of external current account deficit, SBP exchange rate remained stable during FY07.

Monetary policy formulation process has also considerably benefited from the formation of a more comprehensive Monetary Policy Committee within central bank and replacement of the National Credit Consultative Council with a Private Sector Credit Advisory Committee. Other

consultative forums facilitating credit policy and delivery mechanisms such as SME and Agricultural Credit Consultative Committee have also played their due roles.

Exchange Rate and Reserve Management

During FY 2007, the forex market in the country continued to grow both in capacity and volumes. The exchange rate depicted a stable trend with healthy volatility reflective of prevailing demand and supply conditions. SBP provided an enabling environment to the market forces for playing their due role in determination of exchange rate. During the year, support for POL products continued where SBP remained a net buyer of USD 192 million as against a net seller in the previous year. In addition to financing the external current account deficit, the strong inflow of foreign remittances that reached record high levels, helped Pakistan build up foreign exchange reserves to unprecedented levels touching \$16.1 billion (31.5 weeks of imports) as of end September 2007.

Banking Sector Regulation & Supervision

Banking system is one of the best performing sectors of Pakistan. The enhancement in its capacities has facilitated significant growth in private sector credit which has helped promote broad based economic growth consecutively for the last few years. Growth in the size of banking industry and its profitability has had several positive impacts. The banks contributed almost Rs.39.5 billion annual taxes to Government, allowed over 30% of stock market capitalization, provided job opportunities to 117,856 persons and extended financial services to almost 26.6 million people in the country. The banking system mobilized cumulatively about USD 3.0 billion foreign inflows (including foreign direct investments and Global Deposit Receipts) over the last five years. This has helped mergers and acquisitions in the banking sector that in turn facilitated its consolidation. SBP introduced and implemented broad based policy reforms to ensure that the banking sector is robust and sound. A steady rise in capital requirements has allowed the increase in capital of banks to USD 3.2 billion. Similarly, the enforcement of prudential regulations helped to bring down the non-performing loans to record low levels with exposure to different groups and sectors well balanced.

The work on consumer concerns and protection is underway. Banks have now managed to raise deposit rates, though at slow pace, but offering different product ranges has helped steady growth in deposits. Similarly, an improved branch licensing policy allowed us to focus on the expansion of banks' branch network towards underserved areas, reduce financial exclusion and promote national savings. SBP also strengthened its own supervisory and regulatory capacity which allowed effective vigilance of banks/DFIs.

Recognizing that complacency in this financially integrated world would not be desirable, banks are positioning to augment their provisioning, strengthening risk management frameworks and bracing for more rigorous enforcement of internal audit and controls. Pakistani banks are also preparing themselves for further rise in the Minimum Capital Requirement (MCR), implement the road map for Basel-II, enhance corporate governance, adopt better technological solutions and improve credit information systems.

On the supervisory front, though largely unseen by the public, SBP through its various regulatory actions has strived to nudge the banks towards a more transparent and fair banking culture with consumer protection and awareness at the heart of these initiatives.

Broadening Access of Financial Services

Financial inclusion is a new and most important corporate social responsibility of central banks. Several initiatives are underway to improve access to financial services. A comprehensive Microfinance Strategy approved by the Government in February, 2007, is now well under implementation. A visible result is doubling of microfinance borrowers reaching 1.4 million as of August 2007. Institutional restructuring by way of expansion in microfinance banks and transformation of microfinance financial institutions/non-governmental organization into licensed microfinance banks should help microfinance institutions to emerge as more prominent players. Concurrently, new liquidity support mechanisms, technological solutions, credit enhancement and credit bureau system and other initiatives should all help deepen penetration, among others, in rural areas.

For the promotion of agriculture finance, SBP has developed a strategy which aims towards increasing the outreach level from 1.6 million to 3.3 million farmers in next 3-4 years. In order to achieve this target, SBP is removing the existing regulatory hurdles, ensuring an enabling policy environment, conducting research while focusing on development of Islamic products for agriculture finance and encouraging mobile banking for increased outreach and disbursements. Dealing with collateral issues through introduction of group based lending mechanism, corporate farming, development of collateral-free products; crop loan insurance mechanism and capacity building both at SBP and the commercial banks are also being prioritized for more focus.

Supporting Small and Medium Enterprises (SMEs) development policy, SBP has issued prudential regulations specifically designed for SME lending and is also working with the Government to enhance coverage and access. A Housing Advisory Group has finalized its recommendations toward removal of hurdles in financing for this sector.

Islamic finance is rapidly emerging in Pakistan. As six licensed Islamic banks take stronger foothold it will play a key role in extending financial services to un-banked population. SBP Shariah Advisory Board has been instrumental in approving Shariah manuals and standards. The task force has also submitted its recommendations to the Government for introducing Shariah compliant liquidity instruments. Further, SBP played a proactive role in the Islamic Financial Services Board which is now a well recognized international standard setter for the Islamic banking industry.

Strengthening of Payment Systems

The robustness of payment system is gaining increasing significance in the wake of automation and complexity of financial transactions. The FY 2007 saw the enactment of Payment Systems & Electronic Fund Transfer Act. This Act provides a regulatory framework for strengthening payment systems and e-banking in the country. By the same token, SBP is providing enabling environment for increasing the scope of e-banking by allowing the banks to accept payment of utility bills through ATMs. This step will not only provide convenience to customers of utilities but will also open up business opportunities for banks and the utility companies.

SBP is also in the process of linking up banking sector-wide electronic payment system through Real-Time Gross Settlement System (RTGS) named PRISM (Pakistan Real Time Interbank Settlement Mechanism). The PRISM when implemented will provide the capability to settle inter-bank transactions whether clean or against securities on real time basis and minimize the settlement risk for the participants involved.

Corporate Governance

SBP maintained high standards of corporate governance. In order to further improve the overall governance structure, in addition to implementation of cluster based reorganization, all the committees to the Central Board of Directors were reconstituted and their Terms of References were revised. Further, Board for National Institute of Banking & Finance (NIBAF)-one of the subsidiaries of SBP- was improved whereby prominent economists and individuals from academia were appointed. This allowed us to focus on its overall management and up-gradation of training programs. This enterprise-wide restructuring process permitted us to improve the overall governance. Further, in the wake of growing need for complex financial services to stakeholders, including the government, a change management exercise has been planned at our other subsidiary i.e. SBP-BSC.

Human Resource Initiatives

Recognizing that success of an institution hinges on the structural efficiency of an organization along with overall competence and commitment of staff, SBP has strengthened its organization and introduced a new Human Resource Development Strategy.

SBP has been successful in attracting seasoned professionals from reputed overseas financial institutions into areas like treasury, information technology, corporate services and research. At SBP our selection and training process is both a centripetal as well as centrifugal phenomenon where exposure to SBP is coveted by its talented staff members and the financial institutions find in our staff members competencies hard to find elsewhere.

In order to keep our staff motivated the primary focus remained on development of HR policies & procedures which could help institute a performance based culture in the bank. Some of the major achievements include the launch of New Compensation and Benefits Structure (NCBS) for officers in OG-2 & above, (including employees in Separate Salary Structure for Specialized Professionals) and the Voluntary Separation Scheme (VSS) for employees in OG-1 & below.

Information Technology & Infrastructure Development

SBP has successfully completed all the major projects with regard to implementation and up-gradation of Oracle ERP system, GLOBUS and Data Warehouse applications. The steps undertaken to improve Information Systems & Technology have translated into smooth functioning of SBP's business processes and operations. In order to ensure the integrity of information stored and processed a separate IT Security Division has been established which is responsible for defining Policies & Procedures of IT Security and Risk Management. During the year, SBP drafted the policies on IT Change Management, IT Incident Response and IT Physical Security. SBP further launched a department-wise information security risk assessment of core IT assets and renewed the ISO 9001:2000 certification.

Moving forward, while SBP will continue to perform its role and responsibilities with highest level of integrity and ethical standards our primary emphasis for next year will again be towards maintenance of monetary and financial stability. The banks will be steered to nurture access to development finance, adopt Basel-II, strengthen capital base and implement technology. High standards of regulation and supervision with an emphasis on improving quality of service and efficiency will be enforced.

I would like to acknowledge the role of members of the Central Board of Directors whose timely and effective guidance has strengthened the governance of the central bank. I would also acknowledge the dedication of staff for their continued hard work which has helped SBP to enhance its performance across the board. Finally, I urge the SBP employees to continue their efforts to take the central bank to new heights.

Dr. Shamshad Akhtar
Governor