Strategic Objectives of SBP

1. Broadening Access of Financial Services
2. Ensuring Soundness of the Financial Sector
3. Maintaining Price Stability with Growth
4. Exchange and Reserve Management
5. Strengthening of Payment Systems

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1 Broadening Access of Financial Services

1.1 Overview

There is a large and growing body of literature on development economics which establishes a correlation between economic growth, development and financial inclusion. For decades, the financial intermediation in Pakistan remained accessible mainly to the corporate sector. However, over the years, SBP in confluence with other stakeholders which include government and the banking sector has been making efforts to provide an enabling environment for financial broadening. In this perspective, Small & Medium Enterprises & Micro Finance, Islamic banking, Housing & Infrastructure financing and agriculture credit were the main areas of focus in its development finance paradigm.

The SME sector has its own dynamics which are different from those of the corporate sector. SBP recognizing this fact issued prudential regulations specifically designed for SME lending. The downscaling approach for SMEs, introduced last year by SBP provided the commercial banks with the skill-set needed to expand their outreach. Similarly, microfinance was utilized as an effective tool for making financial intermediation accessible to the poor. SBP in FY 2007 rolled out its Microfinance Outreach Strategy which was approved by the Prime Minister. This strategy provides a comprehensive roadmap for the development of microfinance in Pakistan.

Housing & Infrastructure financing received major attention of SBP in the year under review. The Housing Advisory Group and SBP Task Force on Infrastructure Finance were constituted to make recommendations for removing hurdles in the way of financing for these two important sectors of the economy. In the realm of Islamic banking, a number of initiatives were undertaken last year whereby Shariah compliance mechanism was strengthened. A task force was also constituted to recommend liquidity management, and Shariah compliant products and draft guidelines for Islamic microfinance services were issued for downscaling Islamic banking facilities.

In view of the contribution of agriculture in the economy, agriculture finance remained a crucial part of credit to the private sector. The fundamental changes introduced by SBP in agricultural financing over last few years have transformed the sectoral banking business. The market based incentives allowed the private commercial banks to outperform the specialized institutions like ZTBL and PPCBL whereby banks exceeded their indicative target for financing by 23percent. In order to further strengthen agriculture financing environment, SBP issued Guidelines for Financing of Fisheries, held meetings with farmers to explain the important features of agriculture financing, carried out capacity building both at SBP and the commercial banks and more importantly worked on development of a strategy to expand the overall coverage of agriculture financing from today's 45percent to 75percent in next 3-4 years.

1.2 SME Finance

Small and Medium Enterprises (SMEs) are the growth engines of any economy due to their ability to create jobs, foster entrepreneurship and to provide depth to the industrial base of the economy. There are 3.2 million business enterprises[1] in Pakistan, and SMEs constitute over 99 percent of the aggregate. The share of SMEs in industrial employment is estimated at 78 percent, in value

[1] Economic Census of Pakistan –National Report May, 2005 (www.statpak.gov.pk). The census does not give us precise number of SMEs based on SME definition prescribed by SBP or SME Policy.

addition is approximately 28 percent and in manufacturing export earnings at 25 percent. Nearly 53 percent of all SME activity is in retail trade, wholesale, restaurants and hotel business whereas the contribution of industrial establishments and those involved in service provision is 20 percent and 22 percent respectively. The contribution of SMEs (defined on the basis of number of employees) is over 30 percent to GDP, 25 percent in export earnings and 35 percent in manufacturing value addition.[2]

According to a market study conducted by consultants from Bankakademie, 30.7 percent of SMEs do not have a bank account at all, 85 percent do not take any loan from banks, and 50.5 percent consider it very difficult to get loans from a bank. Lack of collaterals, time and cost involved in the process of preparing financials, time consuming disbursement process at banks, lack of innovative products, and bureaucracy in banks are the main obstacles in the way of SMEs to access formal financial intermediation channels. Table-1.1 below gives profile of credit to private sector.

(Rs. In Billion)

Table-1.1: Credit to Private Sector- A Profile

Sectors of Economy	Dec-04		Dec-05		Dec-06	
	Amount	Share (%)	Amount	Share (%)	Amount	Share (%)
Corporate Sector	873.0	53.9	1,076.2	52.7	1279.1	53.3
SMEs	**284.0**	**17.5**	**361.4**	**17.7**	**408.3**	**17**
Agriculture	119.3	7.4	138.0	6.8	141.9	5.9
Consumer Finance	152.6	9.4	252.8	12.4	325.2	13.5
Commodity Operations	122.1	7.5	140.6	6.9	171.9	7.2
Staff Loans	40.8	2.5	42.4	2.1	48.0	2.0
Other	28.6	1.8	31.6	1.5	26.4	1.1
Total	1,620.4	100.0	2,043.0	100.0	2,400.8	100.0

The profile of credit disbursement supports the above quoted study that SMEs financing is still a small share of the total credit off-take by the private sector. The major portion of SME financing is used for financing working capital which constituted 76 percent of total lending for the year ended December 2006, followed by trade financing and long-term/fixed investment.[3] The break-up of lending to SMEs by nature of facilities is mentioned in Table-1.2 & Figure-1.1 below:

It is encouraging to note that the outreach of the banking system to SMEs has increased from 67,520 to 168,233 borrowers (149 percent) for the period Dec. 02-Dec. 06. In spite of the fact that this growth is much lower in comparison to increase in number of borrowers for consumer finance, which increased by 967 percent during the same period[4]; market participants do claim that some of the consumer finance obtained through unlocking of equity might have been used by SMEs for business purposes.

[2] Economic Survey of Pakistan 2003-04
[3] Quarterly data reported to Banking Supervision Department (now Offsite Surveillance and Enforcement Department)
[4] Quarterly data reported to Banking Supervision Department (now Offsite Surveillance and Enforcement Department)

Fig-1.1 Lending to SME

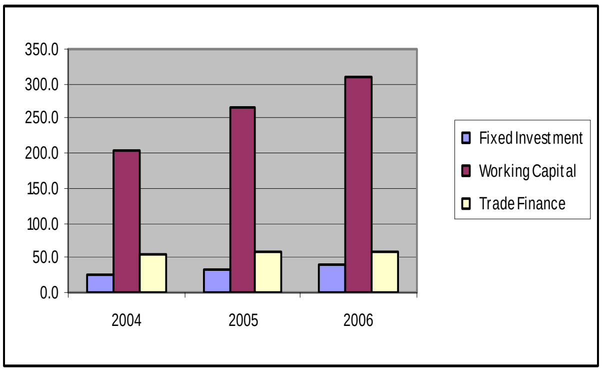


Table-1.2: Break-up of lending to SME by nature of facilities			
Nature of Facilities	**Dec-04**	**Dec-05**	**Dec-06**
Fixed Investment	23.9	34.1	41.8
Working Capital	204.2	267.7	308.4
Trade Finance	55.9	59.6	58.1
Total	**284.0**	**361.4**	**408.3**

1.2.1 Market for SME Finance in Pakistan

The results of a demand survey conducted in Punjab by Business and Finance Consulting in year 2005 suggests that the total credit demand of small businesses in Pakistan (with credit demand in the range of one hundred thousand rupees to six million rupees) is at least Rs. 500 billion.

1.2.2 SBP's Initiatives for Growth of SME Finance

- Issuance of Separate Prudential Regulations for the SMEs, which allow banks/DFIs lending to SMEs on the basis of asset conversion cycle/cash flow basis with a clean lending limit of Rs.3 million.

- To facilitate the banks in accessing the SME sector, SBP has, inter alia, allowed banks clean lending to SMEs up to Rs.3 million (Rs.2 million for funded and Rs.1 million unfunded). This facility would allow the banks to be more innovative and develop different SME specific products to increase the outreach.

- Banks are encouraged to adopt downscaling approach in SME finance. For this, under the Asian Development Bank (ADB) Technical Assistance, M/s IPC, Germany prepared a Report on "SME Finance via Downscaling Approach" for banks in Pakistan, which was disseminated through a seminar for facilitating the banks to use this report for developing their SME Lending units.

- Introduction and implementation of "Downscaling approach" in collaboration with multilateral institutions, namely, ADB, World Bank and DFID. The downscaling approach is designed to provide existing commercial banks with the technical know-how they need in order to be able to disburse loans to very small and small and medium enterprises. During Year 2005-2006 a German firm, named M/s Bankakademie provided some assistance to SME Bank and Bank Alfalah on cost sharing basis while more banks will be provided technical assistance to implement downscaling approach on similar lines. This approach includes building whole spectrum of lending infrastructure within a bank ranging from establishment of SME lending units, IT, product development and training of staff.

- SBP, in collaboration with SMEDA conducted a series of seminars for the benefit of SMEs on "SME Products and Delivery Channels by the Banks". These seminars were conducted at SME hubs locations in the country and were widely attended by small entrepreneurs. Another series of seminars on "Hassle Free Business Environment for SMEs" is being arranged in collaboration with SMEDA for which the first seminar was held in May, 2007 in Karachi.

- SBP conducted two Training workshops on SME lending for bankers, through local and German experts, in which around 100 bankers from different banks/DFIs participated. SBP also organized a Three-day Seminar on SME Finance under the aegis of SAARCFINANCE (a network of Central Bank Governors and Finance Secretaries of SAARC Region).

- On the advice of SBP, banks have established dedicated SME branches. These branches are collaborating with SMEDA and provide all the necessary information relating to finance along with guidance on how to become bankable.

- State Bank in its different credit schemes namely: 1) Long Term Financing of Export Oriented Projects; 2) Locally Manufactured Machinery (LMM); and 3) Export Finance Scheme (EFS) paid special attention to financing needs of SME Sector.

- SBP, in collaboration with ADB commissioned a feasibility study to strengthen secured transaction regime which will help develop a system that makes it efficacious for financial institutions to accept movable property as collateral. This was particularly important for improving SMEs' access to credit as they are more likely to be able to post movable property as collateral. A robust and secured transaction regime will help improve the enforcement of repossession and sale of movable property. The objective of this reform is to design methods that could shift a bulk of repossessing and selling of collaterals away from courts.

1.3 Performance of Micro Finance Banks

Pakistan's Microfinance landscape though evolved initially from a non-regulated paradigm (NGOs, Rural Support Program etc.) has seen increasing penetration of regulated institutions after the Year 2000-01 when the formal financial sector was opened to Microfinance Banks (MFBs). This was the first major step towards integrating microfinance in the financial sector development strategy. The MFBs established under the Ordinance in the Year 2000-01, have been operating within the regulatory and supervisory framework of SBP. Recognizing the challenge to serve a potential market comprising of 25-30 million clients, our microfinance policy framework allowed institutional diversity as both regulated (Deposit-taking) and non-regulated (Non-Deposit-taking) institutions were allowed to cater to financial services needs of the poor.

During the Year 2006, market share of the regulated MFBs rapidly increased. Similar growth was also observed in other areas including provision of an enabling policy environment; supportive infrastructure; institutional development through development of alternate delivery channels, human resources, use of technology and outreach enhancement in the form of number of microfinance banks. The continuum of Pakistan MF banking industry in the last six years presents a sequence of ownership/sponsorship interests initiated first by the Government in the form of pioneer public-private partnership model MFB, followed by social investors' initiative of establishing MFBs and entry of commercial investors (both local & foreign) in the market. The commitment of GOP and SBP has helped in laying foundation of the sector which holds promise for broadening access to finance and expanding the associated business opportunities for commercial as well as social investors. Recently, SBP in consultation with other stakeholders developed a strategy for expanding Microfinance outreach which was approved by the Prime

Minister of Pakistan. This strategy provides Roadmap for expanding outreach from existing one million to three million borrowers by Year 2010.

1.3.1 Institutional Characteristics

All the six MFBs are subject to provisions of regulatory and supervisory framework of SBP. In June 2006, SBP issued guidelines for commercial banks to promote their entry into wholesale and retail microfinance operations. These efforts are expected to allow integration of microfinance into formal financial markets.

1.3.2 Outreach

The pace of outreach expansion in our microfinance industry has been fairly satisfactory. Since the Year 2000-01, microfinance banking industry has experienced a continuous upward growth exhibited in the table-1.3 below:

Table-1.3: Micro Finance Outreach

	2002	**2003**	**2004**	**2005**	**2006**
Institution Age (Yrs)	2	3	4	5	6
No. of Branches	39	56	75	91	145
Total No. of Borrowers	56,939	95,090	177,648	48,091	326,498
No. of New Borrowers	56,939	38,151	82,558	70,443	78,407
Total No. of Depositors	2,773	10,150	18,589	32,577	70,891
No. of New Depositors	2,773	7,377	8,439	13,988	38,134
Average Loan Size (Rs)	6,232	7,969	7,340	9,450	8,721
Average Deposit Size (Rs)	23,231	38,625	25,229	20,867	20,731

Currently, four nation-wide and two district-wide Micro Finance Banks (MFBs)[5] are providing financial services. During CY 2006, combined outreach of micro finance banks exhibited consistent growth where number of borrowers increased by 32 percent and the number of depositors 118 percent. However, this improvement was largely urban based as many of the new branches and service centre opened during CY 2006 were in big urban cities like Karachi, Lahore, Rawalpindi, and Peshawar.

The Pakistan Post Office (PPO) with an extensive branch network and experience in some banking functions like deposits and remittances has been encouraged to consider entry into microfinance service delivery. If PPO decides to initiate microfinance services, it will be a significant boost to outreach enhancement. In addition, ongoing feasibility of branchless banking in Pakistan is a major development activity with the potential for breakthrough in up-scaling of microfinance operations.

[5] Khushhali Bank, First Micro Finance Bank, Tameer Micro Finance Bank, Pak Oman Microfinance Bank, Network Micro Finance Bank and Rozgar Micro Finance Bank

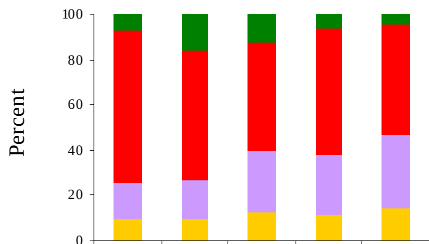
1.3.3 Financial Structure

As the MF sector continues to expand, the overall balance sheet footing of MFBs recorded a 24 percent increase from Rs.8,458 million to Rs.10,514 million in CY 2005 (see Figure 1.2). This year, the growth momentum was somewhat diluted as the largest MFB failed to pursue the previous growth pattern. A critical factor to the bank's conservative strategy was not to start generation of internal funds through deposit-mobilization in the wake of reduced ADB credit lines.

As regards the quality of loan portfolio, it was encouraging to see that the portfolio quality remained satisfactory as NPLs to Assets Ratio declined from 4.4 percent to 1.8 percent. The major reasons for this decline were revised stringent criteria of loan classification and better management of loan quality.

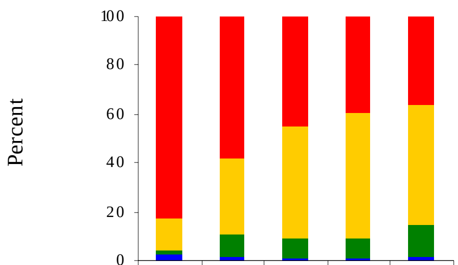
The funding structure continues to be dominated by owners' equity and borrowings (largely from ADB). Some minor adjustments were observed in the funding structure for the last three years as shown in figure 1.3. The borrowings continued to be a major funding component at 48.9 percent followed by shareholders' equity at 36.1 percent. The average capital to asset ratio stood at 36 percent, which indicates 'underleveraged' position of MFBs. However, deposit mobilization remained weak as deposits to total funding ratio only marginally improved from 8.3 percent to 13.5 percent. During CY 2006, two district MFBs also registered a negative trend in deposit mobilization. With the exception of two MFBs rest have not yet developed any strategies or put systems in place for mobilizing deposits.

Figure-1.2: Asset Structure of MFBs



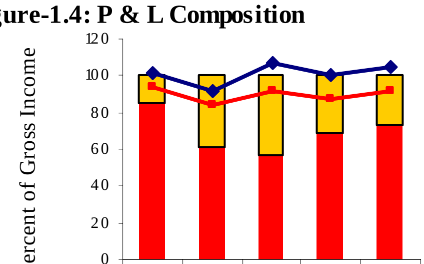
	2002	2003	2004	2005	2006
Cash and Balances	6.8	15.9	12.6	6.5	4.2
Investment	67.2	57.6	47.5	55.4	48.5
Advances	16.0	16.6	27.1	26.7	32.8
Other Assets	9.9	9.8	12.8	11.4	14.5

Figure-1.3: Funding Structure of MFBs



	2002	2003	2004	2005	2006
Equity	82.7	57.9	45.0	39.6	36.1
Borrowings	13.0	31.7	45.8	51.2	48.9
Deposits	2.1	8.9	8.3	8.0	13.5
Other Liabilities	2.1	1.6	0.9	1.2	1.5

Figure-1.4: P & L Composition



	2002	2003	2004	2005	2006
Non Interest Inc	14.6	38.9	42.9	31.7	27.3
Net Interest Inc	85.4	61.1	57.1	68.3	72.7
Operating Exp + Prov	101.1	91.2	106.5	100.2	104.9
Operating	94.2	84.4	91.7	87.6	91.1

1.3.4 Financial Performance

The financial performance of the sector needs improvement. The key factors associated with negative returns were the modest growth of core-revenue generating portfolio (loans), continued inefficiencies and low yields.

Table-1.4: Key Performance Indicators (% age):

	2002	2003	2004	2005	2006
NPLs to Advances	1.59	7.57	7.20	4.40	1.80
Net NPLs to Net Advances	(2.94)	2.72	1.33	0.73	(0.88)
Provisions to NPLs	356.76	65.02	78.27	84.08	147.92
Net NPLs to Capital	(0.58)	0.81	0.84	0.52	(0.84)
Growth in Advances	346.84	49.26	108.79	46.92	50.90
Net Interest Margin	8.39	6.94	6.75	7.79	8.82
Non Interest Income to Average Assets	1.19	3.46	3.81	3.21	3.28
Non Interest Exp to Average Assets	7.68	7.50	8.13	8.84	11.05
Operating Exp to Gross Income	94.16	84.36	91.66	87.60	100.16
ROA	0.02	0.63	(0.49)	(0.20)	(0.36)
Operating Sufficiency	91.40	75.83	71.90	84.06	76.27
Financial Sustainability	45.35	39.33	42.27	51.49	61.89

The share of interest-based income to gross income has been increasing continuously. During CY 2006 its share increased to 72.7 percent as compared to 68.3 percent over the previous year (see **Figure 11.3**). The interest from loan portfolio continued to contribute a higher share towards the interest income of MFBs. The average earning assets also recorded growth of 23 percent, which resulted in an improved share of net interest income to gross income.

1.3.5 SBP Initiatives for Strengthening MF Policy & Supervisory Framework in Pakistan

- **Micro Finance Division (MFD)** at SBP was staffed with personnel having prior experience in regulating the banking industry and exposure to operational & financial dynamics of microfinance institutions. Further, State Bank Partnership for Microfinance (SBPM)-capacity building and skills enhancement program was undertaken with the assistance of Swiss Agency for Development & Cooperation (SDC) which contributed towards capacity enhancement at SBP.

- Under SBPM, separate **On-site Examination and Offsite Surveillance Manuals** were developed by International Consulting Consortium (Inc). These supervisory manuals focused on risk-based supervision principles and the training of SBP staff involved in supervision. This development activity was in line with the functional strategies of SBP inter alia requiring it to focus on financial sector deepening, proactive supervision and regulation of financial institutions. Both these manuals were finalized in May 2006 and are being used for supervision of MFBs.

- Alongside these developments, policy formulation continued to be our focal area of concern at SBP. **The Microfinance Consultative Group** (MFCG) comprising of key stakeholders continued to act as an advisory body for SBP in MF related policy formulation. During the Year 2006, SBP developed the regulations for Loan Classification and provisioning in light of best international practices. The necessary amendments have been made in the existing prudential regulation for ensuring soundness and stability of microfinance industry. In the Year 2006, amendments in MFIs Ordinance-2001 were introduced through the Finance Bill-2006. These amendments while giving more supervisory powers to SBP also open other investment options for MFBs. Another important development was issuance of guidelines for commercial banks for venturing into microfinance business.

1.3.6 SBP's Development Initiatives for Microfinance

- During Year 2006, a dedicated **Development Finance Group (DFG)** was established within the Banking Cluster at SBP. This allowed SBP to focus on its advocacy role of promoting development finance in Pakistan. The DFG is inter alia responsible for fostering an enabling environment to facilitate intermediation of market based microfinance industry for developing institutional capacities. DFG engaged with the existing development partners to further strengthen the relationships so as to maintain focus on ongoing activities planned under pre-agreed contracts. In addition, DFG also explored new avenues of mutual collaboration. In this perspective, DFG entered into dialogue with DFID for developing a partnership program for promoting common development goals under the DFG umbrella.

- In November 2006, GOP & ADB signed a program on **"Improving Access to Financial Services Program (IAFSP)"**. The program comprised of two loans of USD 320 million for supporting the reforms program aimed at improving access to credit and other financial services. These loans will be accompanied by the technical assistance grant of USD 2 million.

- **Workshop on Partnership Model of ICICI Bank, India:** The event was held at SBP on November 1-2, 2006. The objective of the discussion was to find ways for scaling up delivery of a broad range of financial services for poor. The guest speakers at discussion were Mr. Nachiket Mor, Deputy Managing Director, ICICI Bank (2nd largest Indian commercial bank) and his senior members who shared their bank's objectives and methodology for fast growing innovative partnership models with NGOs.

- **One day Workshop with the President of Grameen Foundation, USA:** The Grameen Foundation's executive team comprising of Mr. Alex Counts, CEO and Mr. Bob Eichfields, a senior member of the Board of Directors visited SBP. The team highlighted that GF can provide technical assistance in the areas of funding, technology, and training to Pakistani microfinance organizations.

- **Prof. M. Yunus's Visit to Pakistan:** Nobel laureate, Prof. M. Yunus visited SBP in March 2007. He also delivered a key note address in an Interactive workshop held at SBP Auditorium. A large number of stakeholders both from the financial and MF sector attended the workshop. The event was aimed towards getting an insight of the legendary services of Prof. M. Yunus and the Grameen Bank for economic and social development of the poor.

- **Country-Level Effectiveness and Accountability Review:** At the request of eight development agencies (through the informal donor group) and SBP CGAP conducted a Country-Level Effectiveness and Accountability Review (CLEAR) combined with a Policy Diagnostic Review of Pakistan in November and December 2006. The CGAP reviewers proposed seven priority recommendations, which included sustainability, innovation, entry of new players and approaches, promotion of commercial wholesale market, diversified use of funding instruments, creation of a joint TA facility, increased SBP focus on regulation & supervision and delineation of GOP role as a facilitator.

- **Roundtable Discussion on Branch-less Banking:** The event jointly organized by CGAP, SBP, MOIT, & PMN; was held at SBP in April, 2007. The objectives of the discussion was to clarify the current status of policies and regulations for Branchless Banking, role of the Task Force on M-Banking established by SBP and MOIT, international experience on Business models of Branchless Banking along with associated Regulatory framework and stimulating a discussion on the next steps towards branchless banking in Pakistan. The pursuance of these objectives would promote development and implementation of policies and regulations on branchless banking.

- **Round table discussion with World Women Banking on Negotiating Access to commercial loans/Capital Market:** The event organized by PMN & SBP, was held at SBP in May, 2007. The objective of the event was to prepare MFBs/MFIs to become ‘investment ready’ with a clear understanding of the core requirements necessary to pitch commercial investors as attractive investment potential of microfinance.

- **Interactions with other International Organizations:** In addition to the above, DFG is also engaged both directly and indirectly with various other internationally-recognized organizations like ASA, BRAC, IFAD, KfW, Unitus etc. to stimulate their interest in our microfinance sector.

1.4 Export Finance Regime

The Export Finance Scheme (EFS) has remained one of the major avenues for meeting the funding requirements of exporters. During FY 2007, Rs.328.715 billion was disbursed under EFS by various offices of SBP-BSC (Bank). A comparative position of export refinance is given in Tables 1.4 & 1.5 below.

(Rs. in Million)

Table 1.5:Comparison of the Export Refinance Provided During the year 2006-07 with the previous year

Refinance provided during the FY 2005-06			Refinance provided during the FY 2006-07			percent change of amount provided during FY 2006-07 over amount provided during FY 2005-06		
Part-I	Part-II	Total	Part-I	Part-II	Total	Part-I	Part-II	Total
74,263	189,539	263,802	91,365	237,350	328,715	23	25	25

(Rs. in Million)

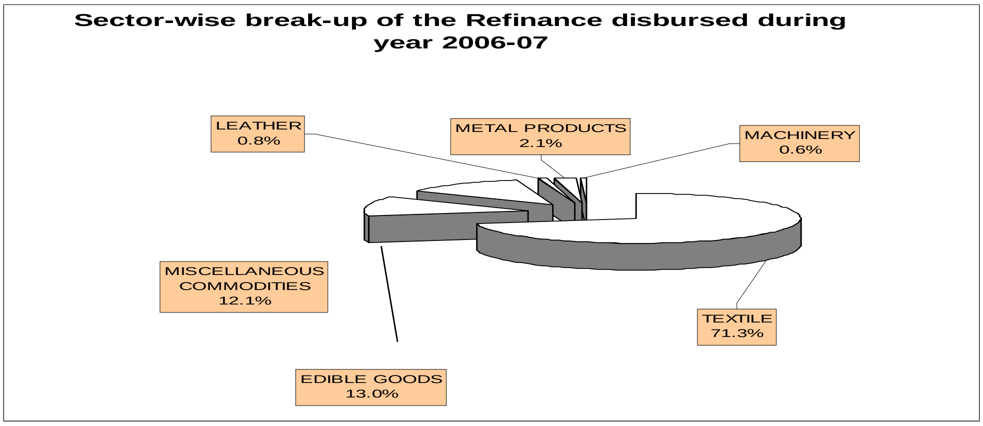
Table 1.6: Comparison of Outstanding Position of Export Refinance as on June, 07with the Outstanding Position as on June, 06

Outstanding as on end June, 2006			Outstanding as on end June, 2006			percent change of amount outstanding end June, 2007 over amount outstanding end June, 2006		
Part-I	Part-II	Total	Part-I	Part-II	Total	Part-I	Part-II	Total
26,974	81,089	108,063	34,654	99,773	134,427	28	23	24

1.4.1 Commodity-Wise Position

The commodity-wise position reveals that the highest amount (Rs.219.823 billion) was disbursed to the textile sector. Within textile sector, Ready Made Garments availed the highest amount (Rs.50.959 billion). Under the edible goods, highest amount was disbursed for export of rice (Rs.32.183 billion). The overall sector-wise break-up is given in the following pie chart.

Figure-1.5



A number of incentives were allowed to all exporters in general and the exporters of Textile Sector in particular viz. (i) allowing debt swap option under LTF-EOP Scheme to exporters of value added textile sector (excluding spinning sector but including its six sub sectors), (ii) reduction in bank spread from 3 percent to 2 percent per annum (iii) permission to allow LTF-EOP financing for import of generators. The option of debt swap provided an opportunity to the value added textile sector to swap their long term loans taken from commercial banks/DFIs, from January 1, 2003 to 31st December, 2006, for import of machinery for units established under LTF-EOP Scheme, which offers mark up rates fixed for the tenor of the loan approximately 5-6 percent below the market rates. SBP provided Rs.34 billion under debt-swap option against the original estimates of Rs.31 billion. Out of Rs.34 billion of debt-swap, privatized banks (including NBP) have swapped long-term loans of Rs.22 billion, followed by private banks for Rs.6 billion, foreign banks for Rs.4 billion and development finance institutions for Rs.2 billion.

In addition to debt-swap, the SBP has also provided a total amount of Rs.15.060 billion as LTF-EOP refinance up to June 30, 2007. Thus, on an overall basis, SBP has provided refinance amounting to Rs.49.06 billion as of June 30, 2007 under the Scheme.

Table 1.7: Rate of Finance & Refinance			
Tenor	**Rate of Finance**	**Rate of Refinance**	**Spread**
up to 2 years	6.00 percent	4.0 percent	2.0 percent
more than 2 years but up to 3 years	6.00 percent	4.0 percent	2.0 percent
more than 3 years and up to 7 ½ years	7.00 percent	5.0 percent	2.0 percent

1.5 Infrastructure Project Financing

There has been a fundamental change in financing of infrastructure projects the world over. The modern approach is based on the concept of Public-Private Partnerships (PPP). In Pakistan, PPP is still in its infancy stage and needs careful nurturing by all stakeholders.

1.5.1 Initiative undertaken by State Bank of Pakistan:

There is a need to develop a market based mechanism to enhance flow of credit to infrastructure finance. In order to accelerate infrastructure development and promote public-private partnership, SBP adopted a number of initiatives for provision of credit to priority sectors like infrastructure and housing finance. These include creation of a department for Infrastructure & Housing Finance, establishment of a Housing Advisory Group (HAG) and SBP Task Force on Infrastructure finance.

- **Housing Advisory Group (HAG):** SBP constituted a "Housing Advisory Group" with representation from the private sector stakeholders. The objective of this group is to review the existing regulatory and policy framework so as to prepare recommendations for promotion and development of housing finance in the country.

- **SBP Task Force on Infrastructure Finance:** SBP has established a task force with representation from the private sector. This task force is mandated to achieve the following objectives;

  - Asses the country's infrastructure needs.
  - Review the problems faced by financial institutions towards provision of infrastructure financing with suggestions for improvement.
  - Identify the potential avenues for infrastructure financing and recommend financial products.
  - Examine available options for exploiting credit enhancement mechanisms.
  - Recommend an institutional mechanism for risk management of infrastructure financing.

- **Impediments for Provision of Housing Finance:** Although, banks have increased exposure to housing finance; they are faced with a number of impediments towards provision of housing finance to general public which include lack of proper property titles; land registration information system and the implementation of foreclosure laws. In the case of low income groups such impediments are further compounded due to difficulties in ascertaining monthly incomes due to non-existence of mechanism for determining monthly incomes and the fact that most of the low income dwellings are situated in shanty towns and irregular settlements without legal/clear title documents.

- **Housing Finance Disbursement and Outstanding:** An analysis of the housing finance portfolio of banks is indicative of the fact that banks are showing strong affinity towards providing housing loans.

(Rs. Million)

Table-1.8: Housing Finance by Banks and HBFC from Dec-03 to Dec-06

	31-Dec-03		31-Dec-04		31-Dec-05		31-Dec-06	
Gross Disbursment	**Amount**	**No.of Laon**	**Amount**	**No.of Laon**	**Amount**	**No.of Laon**	**Amount**	**No.of Laon**
Banks	5,701.30	4,797.00	19,285.10	12,277.00	43,041.00	22,088.00	65,376	27,834
HBFC	31,390.80	420,671.00	33,920.30	427,562.00	36,117.50	433,790.00	38,428	441,386
Total	37,092.10	425,468.00	53,205.40	439,839.00	79,158.50	455,878.00	103,804	469,220
Banks' Share (%)	15.37	1.13	36.25	2.79	54.37	4.85	62.98	5.93
HBFC' Share (%)	84.63	98.87	63.75	97.21	45.63	95.15	37.02	94.07
Total (%)	100	100	100	100	100	100	100	100
Net Outstanding								
Banks	4,097.20	3,542.00	16,712.90	10,552.00	35,973.00	19,112.00	50,906.00	23,409
HBFC	18,293.90	152,084.00	20,139.20	141,779.00	19,319.50	116,577.00	19,048.00	107,575
Total	22,391.10	155,626.00	36,852.10	152,331.00	55,292.50	135,689.00	69,954.00	130,994
Banks' Share (%)	18.3	2.28	45.35	6.93	65.06	14.09	72.77	17.88
HBFC' Share (%)	81.7	97.72	54.65	93.07	34.94	85.91	27.23	82.12
Total (%)	100	100	100	100	100	100	100	100

Table 1.8 reflects that the housing finance has experienced a turn-around. The gross disbursements by commercial banks increased from Rs. 31,390.80 million to Rs. 5,701.30 million. However, the amounts disbursed by commercial banks increased to Rs. 65,376 million in December 2006 as compared to Rs. 38,428 million by Development Finance Institutions (DFIs). Consequently, the share of banks in housing finance increased from 15.37 percent in December 2003 to 62.98 percent in December 2006.

- **Product and Target Market:** Currently, the banks are financing outright purchases as shown in Figure 1.6. At the end of December, 2006, the total outstanding in outright purchases was Rs.34,867.59 million, which was 68.49 percent of total housing finance portfolio.

Fig-1.6: Housing Finance Outstanding by Banks (Rs.Million)

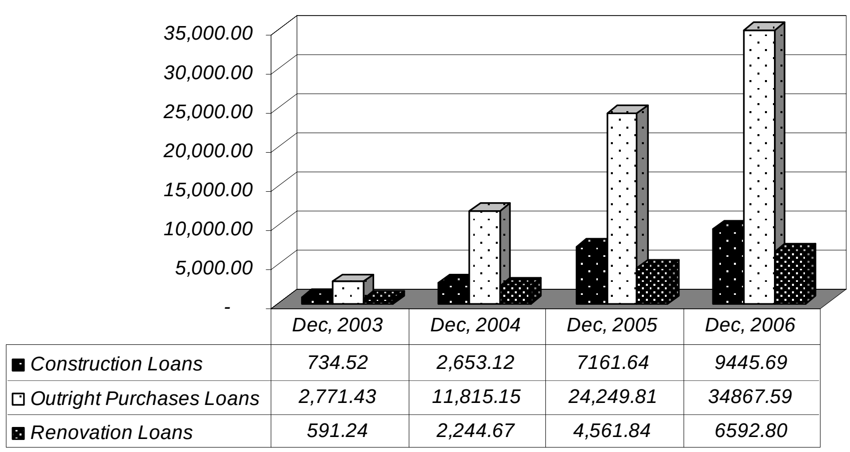
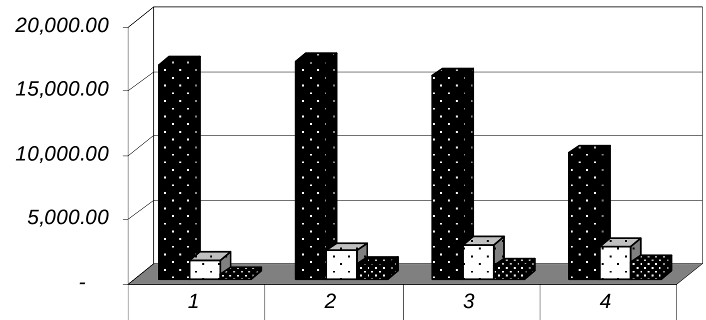


Fig-1.7: Housing finance Outstanding by HBFC (Rs.Million)



	1	2	3	4
Construction Loans	16,558.07	16,878.38	15,708.90	9734.97
Outright Purchases	1,446.46	2,176.39	2,631.79	2513.44
Renovation Loans	289.32	1,084.45	978.86	1204.32

As far as the operations and results depict, the product market is totally different from banks. The figure 1.7, confirms that the share of construction loans outstanding represented the highest share in total DFIs housing finance outstanding. At the end of December 2003, share of construction loans in aggregate housing finance portfolio of DFIs was 90.51 percent, which declined to 78.91 percent by December 2006. The share of loans for outright purchases & renovations increased to Rs.2,804.73 million (14.72 percent) and Rs.1,212.10 million (6.36 percent) respectively.

1.6 Islamic Banking

1.6.1 Islamic Financial Services-Global Scenario:

The international Islamic financial market is becoming more and more dynamic and diversified. Over the past thirty years, Islamic finance industry has made considerable progress at the global front. In the previous decade, Islamic Financial Sector (IFS) registered a growth (between 15-20 percent per annum); making it one of the fastest growing segments. It comprises of onshore & offshore banks, non-bank finance companies, housing cooperatives, microfinance institutions, venture capitals, mutual funds, Takaful companies etc. Moreover, there are dedicated regulatory, legal and academic institutions at the international level that are providing support in establishing and developing the IFS.

1.6.2 Islamic Banking in Pakistan:

State Bank of Pakistan has played an important role towards development of Islamic banking in the country. The establishment of a full-fledged Islamic Banking Department at SBP to focus on Islamic Banking issues provides the industry with necessary impetus to grow and emerge as a preferred choice. SBP's drive to promote Islamic banking as a parallel banking system while operating on a level playing field with conventional banks was aimed at building a broad based financial system to enable all segments of the population to access financial services. The performance of the sector could be clearly viewed from figures given in the following tables.

(Rs. Million)

Table-1.9: Trends in Islamic Banking in Pakistan

Description	Jun 03	Jun 04	Growth (%)	Jun 05	Growth (%)	Jun 06	Growth (%)	Jun 07	Growth (%)
Deposits	6,517	13,158	**102**	37,835	**188**	59,657	**58**	107,427	**80**
Financing & Invest.	5,421	13,102	**142**	37,171	**184**	57,936	**56**	89,215	**54**
Total Assets	8,821	18,830	**113**	54,017	**187**	87,603	**62**	157,927	**80**

Table-1.10: Islamic Banking Players:

Description	2003	2004	2005	2006	2007
No. of Islamic banks (operating)	1	1	2	4	6
No. of branches of Islamic banks	8	10	32	48	122
No. of conventional banks operating Islamic banking branches	0	5	9	11	13
Total No. of Stand alone Islamic banking branches of conventional banks	0	10	30	39	61
Total Islamic banking branches (a+b)	8	20	62	87	183

1.6.3 Initiatives undertaken by SBP for Promotion of Islamic Banking

During the year under review, the following initiatives were adopted by SBP for promotion and development of the industry:

- **Strengthening the Shariah Compliance Mechanism:** SBP has put in place a comprehensive Shariah compliance framework for Islamic Banking Institutions (IBI). The main features include:

  - Shariah Board at SBP.
  - Shariah Advisor for each IBI as per Fit & Proper Criteria approved by SBP.
  - Guidelines on Islamic banking in the form of Shariah Essentials and Model Agreements of Islamic modes of financing.
  - Shariah Compliance Inspection.
  - Segregation of funds made compulsory for conventional banks offering Islamic banking products & services through dedicated branches.

  In order to further strengthen the Shariah compliance framework the following initiatives were also taken during the year under review:

  - Issuance of Draft Instructions & Guidelines for Shariah Compliance in Islamic Banking Institutions.
  - Revision of Fit & Proper Criteria for Shariah Advisors on IBIs.
  - Adoption of Shariah Standards developed by Accounting & Auditing organizations for Islamic Financial Institutions (AAOIFI).
  - Constitution of a Shariah Advisors Forum

- **Islamic Financial Services Board Standard:** The Islamic Financial Services Board (IFSB) serves as an international-standards setting body of regulatory and supervisory agencies that is working to ensure the soundness and stability of Islamic financial services industry. IFSB promotes the development of prudent and transparent Islamic financial services industry by introducing new, or adapting existing international standards consistent with Islamic Shariah principles, with recommendations for their adoption.

  Being a full member of IFSB, SBP is responsible to support & adopt the different standards approved by IFSB. Some of these include:

  - Draft Risk Management Guidelines for IBIs.
  - Establishment of Team to Conduct Impact Study on IFSB Capital Adequacy Standard

- **Human Resource Development:** For catering to the developmental needs of potential and existing workforce in Islamic banking, SBP has launched a three weeks Islamic Banking Certification Course at National Institute of Banking & Finance. The course is aimed at building capacity of bankers to deliver Islamic banking products and services.

  Memorandum of Understanding has been signed between SBP and International Centre for Education in Islamic Finance (INCEIF), Malaysia which envisages creating a strategic alliance between the two institutions for promotion of educational excellence by making joint efforts so that the human resource needs of the industry may be appropriately met. Under this Memorandum of Understanding 10 scholarships for “Certified Islamic Finance Professional (CIFP)”, a distance learning program developed by INCEIF have been offered to Pakistan. The candidates for the said Program were nominated by SBP from its own staff, NIBAF and Islamic banks.

- **SBP Initiatives at International level:** SBP is one of the founding members of Islamic Financial Services Board (IFSB). In its 9th meeting held in November, 2006 at Jeddah, the council approved appointment of Dr. Shamshad Akhtar, Governor-SBP as Deputy Chairperson of IFSB for the year 2007 who will be appointed as Chairperson of IFSB for the year 2008.

  In order to enhance investment opportunities and strengthen linkages with global Islamic financial markets, SBP became a permanent member of International Islamic Financial Market (IIFM) and participated in its Board of Directors meetings, working groups etc. SBP has also been collaborating with central banks of Malaysia, Bahrain and Indonesia for promotion of Islamic banking and finance. MOUs were signed with Malaysia and Bahrain for promotion of Islamic banking on a host of issues including supervision, technical expertise and training assistance.

  A number of international events were also organized in Pakistan with the support of SBP:

  - November 07-08, 2006 – “Positioned for Growth” Second Pakistan Islamic Banking and Money Market Conference.
  - January 24-25, 2007 - The “Islamic Financial Markets Conference & Specialized Workshops”

These conferences were attended by officials from central banks of several countries, industry experts and practitioners, corporate, investors, Shariah Scholars, financial institutions as well as academics. In these events, the need for well-developed and transparent Islamic capital and money markets was stressed.

- **Liquidity Management:** State Bank of Pakistan has formed a Task Force to map out a plan for introduction of short-term and medium-term liquidity management products based on innovative Islamic structures. It has also prepared a structure for short-term Shariah compliant government instrument which has been sent for GOP approval.

- **Accounting and Taxation Issues:** For development of Accounting Standards for Islamic Modes of Financing, a Committee was constituted at Institute of Chartered Accountants Pakistan (ICAP). This Committee is reviewing the accounting standards prepared by Accounting and Auditing Organization for Islamic Financial Institutions, Bahrain (AAOIFI) with a view to adapt them to Pakistani circumstances and if considered necessary to propose new accounting standards.

  There have been some major taxation issues faced by the industry due to its nature of asset backed/trade based modes of financing. SBP, along with other relevant bodies took-up the issues with Central Board of Revenue for resolution of tax problems.

- **Venturing into New Sectors**

  - **Draft Guidelines for Provision of Islamic Microfinance Services**: SBP issued Draft Guidelines for provision of Islamic microfinance services and products by financial institutions covering the following:

    I. Establishment of Full Fledged Islamic Microfinance Banks (IMFB)
    II. Provision of Islamic microfinance services by Full-fledged Islamic banks
    III. Provision of Islamic microfinance services by Conventional banks
    IV. Provision of Islamic microfinance services by Conventional microfinance banks.

- **Other Initiatives:** The Islamic Banking Department also launched a Quarterly Islamic Banking Bulletin. This bulletin gives an overview of local and international developments and has been placed on SBP website for providing easy access to all the stakeholders.

1.7 Agricultural Credit Disbursements during FY 2006-07

The agriculture credit requirements of the farming sector have been increasing over years. This was mainly due to rise in the use of farm inputs like fertilizer, pesticides and mechanization. The demand for credit by non-crop sector, particularly livestock and dairy farming has also increased significantly. In order to cope with this increasing demand for agricultural credit, the institutional credit to farmers is being provided through five big banks i.e. HBL, NBP, UBL, MCB and ABL, two specialized banks i.e. ZTBL & PPCBL and the fourteen Domestic Private Banks. During the Year 2006-07, SBP allocated Rs. 160 billion for agricultural credit disbursements which was 23 percent and 16.4 percent higher than the target and actual disbursements respectively for the preceding year.

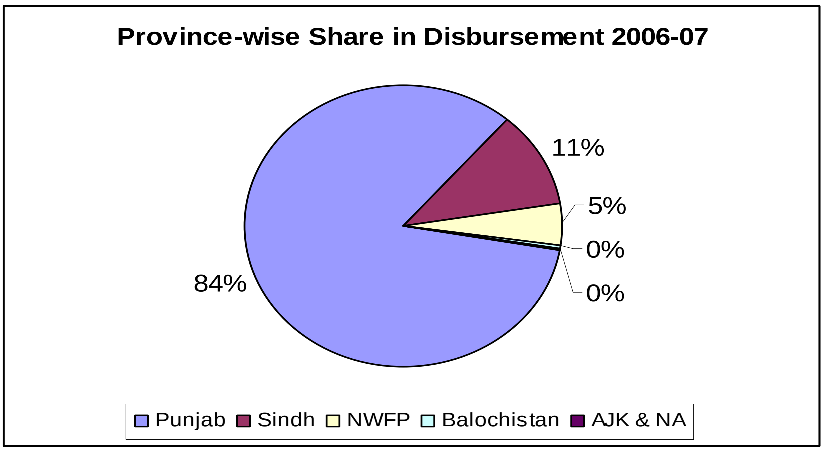
These allocations are always indicative in nature as the mandatory allocations policy has been done away with in the post reform era. The elimination of mandatory credit allocations coupled with active involvement of commercial banks in agricultural finance is a major milestone towards mainstreaming this mode of finance. The commercial banks which traditionally shied away from agriculture credit are leading the way towards growth of agriculture finance. All this has been made possible due to continued efforts for mainstreaming agriculture through promotional/facilitative role of SBP.

Out of the total agriculture credit target of Rs160 billion, Rs.80 billion was allocated to the five big commercial banks, Rs.48 billion for ZTBL, Rs.9 billion for Punjab Provincial Cooperative Bank Ltd., and Rs.23 billion for other Domestic Private Commercial Banks. The Agricultural Credit Advisory Committee (ACAC) also allocated province and sector-wise targets where-by 78 percent, 14 percent, 6 percent, 1.5 percent and 0.5 percent were to be disbursed in Punjab, Sindh, NWP, Baluchistan and AJK & Northern Areas respectively. Similarly, on purpose-wise basis Farm Sector, Orchards, Livestock, Poultry, Fisheries and other allied sectors were required to get 76 percent, 4 percent, 11 percent, 4 percent, 3 percent & 2 percent respectively.

During July-June, 2006-07 Rs.169 billion were disbursed through the banking system, which was 23 percent higher than the amount disbursed in the previous year. This disbursement was about 106 percent of full year target. Bank-wise break-up of credit disbursed reflect that five big commercial banks disbursed Rs.80.4 billion against a target of Rs.80 billion whereas ABL, MCB, ZTBL and the Domestic Private Banks (DPBs) surpassed their targets. The data on agricultral credit disbursement for FY07 (July-June) by banks reveals that major share of credit is extended for production purposes. Out of total disbursement of Rs. 169 billion, Rs.151 billion were extended for production purposes whereas only Rs.18 billion were disbursed for development purposes.

Further analysis of agricultural credit disbursements reflects that there is significant disparity among provinces in terms of credit disbursed. All the provinces except Punjab exhibited a low absorption of agricultral credit and could not meet the allocated percentage of indicative credit disbursement targets. The satisfactory performance in Punjab was largely due to the efforts by the Government of Punjab which created right environment and made proper institutional arrangements for promoting credit delivery. The province-wise disbursements is given in the following figure-1.8:

Fig-1.8



(Rs. Billion)

Table-1.11: Growth in Agricultural Credit

Banks	FY05		FY06		FY07	
	Targets	**Disburs.**	**Targets**	**Disburs.**	**Targets**	**Disburs.**
5 Big Comm. Banks	38	51.3	63	68	80	80.4
ZTBL	34	37.4	43	47.6	48	56.5
DPCBs	5	12.4	15	16	23	23.9
PPCBL	8	7.6	9	5.9	9	8.0
Total	85	108.7	130	137.5	160	168.8

1.7.1 SBP's Initiatives towards Promotion of Agricultural Credit

The following activities were initiated and completed during the FY 2006-07.

- **Guidelines for Fisheries Financing:** The fisheries are an important sub-sector of agriculture. It has the potential to play a significant role in the national economy by contributing towards food security, reducing pressure on demand for mutton, beef and poultry and earning of foreign exchange. SBP issued these guidelines for fisheries financing to facilitate the banks/DFIs towards enhancing flow of credit for this sector. These Guidelines cover all areas of fisheries financing business including products development and review, purposes & objectives of loans, eligibility of borrowers, delivery channels, monitoring mechanism.

- **Revision of FAQs on Agriculture Financing:** For awareness of banks and the farming community, FAQs regarding different policies and schemes of SBP on agricultural credit were issued in theYear 2005. Further, during our specialized outreach training programs on agricultural credit many basic questions were raised by the farmers/growers and agriculture credit officers of banks. Resultantly, it was felt necessary to update these FAQs for benefit of stakeholders. The revised/updated FAQs have been posted on SBP website and are also being translated into Urdu.

- **Handbook on Agri. Finance Products of Banks:** As part of SBP awareness & capacity building campaign a Handbook on 'Agricultural Finance Products' offered by banks is being compiled. This will facilitate banks to review their existing agricultural finance products, and farming community in accessing credit from the formal sector.

- **Rationalization of Database:** In order to cater to the needs of researchers and policy makers, the data forms related to agriculture finance being provided by the banks were reviewed under the Rationalization of Data Project. After this exercise, the redundant or duplicate information has been discontinued while certain new dimensions have been included. Now, the newly developed data formats will cover dimensions like holding-wise disbursement, crop-wise lending, purpose-wise utilization, information about number of borrowers and NPLs in agri. Credit.

- **Specialized Training Programs for Capacity Building of SBP and Banks:** The dissemination of knowledge by continuing special outreach & training programs, field visits, publicity through press and electronic media continued during FY 2007 in collaboration with Banks, Chambers of Agriculture and Farmers/Growers/Abadgars Associations. During the year ten programs were successfully conducted throughout Pakistan wherein, besides dissemination of SBP policies to farmers, training to field officers of banks on products & procedure for lending, system for appraisals, documentations, loan monitoring and recovery mechanism etc. was also provided. The centers covered during the year included Swat, Nosheroferoze, Gujrat, Turbat, Sadiqabad, Okara, Mirpur (AJK), Sanghar, Mansehra and Loralai.

- **SBP Strategy to increase Outreach of Agriculture Credit:** Despite rigorous efforts by SBP, the banks are only meeting 45 percent of credit requirements. In order to enhance the flow of credit to farming community, SBP has developed a draft strategy to increase the outreach to 3.3 million borrowers from the existing 1.6 million, with aggregate disbursements of agricultural loans to meet the credit needs to the extent of 75 percent, from existing 45 percent in the next 3-4 years. The strategy would also focus on diversification of geographical coverage, financing to non-farm sector and disbursements to small farmers. The strategy paper was approved by ACAC in its meeting held on 10th July, 2007. However, a committee has been constituted to develop a methodology for proper estimation of agriculture and rural credit requirements in conformity with overall agricultural production as set by respective ministries.

- **Agricultural Credit Targets for FY 2008:** The ACAC has set indicative target of Rs. 200 billion for agricultural credit disbursements by banks during FY 2008. This would be 25 percent and 19.1 percent higher than target and actual disbursements respectively in the preceding year. This provides combined lending of Rs132 billion from commercial banks and Rs68 billion for specialized institutions i.e. ZTBL & PPCBL. The Committee also recommended province-wise allocations of disbursements based on cropped area and absorption capacity of each province along with Azad Jammu & Kashmir and the Federally Administered Tribal Areas.

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2 Ensuring Soundness of the Financial Sector

2.1 Overview

One of the prime responsibilities of State Bank of Pakistan (SBP) is to ensure that the financial system, particularly the banking system, is robust and well functioning. This entails SBP to continuously endeavor for improvement of the banking infrastructure, optimize its market potential and more importantly monitor the risk profile of banking institutions to safeguard the interest of depositors.

SBP has undertaken a number of initiatives to mitigate the risks attached with the banking industry. These mainly included enhancements in Minimum Capital Requirement (MCR), development of Roadmap for implementation of Basel-II, enhancement of corporate governance standards and improvement in the information systems. The banking industry also experienced greater number of mergers and acquisitions, which reflect both on its strength and the increasing confidence of domestic & international investors. SBP continued with its focus on resolution of issues relating to problem banks along with their rehabilitation. The branch licensing policy was implemented with the perspective to extend branch network to underserved areas, reduce financial exclusion and promote national savings. SBP also strengthened its own supervisory and regulatory capacity recently which allowed effective vigilance of banks/DFIs along with specialized Islamic and Microfinance institutions.

2.2 Undertaken to Strengthen the Banking System Stability

2.2.1 MCR Enhancement and Capital Charge under Basel-II: Given the vulnerability of small and medium sized banks to unexpected shocks, it is important to have institutions which are stronger, stable and resilient to provide the essential embankment against financial instability. The implementation of Basel-II and continuous changes in risk management has increased the need for the financial sector to develop necessary skills and technology. In such circumstances only strong and well capitalized banks could be in a better position to adapt to changing environment. Thus, SBP continued with its strategy to focus on enhancement of Minimum Capital Requirements (MCR) to Rs.6 billion by end of December, 2009.

Under this strategy, the banks/DFIs are required to enhance their capital by Rs. 1 billion each year to achieve the target of Rs.6 billion by the year 2009. However, those foreign banks whose respective head offices hold capital equal to or more than USD 100 million are exempted from this increase in capital base. Up to June 2007, out of domestic twenty nine commercial banks, twenty four were able to meet the capital requirement of Rs.3 billion for the year 2006. Most of the remaining three institutions are passing through various stages of consolidation.

The risk management structures are being further refined with the issuance of comprehensive Roadmap for implementation of Basel-II in the year 2006. The new capital requirements under Basel-II incorporate a capital charge for operational risk alongside credit and market risks. This helps to set aside a cushion in the form of capital for probable operational losses and develop an understanding of institutionalized measurement criteria for operational risks of banks.

2.2.2 Mergers and Acquisitions in the Banking Sector: One of the main features of financial sector reforms were consolidations with the ultimate objective to have fewer but stronger institutions in the market. The scope of consolidations through mergers & acquisitions included not only banking sector but also leasing companies, investment banks and modarbas.

Since year 2000, SBP has processed twenty-nine merger & acquisitions related transactions out of which seven were acquisitions while twenty-two were mergers. In majority of the cases, the commercial banks merged with investment banks while in other cases mergers occurred between commercial banks and DFIs/leasing companies. This process resulted in capital inflows as evident from higher foreign participation. The main factors responsible for mergers and consolidations in the banking system of Pakistan were as follows:

- Increased capital requirements from Rs. 500 million in the Year 2001 to Rs. 3 billion by the end of Year 2006, which would go up to Rs.6 billion by Year 2009.
- SBP adopted the strategy to resolve problems of sick institutions through facilitation of merger with more vibrant financial organizations under section 47 of BCO, 1962.
- Presently there is a moratorium on issuance of new commercial banking licenses. Therefore, aspiring new entrants into financial sector adopted the route of acquiring majority shareholding of existing commercial banks.
- The need to rapidly expand branch network like acquisitions of Union Bank by Standard Chartered Bank, Prime Commercial Bank by ABN Amro Bank and Rupali Bank by Arif Habib Group.

In order to streamline consolidations, SBP took many important policy measures. A number of amendments were brought about in the legal framework to facilitate these such as like section 48 was amended to allow merger of NBFCs with banks under provisions of BCO, 1962. Similarly, to facilitate mergers between financial institutions, SBP also proposed amendment in Income Tax Ordinance like section 57-A which was incorporated to allow carry forward of tax losses of both amalgamated (target) & amalgamating (surviving) institutions.

These initiatives adopted by SBP allowed it to reduce the number of banks from forty-six in 1997 to thirty-nine in the Year 2006 and strengthen their capital position. Moreover, it also added to the development of a healthy competitive environment among bigger and stronger financial institutions. Going forward, if this process continues at its current pace, development of more stable and resilient banking system can be expected in the country.

2.2.3 Resolution of Problem Banks: SBP supervised the banks closely in order to assess their operational and financial soundness, different risks assumed thereon and compliance with the rules & regulations. Nevertheless, due to external variables like changing market conditions and various internal factors, there is always a probability of unsatisfactory performance by some banks. This increased the need and importance of developing and implementing Early Warning Systems which allow us to identify problems at an early stage and adopt mitigating measures to minimize the attached systemic risks.

Besides monitoring of basic indicators, ratios and limits pertaining to prudent banking, SBP also ensures that banks' management maintain high ethical standards and are competent enough to assess and monitor the attached risks. SBP has a coherent strategy for dealing with problem banks/DFIs which is based on the strategy of getting realistic and timely diagnosis of problems and choosing the best alternative, leaving public intervention as a last resort mechanism when market-based solutions and liquidation are not possible.

As a result, on average the total number of problem institutions decreased from five to three during the period 2002-2006. The total assets, advances, deposits and non-performing loans of problem banks also declined whereas the total assets came down considerably from Rs. 224 billion to Rs. 38 billion. Similarly, advances, deposits and Non-Performing Loans (NPLs) showed significant decrease overtime. The NPLs which had reached 36.5 percent in the year 2002 came down to 9.4 percent in the year 2006. Moreover, decline in NPLs was also followed by improvement in asset quality. The improvement in these indicators suggests that problem institutions are now contributing positively towards the overall performance.

2.2.4 ***Branch Licensing Policy:*** State Bank of Pakistan Act, 1956 (SBP Act, 1956) and the Banking Companies Ordinance 1962 (BCO, 1962) provide legal framework for licensing of bank branches. Under section 28 of BCO 1962, SBP has introduced a comprehensive branch licensing Policy for allowing the banks to independently make their branch housing decisions within broad parameters. Under the Branch Licensing Policy, commercial banks/DFIs, Islamic banks, Islamic bank branches and Microfinance banks are required to submit their Annual Branch Expansion Plan (ABEP) by November of each year. SBP evaluates these expansion plans in the light of the parameters set under the Branch Licensing Policy (BLP) for commercial/Microfinance banks and IBD Circular No. 2 of 2004 where banks with CAMELS-S composite rating below 'Fair' are not eligible to open more branches.

The outreach expansion has been one of the important pillars of SBP's Branch Licensing Policy where the commercial banks having more than 100 branches are required to open 20% of their branches outside the jurisdiction of big cities and in Tehsil Headquarters where no branch of any bank exists. Further, the new options are also being considered in the revised branch licensing policy, which include opening of sub-branches where banks can perform limited banking functions as extended arms of some nearby branch or Sales & Service Centers allowing the bank to perform functions like delivery of product information & queries; customer support or drop box facilities for collection of payments.

2.2.5 ***Enhanced Focused on Corporate Governance:*** State Bank of Pakistan, in its resolve to strengthen the corporate governance framework made certain amendments in two important components of Code of Corporate Governance viz. "Fit & Proper Test (FPT) Criteria" for Board of Directors, CEOs/Presidents and the Key Executives alongside "Responsibilities of Board of Directors and Management" of banks/DFIs.

2.2.6 ***Credit Information Bureau of Pakistan:*** SBP considers the functioning of Credit Information Bureau (CIB) as integral towards promotion of financial discipline and better credit risk management at the banks/DFIs. In its endeavor to facilitate financial institutions in making prudent lending decisions, CIB was established in 1992 which was capturing corporate borrowers' record of more than Rs. 0.5 million & above only. Over the years, SBP has significantly enhanced the scope of CIB operations. In April 2006, it enhanced the coverage and effectiveness of CIB by introducing e-CIB online facilities and became the first bureau of the region to introduce online facility to its member financial institutions. This development enabled financial institutions to upload their data directly into CIB system and generate CIB reports on real time basis.

The high volume of consumer, SME and micro financing portfolio required the development of a healthy and efficient consumer credit reporting system. The markets for credit cards, mortgages, automobile and personal loans have also grown exponentially. The CIB at SBP responded positively to these new challenges. The Bureau's reporting, operational and IT systems were revamped and significantly upgraded. The scope and administration of CIB database was enhanced in collaboration with Pakistan Banks Association (PBA). The main objectives were:

- Enhance the existing credit reporting limit of Rs0.5 million & above by expanding its database to cover all credits of member financial institutions.
- Change the composition of information to include more financial and non-financial details of borrowers.
- Improve the overall operational efficiency of e-CIB by upgrading communication infrastructure, hardware and software.

In order to make the project a success, e-CIB team conducted a series of testing workshops. These included Training of Trainers Program and hands-on training for more than 400 users of 110 institutions on installation, customization and usage of software applications. The CIB team also provided continuous counseling and support through automated Help Desk System. This project was successfully completed in June 2006, allowing significant improvement in the overall operational and technological infrastructure of CIB. The key improvements in the features of e-CIB system over the old CIB system are envisaged as below:

- Improved efficiency in terms of speed, reliability and security of CIB data
- Deployment of high capacity servers, security firewalls, broader bandwidth and point to point data encryption.
- Multi-user and Multi-tiered Rich Client Data capturing software developed using latest programming tools and that was provided to 100 financial institutions
- Highly sophisticated and completely automated Back Office (BO) system for processing data at CIB end. With the implementation of the BO system the task of data processing has been reduced from 15 days to three days only.
- Web based interactive data inquiry systems to provide online Credit Information Reports to financial institutions, and allow online amendment & updates.
- Replaced dial-up with scalable Virtual Private Network (VPN) that allows FIs to connect to the CIB with any of the fastest available medium.
- Comprehensive data validation rules implemented to ensure correct entry of records.
- Product-wise availability of loan information.
- Record of last four credit inquiries from the financial institutions has also been made part of the respective borrower's credit report.
- Formation of group of borrowers for CIB reporting purpose has left to the sole discretion of reporting FIs. The reporting FI will report the groups of borrowers in the line of the definition as given in the PRs.

This improvement has been beneficial for finance industry as the number of borrowers in CIB database has significantly increased from less than 0.2 million to well over 4 million. Further, it has greatly expanded the outreach to a large number of borrowers who until now remained untapped because of the floor of Rs.500,000/- for reporting purposes. This has its important implications with regard to credit expansion to low-value borrowers of SMEs, agriculture and consumer finance sectors. Further, in order to facilitate the users of e-CIB system, SBP also established a web based Help Desk System for providing support to users of the new system and help general public in lodging their complaints regarding credit reporting issues.

2.3 Initiatives Undertaken to Strengthen the Supervisory System

- ***Basel-II implementation:*** The Basel-II Capital Accord provides a comprehensive and more risk sensitive capital allocation methodology. Its implementation has become a challenging task for regulators around the world, keeping in view the fact that it prescribes significant up-gradation of risk management standards and technological advancement within banks. In this respect, SBP has taken a number of initiatives and issued a roadmap for implementation of Basel-II to ensure smooth transition to the new regime. Under this Roadmap, banks are initially required to go through a parallel run of one and half years for Standardized Approach starting from 1st July 2006.

  Majority of the banks have expressed their intention to first adopt comparatively simple Standardized Approach before going for the more sophisticated advanced approaches. However, some foreign banks might go for the advanced approach in view of the strategy adopted by their head offices located abroad. A comprehensive review exercise on part of SBP culminated in a bank specific internal plans. In order to streamline the implementation process and ensure better coordination, each bank deputed their respective coordinators at group head level along with formulation of Basel-II units.

  Under the standardized approach, capital requirements against credit risk would be determined on the basis of risk profile assessment by rating agencies recognized by the regulators as External Credit Assessment Institutions (ECAIs). In order to ensure transparency in the recognition process, eligibility criteria for recognition of ECAIs was devised in consultation with stakeholders on the basis of broad guidelines described under Basel-II. After review, ECAI status was granted to two rating agencies namely PACRA and JCR-VIS as both were meeting the minimum requirements. This implies that the banks would use ECAI's risk assessment rating of portfolio for calculation of capital requirement under Basel-II. The mapping of ratings with appropriate risk weights has also been finalized in consultation with recognized ECAIs.

  The formats for submission of results produced for measurement of capital on the basis of Basel-II instructions were prescribed in March 2007. These formats primarily cover capital calculation under Standardized Approaches for credit & market risk and Basic Indicator and Standardized approaches for operational risk. The results of capital measurement on the basis of Basel-II instructions have been submitted by the banks. A detailed survey to assess the level of preparedness was conducted in February 2007. This survey was helpful in assessing the issues prevalent in the banking industry.

  The implementation of Basel-II poses tremendous challenges for the banking system in Pakistan. In order to meet the objectives, SBP and the banks are engaged in capacity building both in terms of up-gradation of IT systems and enhancement of expertise. In this regard, SBP conducted a number of seminars & workshops on the New Capital Accord for both internal & external stakeholders and also remained engaged in improvement of IT systems to bring the regulatory reporting in line with the disclosure requirements defined under Basel-II.

- ***Policy Framework in Banks/DFIs:*** The role of Board of Directors (BOD) is considered to be crucial in setting of strategic direction and standards for the management. This is achieved through policies which go a long way towards establishing good governance practices. In the light of its importance, SBP issued consolidated instructions on policy framework to ensure that banks/DFIs have policies in various areas that are synchronized and have uniformity according to varied nature of their respective operations. Accordingly, the banks/DFIs have been advised to develop policies for the following areas and also ensure their implementation:

    - Risk Management Policy
    - Credit Policy
    - Treasury & Investment Policy
    - Internal Control System and Audit Policy
    - I.T. Security Policy
    - Human Resource Policy
    - Expenditure Policy
    - Accounting & Disclosure Policy.

- ***Write-off of Loans:*** In the backdrop of financial sector reforms, SBP made amendments in the instructions for Writing off irrecoverable/bad loans and advances. The Board of Directors can grant approval under a well defined and transparent write-off policy. The write-off policy, if not already in place may be made and revised by BOD. The BOD can delegate adequate and appropriate powers down the line to President/Chief Executive Officer and other senior officers of the bank/DFI as they deem fit. In order to ensure proper management and supervision of write-off for bad/irrecoverable loans/advances under delegated powers, an effective internal control and supervisory mechanism has to be put in place. The Write-off of loans & advances, in the names of Directors, Chief Executive or their relative in which they have any interest of 5% or more shall requires prior approval of SBP. In exceptional case where banks/DFIs are unable to comply with the guidelines, BOD may decide the case on merit by recording reasons in writing for approval or otherwise. These cases shall also be reported immediately to SBP.

- ***Consolidation of Supervisory functions and Segregation of Regulatory functions:*** As part of overall change initiatives adopted by SBP, policy formulation and supervision functions were segregated into separate groups. Off-site Supervision and Enforcement Department (OSED) is responsible for overall supervision of banks/DFIs and MFBs. OSED now carry-out all functions related to off-site supervision of banks/DFIs, which include preparation of Off-site Surveillance Reports, monitoring of banks' ratings under IRAF, enforcement actions along with development of Supervisory Options/Action plans for the assigned institutions.

- ***Revision of Rating Criteria for Assessment of CAELSS Components:*** The regular on-site inspection is conducted on the basis of CAMELS-S Framework (Capital, Asset Quality, Management, Earnings, Liquidity, Sensitivity and Systems & Controls). The key ratios and their benchmarks for different components are specified in the On-site Inspection Manual developed under FSID Project in the year 1997. However, in the light of emerging changes in financial sector, a need was felt to review/revise the parameters/benchmarks set in the manual. Therefore, a comprehensive exercise was carried out which allowed SBP to revise the banks' rating criteria.

- ***Shariah Compliance Inspection of Islamic Banks:*** The format for inspection reports on Islamic banks has been revised. This has been done after taking into consideration their increasing market share and the need to bring them in line with the Shariah Manual. A new component titled 'Shariah Compliance' has also been incorporated in the inspection reports for Islamic banks.

- ***Development of Resource Pool for Specialized Areas:*** In order to prepare the Banking Inspection Department of SBP for future supervisory challenges, a pool of officers has been identified for developing a critical mass in the important specialized inspection areas like Basel- II, Anti Money Laundering (AML), Islamic Banking and treasury operations. These officers would be provided specialized trainings to develop the required supervisory strengths.

- ***Automation of Loan Line Sheets:*** The Loan line sheets are an important tool used in the evaluation of loan portfolio at the banks/DFIs. These Loan line sheets contain financial data along with observations on the strengths & weaknesses of borrowers. Previously, these Loan line sheets were prepared either on excel formats or on printed formats. However, in order to enhance the overall efficiency, a project to automate these loan line sheets was initiated. In the Phase-I, Client Module (Data Entry Module) was developed and uploaded on the laptops of inspecting staff. During the Phase-II, Host Module installed at ISTD servers was developed while the Client Module was linked with e-CIB. This made it possible to import data on to Client Module from e-CIB data reported by banks/DFIs. A number of reports necessary for pre-inspection planning were developed in the Host Module. This process would allow an improvement in the sampled selection of borrowers for scrutiny, replace the paper based loan line sheets, archive loan line sheets at central location and monitor the performance of inspection teams.

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3 Maintaining Price Stability with Growth

3.1 Overview

Price stability is generally and widely considered as the most desirable pre-requisite for growth and has become the primary objective of central banks in industrialized as well as in developing countries since 1990s. Price stability simply means avoidance of high and volatile rate of inflation.[1] High and volatile inflation creates uncertainty about future path of price level that in turn creates distortions in an economy and affects investment and growth momentum. A number of empirical studies have shown that high inflation negatively affects growth in the long-run. Some of the studies have even estimated precise levels of inflation (point or ranges) above which it hurts growth.[2] In this perspective, central banks attempt to maintain low and stable inflation so that it does not hurt economic growth. At the same time, central banks also ensure that adjustments in monetary policy to stabilize inflation do not hurt growth in the short run.

State Bank of Pakistan (SBP) continued to adopt a two-pronged strategy of achieving price stability with sustainable economic growth. However, during FY 2007 it was quite challenging to formulate an anti-inflationary monetary policy that leaves the growth momentum unhurt. In particular, the inflation was already high (i.e. 7.9 percent for FY 2006, 1.4 percentage points above the FY 2007 inflation target of 6.5 percent), current account deficit was widening due to higher demand for imported goods and expansionary fiscal policy stance that had implications for monetary policy. These factors were indicative of the existence of excessive demand pressures in the economy and were likely to add to inflationary pressures.

In the backdrop of these developments, SBP maintained tight monetary policy stance. In July 2006, SBP tightened monetary conditions first by raising the Cash Reserve Requirement (CRR) and Statutory Liquidity Requirement (SLR) ratios. Second, SBP raised the Repo rate by 50 bps in its Monetary Policy Statement issued for 1st Half of FY 2007. During rest of the year, SBP maintained tight policy stance through conduct of open market operations and pro-active liquidity management strategy.

On the other hand, SBP allowed increased access to credit for export and other industrial sectors through concessional financing schemes so that the exports and investment growth in the economy is not impaired in any manner by the pursuance of tight monetary policy stance. As a consequence, the GDP growth target of 7.0 percent was achieved with agriculture and services sectors giving above target growth, while growth in the industrial sector also accelerated over FY 2006.

The tight monetary policy stance from the start of FY 2007 also dampened demand pressures in the economy which was evident from sustained downtrend in core inflation. The non-food, non-energy (NFNE) measure of core inflation declined from 7.1 percent in FY 2006 to 5.5 percent in

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[1] Broadly, price stability is defined as situation when economic agents do not account for expected changes in price level in economic decision making. This happens when inflation i.e. rate of change in price level is minimum or people do not expect inflation rate to deviate much from the current level.

[2] This level, usually called *threshold point of inflation*, varies from economy to economy. In case of Pakistan, the threshold level of inflation falls between 4-9 percent based on two different studies carried out on the subject. However, the desirable range for inflation target is 4-6 percent.

FY 2007. Another measure of core inflation i.e. 20% trimmed mean also declined though slightly from 6.7 percent to 6.6 percent during the same period. The non-food inflation declined from 8.6 percent to 6.0 percent in FY 2007. However, the dampening impact of falling non-food inflation was largely offset by double-digit increase in food inflation while the overall CPI inflation reduced only slightly from 7.9 percent in the previous year to 7.8 percent during FY 2007. Here, if the food inflation had followed the downward trend in non-food inflation, FY 2007 target of 6.5 percent could have easily been achieved.

Beside liquidity management and maintaining of tight monetary stance for achieving the desirable objectives of price stability and growth, SBP continued to strengthen its monetary policy framework and streamline the research functions for effective formulation and implementation of monetary policy. In this regard, significant achievements include formation of Monetary Policy Committee (which replaced Monetary and Exchange Rate Policy Committee), creation of Private Sector Credit Advisory Committee (in place of National Credit Consultative Council), encouragement of progress made in developing macro econometric model for Pakistan and arrangement of International Conferences/Seminar on key monetary policy issues.

3.2 Monetary Policy Statement

In line with the previous years, SBP issued two Monetary Policy Statements (MPS) in FY 2007. In its monetary policy statement for H1-FY 2007, SBP tightened monetary policy to wring out inflationary pressures and bring down inflation from 7.9 percent at the end-FY 2006 to 6.5 percent target for FY 2007. In this regard, SBP raised policy rate (i.e. discount or 3-day repo rate) by 50 bps to 9.5 percent. Earlier, SBP had also increased CRR and SLR ratios for banks in July 2006.

In the second half of FY 2007, SBP kept the policy rate unchanged as inflationary pressures started to ease-off and growth in monetary aggregates also witnessed deceleration by December 2006. Later on when foreign inflows increased during H2-FY 2007, SBP proactively intervened in the markets to keep monetary conditions tight.

3.3 Conduct of Monetary and Credit Policy

FY 2007 was a challenging year for monetary management in terms of reducing inflation without hurting growth momentum in the economy. The key challenges as identified in the monetary policy statement issued for H1-FY 2007 included reduction of inflation from 7.9 percent during FY 2006 to the target of 6.5 percent set for FY 2007, containing monetary expansion in the face of expansionary fiscal policy and narrowing down of current account deficit. In order to contain emerging inflationary pressures, SBP was left with no option but to further tighten its monetary policy stance. Consequently, SBP raised CRR and SLR for the banks in July 2006. In the MPS issued for H1-FY07, SBP also raised the key policy rate by 50 bps to 9.5 percent. During the rest of FY 2007, SBP continued to maintain tight monetary stance through proactive liquidity management using OMOs, without raising key policy rate.

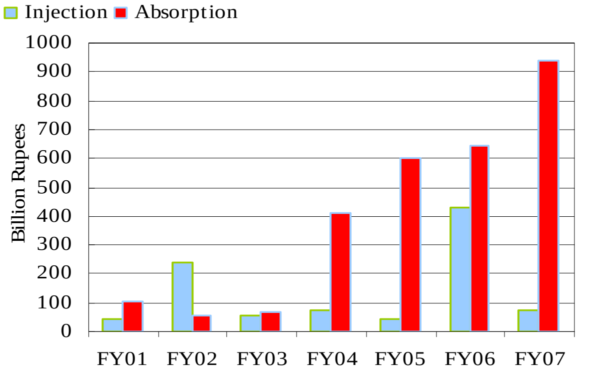
At the same time, SBP also ensured availability of credit for investment and export sectors so that growth in the economy remained unhurt from monetary tightening. For this purpose, SBP reduced the maximum margin/spread on Long-Term Financing for Export-oriented Projects (LTF-EOP) from 3 percent to 2 percent in July 2006. Moreover, SBP reduced refinance rate by 100 bps to 6.5 percent on Export Finance Scheme (EFS) and the maximum margin/spread of banks was reduced from 150 bps to 100 bps. This led to a significant increase in credit under EFS. Under these schemes, industrial sector and the exporters availed Rs 61.5 billion as compared to Rs 4.3 billion in the same period of last year. However, the private sector's excessive reliance on these schemes resulted in additional liquidity with the banking sector, diluting the impact of monetary tightening. This sharp increase in concessional credit combined with heavy government borrowing from the central bank caused significant expansion in reserve money, which grew by 20.9 percent during FY 2007 as compared to 10.2 percent increase in the corresponding period of last year.

The overall credit to private sector witnessed growth of 16.9 percent during FY 2007 as compared to 23.5 percent in the same period of previous year. This slowdown was largely due to desirable slower growth in consumer finance, which is attributable to rising interest rates and prudent lending by banks. A robust real GDP growth and dampening of inflationary pressures also suggests that slowdown in credit was largely due to reduction in loans for consumption purposes and monetary tightening which left the real economic activity unhurt. However, despite slowdown in credit to private sector, the growth in broad money accelerated during FY 2007. This was the result of excessive government borrowings and increase in Net Foreign Assets (NFA) of the banking system.

3.3.1 Open Market Operations

During FY 2007, SBP continued to maintain tight monetary policy stance through timely and effective use of Open Market Operations (OMOs). The FY 2007 saw excessive liquidity in money market coming from significant increase in foreign inflows in the form of remittances and FDI (and consequent SBP intervention in forex market), heavy government borrowing from central bank and refinance provided by SBP against increased credit absorption by the private sector under EFS and LTF-EOP.

Figure 3.1: Open Market Operations



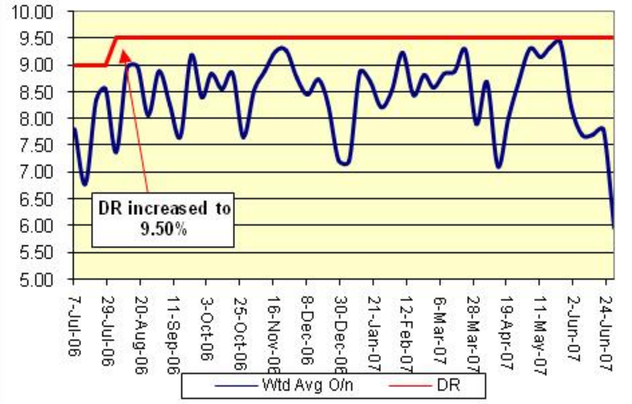
In order to keep liquidity conditions tight in line with monetary policy stance, SBP intervened in the market more aggressively during FY 2007 to mop-up excess liquidity through OMOs. As evident from **Figure 3.1**, liquidity absorption was significantly higher than in the previous years. During FY 2007, SBP also re-introduced outright OMOs, which besides mopping up excess liquidity also helped in off loading the stock of government securities held by SBP. On the other hand, liquidity was injected occasionally on short-term basis whenever market fell short of funds. Due to fewer injections in FY 2007 i.e. 6 as compared to 30 in FY 2006, the overall OMOs frequency came down significantly.

Table-3.1: O/N Rate

O/N Rate	2004-05	2005-06	2006-07
Wtd. Avg.	3.95%	8.07%	8.46%
S.D.	2.33	0.80	0.61
C.V.	0.59	0.10	0.07

The liquidity management strategy pursued by SBP during the year mainly focused on shorter end of the yield curve by mopping up surplus liquidity through OMOs in order to keep the O/N Market tight (see **Figure 3.2**). An important step taken by SBP was the reintroduction of outright OMOs, which not only ensured permanent reduction in government securities held by SBP but also helped in mopping-up excess liquidity for relatively longer periods of time. This development helped towards establishing yield curve for less than 3 months tenor.

Figure 3.2: Weekly Wtd. Average O/N Rate Movement (July 06-June 07)

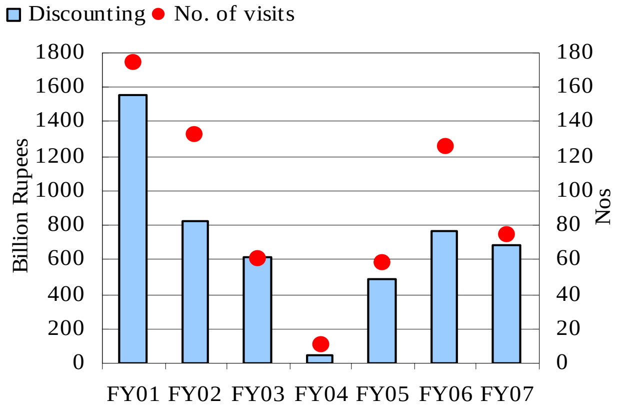


3.3.2 Discount Window Operations

During FY 2007, banks availed discounting of Rs. 686.8 billion that was significantly lower as compared to discounting of Rs. 762.3 billion in the corresponding period of the previous, which indicated the level of excess liquidity in the banking system. At the same time, banks had fewer visits to the discount window, 74 times during FY 2007 compared to more than 125 visits in the previous year (see **Figure 3.3**).

However, disaggregated (quarterly) data reveals that the banks availed discounting facility more frequently during the last quarter of FY 2007. The banks availed discounting of the Rs 383.6 billion as against Rs 267.91 in the fourth quarter of previous year. Out of 74 visits to discount window, the first three quarters witnessed 48 visits (16 visits per quarter on average) while the frequency of visits in the last quarter increased to 26. The reason for this phenomenon was heavy investments by banks in 12-Month T-Bills in anticipation of stable interest rates, resulting in maturity mismatches along one year yield curve.

Figure 3.3: Activity at Discount Window



3.3.3 Statutory Liquidity and Cash Reserve Requirements

In order to further tighten Monetary Policy, SBP raised SLR by 3 percentage points to 18 percent for time and demand liabilities (excluding CRR). The CRR on demand liabilities was raised to 7 percent while CRR on time liabilities was reduced to 3 percent (with effect from July 22, 2006).[3] Under the revised structure, the banks were required to maintain weekly average of 7 percent of the demand liabilities subject to daily minimum of 4 percent, and weekly average of 3 percent of

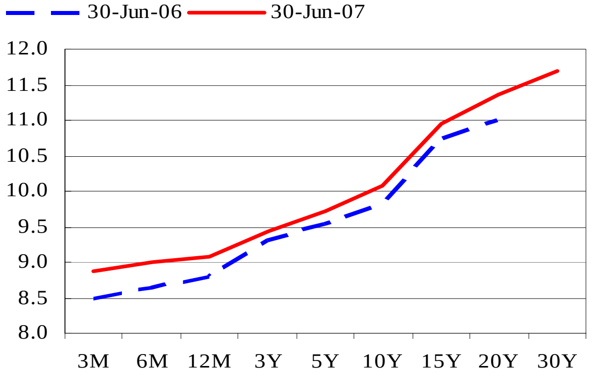
[3] BSD Circular No. 09 dated July 22, 2006. in this circular, banks were also asked to include the time deposits of less than six months into demand deposits to induce banks to raise longer term deposits.

time liabilities subject to daily minimum of 1 percent. Subsequently on 19th January 2007, daily minimum for demand and time liabilities was raised to 6 and 2 percent respectively to reduce the variance between weekly average and daily minimum. Other than squeezing excess liquidity from the market, other major objective of changing the CRR for demand and time liabilities was to induce the banks to raise long-term deposits (effectively through offering higher deposit rates) and to reduce the mismatch risk to banks from their investments in long-term projects financed through short-term deposits. Resultantly, effective CRR remained significantly higher than the previous 5 percent and ratio of time deposits to overall deposits increased from 12.1 percent in the last year to 17.1 percent in during FY07.[4]

3.4 Interest Rate Trends/Yield Curve

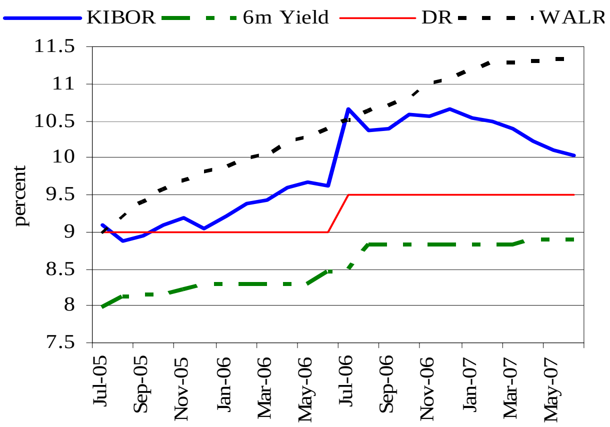
The term structure of interest rates showed a rising trend since SBP raised discount rate, CRR and SLR in July 2006. In subsequent auctions, the overall cut-off yields on 3-month, 6 month and 12 month T-bills were raised by 36 basis points (bps), 41 bps, and 37 bps, respectively during FY 06-07 (see **Figure 3.4**). The increase of key policy rates also influenced market interest rates. The weighted average lending rate (WALR) increased by 39 bps to 10.32 percent and the weighted average rate of return on deposit rose by 61 bps to 5.33 percent.

Figure 3.4: Yield Structure



However, during the last few months of FY 2007, KIBOR showed downtrend while WALR stabilized at higher level. This is because after increase in CRR, SLR, and key policy rate (i.e. 3-day repo rate), the KIBOR started to increase as demand in inter-bank money market increased to meet the daily and weekly (CRR and SLR) requirements. However, as NFA of the banking system improved from inflows and relative slowdown in credit off-take by private sector, KIBOR started to decline by the end of FY 2007 (see **Figure 3.5**). Nevertheless, the KIBOR remained high as compared to last

Figure 3.5: Trend in Key Interest Rates



[4] Earlier, the banks were required to hold government securities at a uniform rate of 5 percent of time and demand liabilities. As bulk of banks' liabilities consist of demand deposit of demand deposits, this change resulted in significant reduction in loanable funds available with banks. Moreover, definition of time and demand liabilities was also changed: the deposits of lass than 6 months were classified as demand and that of more than 6 months as time. However, this redefinition was meant only for the purpose of implementing CRR.

year's level. The downtrends in interest rates during 2nd half of FY 2007 also showed easing of monetary tightening in the backdrop of additional liquidity in the system from increased usage of concessional finance facilities.

3.5 Government Bonds Market

During FY 2007, another challenge for SBP was the promotion and development of secondary market for long-term bonds. The market for long-term bonds had become almost inactive and the prevailing rates were non-indicative of market conditions due to lack of auctions or fresh supply of long-term bonds during the last few years. The market was left with no option but to use KIBOR as benchmark for long-term financing. In this perspective, SBP conducted 5 auctions for PIBs as compared to one in the corresponding period of previous year. SBP also introduced 30-year PIBs in December 2006, which not only helped in enhancing the term structure of the yield curve but also provided benchmark for mortgage and project financing. In the 5 auctions of PIBs carried out during FY 2007, Rs. 87.87 billion were raised, showing an increased appetite for long term bonds. This increased interest shown by investors might be due to expectations of stability in interest rate. The market developments particularly lowering of banks' holding of PIBs from 55 percent in FY 2006 to 45.4 percent in FY 2007 and market yield falling below auction rates are suggestive of revival of the secondary bond market.

3.6 Islamic Money/Sukuk Market

Presently, six full fledged Islamic banks (IBs) with 122 branches and 13 conventional banks with 61 Islamic Banking Branches (IBBs) are operating in Pakistan. During FY 2007, the demand and time liabilities (DTL) of the IBs/IBBs rose by 80.2 percent from Rs 59.6 billion (as of 30th June 2006) to Rs. 107.4 billion (as of 30th June 2007), which is 3.2 percent of total TDL of conventional banks.5 However, due to non-availability of Shariah compliant instruments, the IBs/IBBs have been facing liquidity management problems in inter-bank transactions and they rely on call/clean transactions, which are based on Commodity Murabaha.

Therefore, there is an increasing pressure for development of a well functioning Islamic Money Market (IMM). In this regard SBP is already coordinating with Islamic Financial Services Board (IFSB) to come up with suggestions for developing this segment of the market. In this regard, SBP has also proposed the government to issue Sukuk in the domestic market on priority basis.

3.7 Derivatives Market

SBP's efforts in developing the Derivatives' markets in Pakistan seem to be bearing fruit as the figures of outstanding derivative transactions continue gradual upward trend. With the exception of Interest Rate Swaps, all other categories of derivatives' classes posted slight gains in volumes as compared to figures of quarter ended Mar 31, 2007. However Forward Rate Agreements (FRAs) are still almost non-existent with a paltry outstanding sum of Rs. 300 million. Banks' exposure in FX options stood at approximately Rs. 43 billion, a few billion more than the previous quarter-end figures. Interest Rate Swaps (IRS) including PKR and FX were outstanding to the tune of Rs. 80 billion. The outstanding amount of Cross Currency Swaps (CCS) which posted highest gains, were more than 90 billion Rupees as on June 30, 2007 as against 71 billion on Mar 31, 2007. Although the Derivatives' market is quite concentrated in CCS and FX Options, the rising figures of underlying or notional amounts depict a development trend in Pakistan.

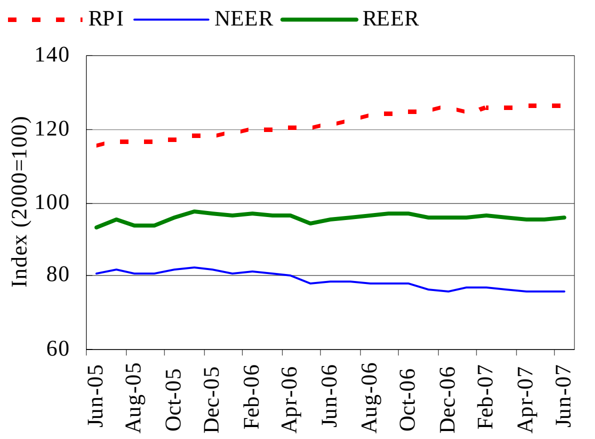
[5] Currently IBs/IBBs require around Rs.20 billion for their reserve requirements.

3.8 Exchange Rate Stability

SBP successfully maintained stable exchange rate in the face of widening current account deficit and huge oil payments. These pressures led to depreciation of Pak rupee by 1.12 percent against US dollar during H1-FY07. However, external pressures eased in the second half of FY 2007, in particular, the current account position improved relative to H1-FY07, which caused an appreciation of Rupee by 0.8 percent. This resulted in an overall depreciation of rupee by 0.3 percent during FY07, lower than the depreciation of 0.9 percent in same period of previous year. The improvement in current account during 2nd half owes largely to increased remittances and FDI.

While depreciation of Rupee against US dollar was marginal at 0.3 percent, its decline was relatively large vis-à-vis other basket (trading partners) of currencies. Nevertheless, the depreciation in Nominal Effective Exchange Rate (NEER) remained lower at 3.4 percent during FY 2007 as compared to depreciation of 3.9 percent in the last year. As the domestic inflation was higher relative to trading partners and competitors, Real Effective Exchange Rate (REER) index appreciated marginally by 0.7 percent, lower that appreciation of 1.9 percent seen in the last year (**see Figure 3.6**).

Figure 3.6: Real and Nominal Effective Exchange Rate



3.9 Forward Looking Framework for Monetary Policy

SBP has taken several measures to improve the forward looking framework of monetary policy. SBP has been strengthening and broadening capabilities for developing macro econometric model of Pakistan economy. SBP has also established a Monetary Policy Committee (replacing the Monetary and Exchange Rate Policy Committee) with a broader mandate.

3.9.1 Macro Modeling and Forecasting

In order to achieve economic stabilization, it is important for SBP to communicate to all stakeholders how it sees the future course of the economy, particularly with reference to inflation and real GDP growth. SBP elucidates its view on the future path of key macroeconomic variables through its various publications i.e., Annual Report, Quarterly Reports, and the Monetary Policy Statements. All of this is based on reliable/consistent forecasts from a suite of models ranging from Macroeconomic framework (based on Financial Programming) to a Small Macro econometric Model of Pakistan Economy developed by Monetary Policy Department of the Bank. These forecasts provide policy guidance to the Central Board of Directors of SBP in the formulation of appropriate monetary policy stance.

Recently, the use of micro-founded Dynamic Stochastic General Equilibrium (DSGE) models by central banks has been growing rapidly. Keeping in view the usefulness of such models in the decision making process, Monetary Policy Department has initiated the development of a DSGE Model for Pakistan economy.

3.9.2 Monetary Policy Committee

The Monetary Policy Committee (MPC) was established in September 2006 (which replaced Monetary and Exchange Rate Policy Committee) with the objective to regularly review macroeconomic developments with focus on monetary and financial market development. The MPC, which is headed by the Governor, meets on six-weekly cycle and monitors economic conditions with focused deliberations on inflation and key macroeconomic variables. The MPC is also in-charge of finalizing the draft Monetary Policy Statement for submission to SBP Central Board of Directors for its approval and endorses working papers for submission to Monetary & Fiscal Policies Coordination Board. In line with the MPS approved by the Central Board, MPC is empowered to use monetary policy instruments to achieve objectives of monetary policy.

3.9.3 Restructuring of National Credit Consultative Council

SBP replaced National Credit Consultative Council (NCCC) with Private Sector Credit Advisory Council (PSCAC) in January, 2007. The main objective of PSCAC is to suggest ways and means for private sector access to credit for promoting economic development. PSCAC will demarcate the impediments in credit availability and disbursements to various sectors[6]. Moreover, it will also review the proposals of Agricultural Credit Advisory Committee (ACAC) relating to agricultural credit. The Governor (SBP) is the Chairperson of PSCAC, while its other members include representatives from banks, private sector chambers/associations/trade bodies and concerned GOP ministries/institutions. The Executive Director-Development Finance Group of (SBP) serves as Secretary to PSCAC. The PSCAC meets in April and October of every year as the private sector credit cycle usually begins in September-October and ends in March-April.

3.10 Strengthening of Research Functions

SBP has further strengthened the scope, coverage and dimensions of its research functions mainly to improve the quality of analysis for economic, business, and financial events, important for the adoption of an appropriate, proactive and forecast based monetary policy.

For the achievement of desired goals, the research functions have undergone restructuring and reorganization process. As a result, four departments were created/ reorganized on the basis of their functions under Monetary Policy and Research (MPR) Cluster:

1. *Research Department;*
2. *Economic Analysis Department;*
3. *Monetary Policy Department and.*
4. *Statistics and Dataware House Department.*

In order to achieve its desired objectives, MPRC continued capacity building and skills enhancement through extensive trainings, exposure visits, induction of professionals, access to quality journals, research bulletins, and databases, etc. In order to strengthen the research functions, SBP also took a number of initiatives, notable of them are mentioned below:

[6] Which includes project finance, working capital finance, infrastructure & housing finance, consumer finance, SME finance, microfinance, trade finance, Islamic finance and other sectors

3.10.1 SBP Research Bulletin

SBP-Research Bulletin was launched to further strengthen the research function. This Bulletin covers the research work on most important topics of Pakistan's economy with emphasis on empirical studies. It contributes towards enhancement of scientific standards for SBP research work beside disseminating knowledge to policy makers, market stakeholders and the academicians. During FY 2007 two issues were published and simultaneously released on SBP website. One was a regular issue while the other was a special issue which covered the papers and proceedings of SBP 2nd International Conference held in December 2006.

3.10.2 SBP Working Papers

Monetary Policy & Research cluster mainly contributes towards SBP working papers on different topics, although other departments of SBP are also encouraged to contribute in working paper series. The papers contain empirical analyses of economic issues and provide policy makers insights and candid feedback useful in policy formulation and decision making process. By the end of June 2007, seventeen working papers were released and posted on SBP website (www.sbp.org.pk).

3.10.3 SBP Annual/Quarterly Reports

SBP Annual and Quarterly Reports provide an objective assessment of the state of economy and a meaningful review of economic policies. With a high level of disclosure, these reports help in making SBP policies more transparent while encouraging the people to become more objective in their views on monetary and banking policies of SBP. In addition, these reports also help in rationalizing the market expectations by guiding public perceptions on important economic issues and consequently, make the implementation of SBP policies easier. Furthermore, with an extensive coverage of real and fiscal developments, these reports also help in developing a better public understanding of interaction between monetary and fiscal policies and their impact on the overall growth of the economy.

3.10.4 Financial Sector Assessment

In an effort to analyze the impact of financial sector reforms initiated in the early 1990s, SBP has been publishing a review of financial sector developments on an annual basis.[7] So far, these reports have largely focused on changes in risk profile and performance of overall as well as various segments of financial sector, while issues related to financial stability have not been explicitly covered in these reports. However, increasing integration of domestic financial sector with the international financial activities and recent wave of mergers & acquisitions in the financial sector has created new opportunities and challenges for the stakeholders. All this requires us to position ourselves to face the challenges and risks emerging from growing integration as evidenced from: (a) issuance of GDRs; (b) foreign investments in the equity market (FPI); (c) inflows of FDI in some of the high performing sectors; and (d) liberalizing foreign exchange market. In this backdrop, SBP has transformed its "Financial Sector Assessment Report" into the new "Financial Stability Review" to explicitly focus on issues related to financial stability. Being a first attempt to move in this direction, this year's report highlights the risks currently faced by Pakistan's financial sector and their potential impact on stability.

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[7] To date, five such reports have been published. The first report 'Pakistan: Financial Sector Assessment' was published in 2002 that covered period of 1990 to 2000.

3.10.5 Inflation Monitor

The continuous monitoring and analysis of inflation trends has become quite important in view of maintaining price stability as primary objective of the central bank. While SBP always monitors price trends very closely, the general public at large remains unaware of the underlying detailed statistical analysis of price trends. In order to make the public more informed about the inflation developments, SBP started publishing a monthly document titled “Inflation Monitor” in year 2005. More specifically, objective of the Inflation Monitor is to provide as much detail as possible on the price situation so that the economic agents are able to form an independent outlook for the emerging price situation and can make their economic decisions on the basis of a wider set of information. The Inflation Monitor is based on the price data meticulously compiled by Federal Bureau of Statistics.

3.10.6 Publications from Statistics and Data Warehouse Department

The timely availability of quality economic data is the pre-requisite for research and policy formulation. To keep stakeholders updated on latest developments in various segments of economy, State Bank of Pakistan produces a variety of reports and statistical bulletins. The Statistics and Data Warehouse Department (S&DWD) compiles authenticated and reliable statistics on a wide range of economic variables for usage in SBP reports and publishes data with different frequency (monthly, bi-annual and annual) in the form of different publications. These publications are brought out in printed form and are also placed at SBP website for easy access by users. The S&DWD is a primary source of data on money & banking and the Balance of Payments (BOP) for Pakistan. The department also carried out analysis for assessing performance of the country’s stock markets through balance sheet analysis of listed companies, preparation of indices of stock exchange securities and equity yield analysis of ordinary shares. The analysis is also published in the form of annual publications. Besides its regular functions of collecting, updating and publishing a long list of data/statistics, S&DWD also maintains data warehouse.

3.11 SBP International Conferences and Seminars

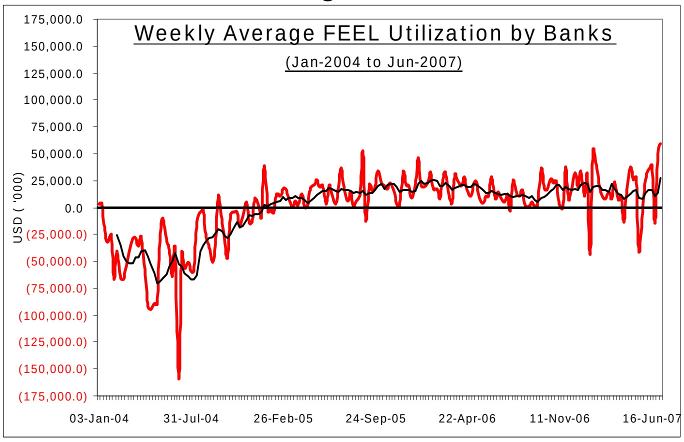
The second SBP International Conference on “Fixed Income Market Development in Emerging Market Economies” was held during 18-19 December, 2006. The conference produced eight thoughtful papers on subject and provided base for further empirical research work on the subject. SBP also conducted three seminars in which eminent economists presented their papers and exchanged views with SBP officers. Later, SBP organized a Seminar on SME (Small & Medium Enterprise) Finance in November 2006 at National Institute of Banking & Finance (NIBAF), Islamabad under the aegis of SAARCFINANCE- Network of SAARC Central Bank Governors and Finance Secretaries. The seminar was aimed at highlighting the emerging role of SMEs under a dynamic economic environment while suggesting the solution to future challenges. The delegates from member SAARC countries presented Country Papers and shared their respective experiences to generate a meaningful dialogue on the subject matter.

4 Exchange Rate & Reserve Management

4.1 Overview

During FY 2006-07, Foreign Exchange Market in the country continued to grow both in terms of capacity and volumes, thus making a valuable contribution to the overall economic objectives of the country. The trade deficit though widened by USD 2.48 billion versus FY 06 was more than off-set by healthy flows on account of Foreign Direct Investments (FDI), Foreign Portfolio Investments (FPI) & home remittance. Resultantly, the exchange rate depicted a stable trend with healthy volatility reflective of prevailing demand and supply conditions. SBP Dealing Room activities in the market were timed to synchronize with the commercial flows and did not in any way impact the value of exchange rate. The support for POL products continued during the fiscal year. However SBP remained a net buyer of USD 192 million as against a net seller in FY 06. SBP's average monthly purchases from the Interbank Market during FY 07 amounted to USD 607 million (FY 06: US$ 336mln/month), which more or less off-set the injection on account of POL.

Figure 4.1



SBP took a number of initiatives in response to the changing market dynamics. The business hours for the Foreign Exchange Market were extended in Jan 2007, thus enabling the banks to cater to their customers' needs more effectively. In addition, the bases for calculating Foreign Exchange Exposure Limit (FEEL) of banks was revised from 10% to 15% of their Paid-up Capital in Mar-2007, which increased the overall exposure limit of commercial banks from USD 200 million to approximately USD 325 million, thus facilitating banks to effectively manage large volume transactions. As a result of the above reforms, SBP diverted approximately 25% of oil support to the Interbank Market in July-2007.

On the SBP's FX Reserve Management front, although foreign exchange outflows including support for oil / commodities and debt amounted to USD 10.9 billion, it were more than off-set by healthy inflows of USD 13.4 billion on account of FDI, Privatization Proceeds, Bond Issuance, Remittances and Market Purchases. The Gross FX Reserves as a result grew by 19% to close the Fiscal Year 2006-07 at USD 15,611.4 million. The restructuring of departments associated with Reserve Management function and the creation of International Market & Investment Department within the newly formed Financial Markets & Reserve Management Cluster resulted in better functional efficiency and dedicated focus to this priority area. Thus, the scope, coverage & dimension of Reserve Management area was further strengthened by de-layering, enhanced efficiency and further institutionalized decision making with a strengthened control & risk culture.

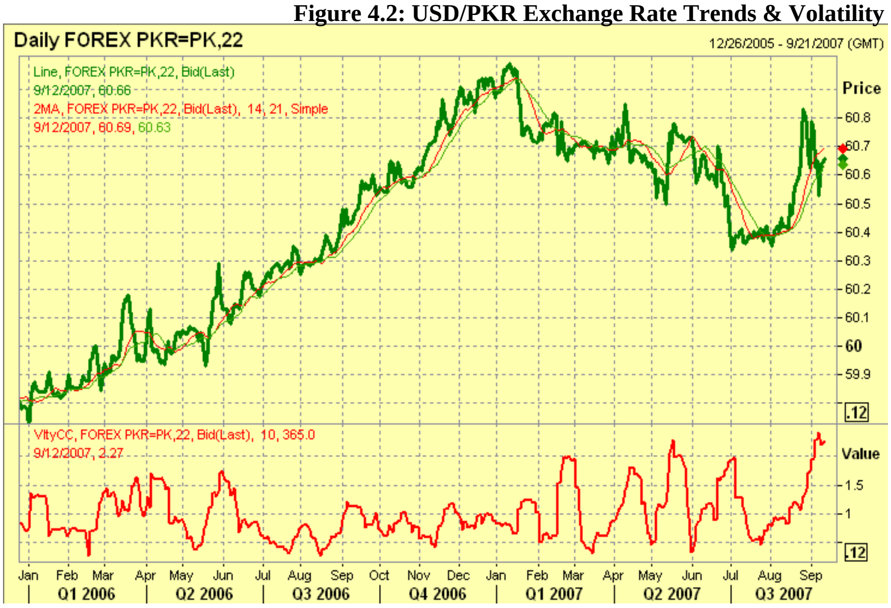
The initiative for liberalization of Foreign Exchange Regime also continued during the period under review. The banks have been allowed to raise Foreign Exchange (FCY) Loans from International Financial Institutions. The Non-residents investors have been allowed to trade in shares in the Futures Market through Special Convertible Rupee Account. Furthermore, in order to further liberalize the trade regime, SBP allowed Advance Payments against Letters of Credit and firm registered contracts up to 100% of FOB or CFR value of the imported goods. Apart from individuals, institutions and professional bodies in Pakistan have also been permitted to make remittances covering subscriptions or membership fee to Professional Bodies/ Principals abroad.

SBP has taken a number of initiatives to further enhance the inflows of workers' remittances through formal channels. The steps taken by SBP have resulted in total remittances to reach USD 5.493 billion in FY-2007, having registered a growth of 19.4% over FY06. SBP initiatives include enhanced commitment of financial sector, consultative role of SBP in developing business propositions, sharing of best practices and efficient feedback mechanism.

In addition to above, other initiatives have also been taken at SBP level to strengthen the regulatory framework for Exchange Companies in Pakistan. During the year, special focus was also given to the improvement in automation & computerization, quality of documenting the transactions, strengthening & streamlining of the internal controls and overall workings of the Exchange Companies.

4.2 Exchange Rate Management

Figure 4.2: USD/PKR Exchange Rate Trends & Volatility



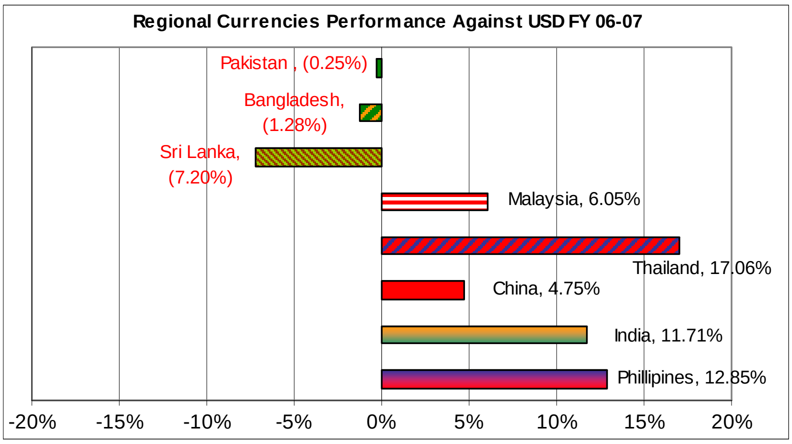
During FY 2006-07 one of the distinctive features was the reversal of continuously depreciating trend in Exchange Rate, witnessed over last couple of years. With growth in trade volume, remittances and other flows brought more depth to the Domestic FX Market and the Exchange Rate during FY 07 exhibiting healthy movements in both directions. In the first half of the year PKR showed a depreciating trend, but in the later half, improved supply of USD helped PKR to regain its strength. The FY 07 was marked by a high volume of inflows, which were mostly realized during the second half of the fiscal year. The Foreign Direct Investment, Foreign Portfolio Investments and record levels of Home Remittances were amongst the dominant sources of supply. The second half also witnessed increased volatility in exchange rate which reflected the changing demand and supply conditions in the market **(See Figure: 4.2)**.

Table 4.1: FY Exchange Rate Trends

Period	High	Low	Close	Average	Volty C/C[1]
FY 2004-05	61.60	57.55	59.64	59.35	2.57%
FY 2005-06	60.45	59.57	60.22	59.87	0.92%
FY 2006-07	61.01	60.18	60.37	60.64	0.96%

On fiscal year basis, PKR showed marginal weakness against USD with a point-to-point nominal depreciation of about 0.25% as compared to depreciation of 0.97% in the previous year. The PKR was amongst the few currencies of the region, which depicted marginal depreciation during the year as a number of other regional currencies such as Indian Rupee, Thai Baht, Malaysian Ringitt, and Chinese Yuan gained significant strength against USD during the period under review. Hence in relation to the regional currencies PKR weakened significantly **(See Figure: 4.3)**.

Figure 4.3: Trends in Regional Currencies against USD



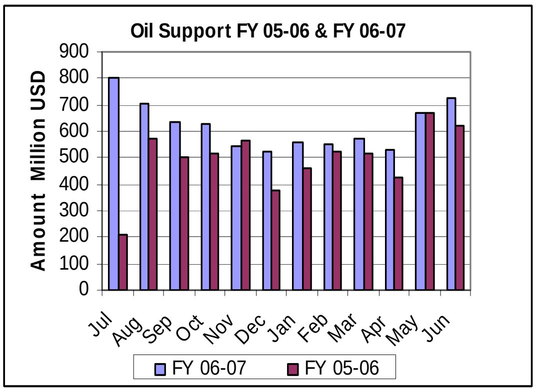
At the start of the year USD/PKR Exchange Rate was 60.22, which slightly depreciated to 60.37 at close of the year. The rate moved in the range of about 83paisas with highs and lows at 61.01 and 60.18 with a yearly average of 60.64/$. In the Open Market (Kerb), PKR kept a stable posture with relatively higher volatility than the Interbank Market. The Open Market rate mostly remained close to the Interbank Rate with an average premium of about 10paisa. On a few occasions, the Open Market rate also remained below the Interbank Exchange Rate inducing the Exchange Companies to divert their supply to Interbank Market **(See Table: 4.1 & 4.2)**.

Table 4.2: Avg. Monthly Exchange Rate

Month	(Average)	
	Interbank	Kerb
JUL'06	60.29	60.71
AUG'06	60.34	60.54
SEP'06	60.52	60.64
OCT'06	60.61	60.65
NOV'06	60.75	60.77
DEC'06	60.91	60.88
JAN'07	60.87	60.90
FEB'07	60.74	60.71
MAR'07	60.70	60.73
APR'07	60.70	60.74
MAY'07	60.67	60.75
JUN'07	60.62	60.99

The USD/PKR Exchange Rate continued to be market-determined, and any market intervention is always aimed at moderating the rate of change or diluting any excessive volatility in the Exchange Rate, rather than establishing any level for it. SBP as a policy doesn't target any specific Exchange Rate level and the rate is driven by prevailing demand & supply conditions. Therefore, SBP's FX Market Management remained concentrated towards monitoring of variations in bid/ask spreads and timely identification of any uni-directional bias emerging due to excessive commercial flows on either side filling the FEEL[1] of the banks. Otherwise, SBP fully allowed the market to appropriately manage the demand and supply on its own. The approach helped in building up capacity of market participants to quickly adjust with changing demand and supply conditions and cultivate a prudent risk management culture in their FX exposure management practices.

Figure 4.4



[1] FEEL: Foreign Exchange Exposure Limit

The increase in Foreign Exchange inflows also had its implications for Monetary Management and the Interbank Money Market. SBP, cognizant of this linkage, fine-tuned its activities in the FX Market in a way which contributed towards achieving its Monetary Policy objectives. In this regard, Foreign Exchange purchases were appropriately distributed in different tenors to coincide with the projected injection of USD liquidity because of POL Support thereby achieving optimal sterilization of Foreign Exchange flows.

Daily Arabian Light Crude Closing Prices

ARL-OSP-A Quote	Highest Quote	Lowest Quote	Average Close	% Y-o-Y Change*
FY 2002-03	$ 33.1	$ 22.6	$ 27.2	
FY 2003-04	$ 37.7	$ 24.9	$ 30.2	11.0%
FY 2004-05	$ 55.0	$ 32.5	$ 41.2	36.4%
FY 2005-06	$ 69.9	$ 49.9	$ 58.7	42.4%
FY 2006-07	$ 73.0	$ 48.6	$ 61.2	4.3%

* Y-o-Y % Change in Average Close Prices

	Jul - Jun: FY 2006-07 (P)				Jul - Jun: FY 2005-06			
	Quantity	**Value**	**Unit Value**		**Quantity**	**Value**	**Unit Value**	
	(in MT'000)	(US$ million)	(/Metric Ton)	(/ Barrel)	(in MT'000)	(US$ million)	(/Metric Ton)	(/ Barrel)
Petroleum Group	**16,789.5**	**$ 7,339.4**	**$ 437.1**	**$ 61.2**	**14,830.1**	**$ 6,674.9**	**$ 450.1**	**$ 63.0**
Petroleum Products	8,581.2	$ 3,733.3	$ 435.1	$ 60.9	6,092.1	$ 2,880.9	$ 472.9	$ 66.2
Petroleum Crude	8,208.3	$ 3,606.1	$ 439.3	$ 61.5	8,738.0	$ 3,794.0	$ 434.2	$ 60.7
	Quantity	**FY 07 versus FY 06**	**Price**					
% Change	**13.2%**	(Comparable Period)	**(2.9%)**					
Table: 4.3	**Source: Federal Bureau of Statistics**				*** Doesn't account for Local Crude**			

During FY 2006-07 also, SBP continued its support for POL payments. The total POL Support by SBP during FY 07 increased to USD 7.47 billion, which was 23.2% higher than the previous year figure of USD 6.07 billion **(See Table: 4.4)**. This was due to 13.2% increase in volume of oil imports **(See Table: 4.3)** and sharp rise in international oil prices which scaled the highs of USD 73/barrel (Arabian Light Crude) during the fiscal year. The international oil prices reflected a downward trend in the first half of calendar year 2007, as price of Arabian Light Crude touched the lows of USD 49/barrel in Jan 2007. However, subsequently the prices started rising again and the FY 07 average stood around $ 61.2/bbl. In line with the Oil Price trend, the monthly POL Support volume that had significantly come down between Dec'06-Apr'07 started rising again.

SBP - Oil Support to Market

FY 2006-07		FY 2005-06	
Jul-2006	$ 805.1	**Jul-2004**	$ 209.0
Aug-2006	$ 703.5	**Aug-2004**	$ 572.1
Sep-2006	$ 636.3	**Sep-2004**	$ 503.9
Oct-2006	$ 631.2	**Oct-2004**	$ 545.7
Nov-2006	$ 542.4	**Nov-2004**	$ 563.9
Dec-2006	$ 524.3	**Dec-2004**	$ 399.8
Jan-2007	$ 557.0	**Jan-2005**	$ 489.1
Feb-2007	$ 552.4	**Feb-2005**	$ 549.4
Mar-2007	$ 572.0	**Mar-2005**	$ 515.5
Apr-2007	$ 553.5	**Apr-2005**	$ 423.8
May-2007	$ 670.9	**May-2005**	$ 671.4
Jun-2007	$ 724.6	**Jun-2005**	$ 622.9
	$ 7,473.2		**$ 6,066.5**

[Table: 4.4] [Amounts in USD million]

Unlike FY 2005-06 when SBP made a net injection of USD 2.04 billion in Interbank Market on account of POL, the improved Foreign Exchange flows & proactive management enabled SBP to buy back more Foreign Exchange than supplied as POL support during FY 07, thus facilitating reserve accumulation. SBP Dealing Room activities in the market were timed to synchronize with the commercial flows filling in the FEEL of banks and did not in any way had impacted the value of the Exchange Rate.

Prudent market management and stability also facilitated in accumulation of FX Reserves. The Foreign Exchange Reserves of the country registered a record increase of USD 2.475 billion, closing the FY 2006-07 at Gross FX Reserves of USD 15.611 billion mark in June 2007, which was unprecedented in the country's history.

4.3 Reserve Management

Table 4.5: Global Official Reserves Trends

fficial FX Reserves (Sorted by FX Reserves Size)	FX Reserves* (Jun-2007)	FX Reserves* (Jun-2006)	% Change	% of Global
Global FX Reserves	**$ 6,061.0**	**$ 4,992.0**	**21.4%**	**-**
Asia & Pacific Rim	$ 3,637.7	$ 3,026.9	20.2%	60.0%
Europe & Russia	$ 1,450.3	$ 1,221.8	18.7%	23.9%
Middle East / Africa	$ 565.5	$ 447.9	26.3%	9.3%
Americas	$ 407.4	$ 295.5	37.9%	6.7%

*** All figures in USD billions** **Source: Reuters & IMF Website**

The Global Official FX Reserves, continue to grow at an average rate of 10% annually since 2001, with total Reserves crossing USD 6.0 trillion mark, and 60% of these Official Reserves are now being held by Asia & Pacific Rim countries **(See Table: 4.5)**. Consequently, the need has also arisen to prudently review the Reserve Management practices and fine-tune them appropriately as per the new circumstances. The Reserve Management globally has been going through a new phase driven by this phenomenal rise in Official Reserve holdings with increased focus on diversification & targeting optimal return. The reserve diversification increasingly has been more visible in terms of allocation to new asset classes & products rather then any major shift in currency allocations.

Table 4.6: Professional Certifications since FY 2005-06

Staff Doing Profesional Certifications in FMRM Cluster				
Certifications	**Certified**	**In progress**	**Planned**	**Total**
CFA	1	6	3	10
FRM	0	2	2	4
Others	0	1	3	4

Similarly, the institutional reforms taken up at SBP last year, continued during the fiscal year. In the reorganization of SBP on a Cluster Based organization, the Reserve Management Group acquired a more prominent place with the formation of Financial Markets & Reserve Management Cluster. Thus the scope, coverage & dimension of Reserve Management area was further strengthened by de-layering, enhancing efficiency, further institutionalizing decision making with strengthened controls & risk culture. The capacity building measures also continued at departmental & cluster levels, with skill enhancements through short-term secondments, extensive international & domestic trainings, self-study and encouraging individuals to take-up professional certifications relevant to the business. Additionally, sourcing competent professionals was carried out to fill open slots for these extremely specialized functions. An independent "Peer Group Review" of the re-organization and initiatives in Reserve Management Group was also conducted during FY 07 by a team of international experts in the area of Reserve Management. The feedback for the same has been extremely positive. This has further lent credibility and confidence that SBP is proceeding in the right direction.

Furthermore, in order to bring Reserve Management in line with the international best practices through diversification into various investment classes, broad guidelines were formulated in the revised Investment Policy, which were approved by the Central Board of SBP in the year 2003. Under this revised policy, Foreign Exchange Reserves have been categorized into three sub-portfolios: Cash, Short Duration Liquidity Portfolio and Medium to Long-term Portfolio. The categorizations of these portfolios were based on liquidity call requirements on the Country's Reserves, which are currently being re-assessed during the Strategic Asset Allocation Review.

Based on broader Investment Policy guidelines, Reserves Management Strategy was devised and a portion of Reserves is being managed by investment in Fixed Income Securities through External Fund Managers. The strategy included criterion for selection of External Fund Managers, Custodians, selection of benchmarks, drafting of investment guidelines and internal capacity building framework. As per the Board's guidelines, a portion of reserves was outsourced in year 2004 to be managed through External Fund Managers while the remaining Reserves are being managed internally. The External Fund Managers are mandated with benchmarks based upon Global Fixed Income aggregated indices customized to the Bank's risk appetite.

The Transition from old methodology of Reserves Management to new sophisticated techniques and practices was strategically important to bring all the reserves related functions under a single cluster to optimize the performance. The restructuring of all relevant departments was carried out in the year 2006 and a new Department "International Market & Investments Department" was created within the Financial Markets & Reserve Management Cluster. The restructuring has already started to pay off as a number of steps have been initiated to improve functional & operational efficiencies. The improvements include the systems up-gradation, a comprehensive MIS and its reporting to management for ensuring timely decisions. The steps taken have resultantly enhanced our analytical capabilities and improved performance measurement of Reserve Portfolio. The formal reporting procedures have been further streamlined and detailed performance reviews are being conducted with all External Fund Managers. Many development projects for enhancing performance, further diversifying our portfolio and improving the risk mix are under progress and will further strengthen our Reserve Management activities in coming years. For keeping the current level of expertise along with enhancement of the skills set of concerned staff, a more focused approach has been adopted as capacity building is now being linked to Reserve Management objectives and goals.

Table 4.7

Reserves Adequacy Ratios

Fiscal Year		Gross FX Reserves	Import* Coverage(Wks)	Reserve to Short-term Labilities*
FY'00	$	1,967.6	10.7	1.0
FY'01	$	3,219.5	16.5	1.0
FY'02	$	6,431.6	35.6	3.3
FY'03	$	10,719.0	49.3	7.6
FY'04	$	12,327.9	46.8	10.1
FY'05	$	12,623.4	34.7	8.6
FY'06	$	13,136.9	27.8	9.4
FY'07	$	15,611.4	30.0	10.4

* Ratio gives the number of times the short-tem liabilites are payable with the existing level of FX Reserves & Import coverage in weeks

Table 4.8: Top 15 Asian Official Reserve Holders

Order	Country's Name (Sorted by FX Reserves Size)		FX Reserves* (Jun-2007)		FX Reserves* (Jun-2006)	% Change	% of Global
	China	$	1,332.6	$	941.1	41.6%	22.0%
	Japan	$	913.6	$	864.9	5.6%	15.1%
	aiwan	$	280.6	$	258.2	8.7%	4.6%
4	South Korea	$	250.7	$	224.4	11.7%	4.1%
	India	$	213.5	$	162.9	31.0%	3.5%
6	Singapore	$	144.1	$	128.7	11.9%	2.4%
7	Hong Kong	$	136.3	$	126.6	7.7%	2.2%
8	Malaysia	$	98.4	$	78.8	24.9%	1.6%
9	Thailand	$	73.0	$	58.1	25.6%	1.2%
10	Indonesia	$	50.9	$	40.1	26.9%	0.8%
11	Phillipines	$	26.4	$	21.2	24.8%	0.4%
12	Pakistan	$	15.6	$	13.1	19.1%	0.3%
13	Vietnam	$	15.4	$	11.5	33.9%	0.3%
	Bangladesh	$	5.1	$	3.4	47.7%	0.1%
15	Sri Lanka	$	2.8	$	2.7	4.1%	0.0%

* All figures in USD billions

Source: Reuters & IMF Website

During FY 2006-07 SBP's Reserve Management has been entirely proactive with improved exposure, duration and liquidity management. Resultantly, Investment portfolio has added substantial value to bank's profitability and has added USD 1.1 billion to Reserves as income over the last 3-years. On gross return basis[2], SBP managed to earn a return of 5.40 percent on Foreign Reserves held by SBP as compared to return of 3.9 percent in FY 06.

4.4 Liberalization of Foreign Exchange Regime

The process of further liberalization of Foreign Exchange Regime continued in FY 07 augmenting the overall liberalized approach followed in the recent years. The major steps taken by SBP during the period under review include the following;

4.4.1 *Borrowings in Foreign Currency by Authorized Dealers:* In order to facilitate banks (Authorized Dealers), they have been allowed to raise foreign currency (FCY) loans from International Financial Institutions for converting into PKR and utilizing the same for liquidity management.

4.4.2 *Trading of quoted shares by non-residents through Special Convertible Rupee Account (SCRA):* In order to facilitate the non-residents investors, they have been allowed to trade in shares in Futures Market through Special Convertible Rupee Account.

4.4.3 *Advance Payments against Imports:* In order to further facilitate the import regime, SBP has allowed advance payments against letters of credit and firm registered contracts up to 100% of the FOB or CFR value of the imported goods.

4.4.4 *Remittance of Membership/Affiliation Fee to Professional Bodies/ Principals abroad:* The institutions and professional bodies in Pakistan with international affiliations have also been allowed to make remittances covering subscriptions or membership fee to bonafide scientific, technical, professional and educational institutions abroad. It may be noted that earlier such facility was only available to individuals.

4.5 Home Remittance Initiatives

SBP has taken a number of initiatives to further enhance the flows of Home/Workers' Remittances through formal channels. The steps taken by SBP have resulted in total remittances to reach USD 5.493billion in FY-2007, having registered a growth of 19.4% over FY06. The following includes the major initiatives:

4.5.1 *Enhanced Commitment of Financial Sector:* In order to achieve this end, SBP has developed continuous interaction with Banks & Exchange Companies. Special 'Home Remittance Cells' have been established in all banks with requisite IT support. Annual strategic plans were submitted by banks to SBP. SBP Task Force on Home Remittances was established for necessary interface with banks for implementation of their strategic plans.

4.5.2 *Consultative Role of SBP in Developing Business Propositions:* SBP officials have been in regular interaction with Banks & Exchange Companies with a view to evaluate implementation of individual strategic plans, identification of perceptive barriers to get

[2] The returns are based on Investment Portfolio

into/promoting remittance business, and provision of technical expertise in introducing new remittance products.

4.5.3 *Sharing of Best Practices:* SBP continuously abreast itself with successful remittance related practices being followed in other labor-sending countries and sharing the same with the stakeholders in Pakistan. A SBP-PBA team undertook the visit of Philippines in November 2006 as a part of the overall fact-finding exercise.

4.5.4 *Feedback Mechanism:* The Complaint and Monitoring Cell at SBP has been strengthened and all out, efforts are made at SBP level to address the public complaints within regulatory framework.

4.6 Exchange Companies

Owing to peculiar environmental characteristics attached with the Exchange Company (EC) sector, it has always been a daunting challenge for SBP to inculcate corporate culture and good governance in the overall sector. The various initiatives have been taken at SBP level to further strengthen the regulatory framework for Exchange Companies. The major steps taken during the period under review are;

- Exchange Companies have been debarred from opening of Nostro A/Cs with Exchange Companies abroad
- In order to ensure that ECs' business related agreements with outside parties and entities are in conformity with the related rules & regulations, ECs are required to obtain clearance from SBP before entering into such agreements.
- The reporting requirements for ECs were revised to make them more meaningful and elaborative for analytical purposes.
- The ECSs have been advised to separately account for all their inward and outward remittances. Under no circumstances, ECs have been allowed netting off inflows and outflows.
- ECs (B-category) have been advised to ensure the installation of efficient software fully capable of fulfilling the business and reporting requirements, ensuring issuance of system generated receipts through integrated and interconnected systems having capability of working on real-time basis.

5 Strengthening of Payment Systems

5.1 Overview

A robust payment system is the backbone of any sound financial dispensation. Information technology advancements, however, have revolutionized the functioning of payment systems. Automated world of today with real time settlement of financial claims has placed great responsibility on the central banks for effective oversight. State Bank of Pakistan has also been endeavoring to keep the payment systems in line with the international best practices and to be responsive to emerging domestic and international requirements.

5.2 Payment Systems and Electronic Funds Transfer Act 2007

The presence of an effective legal framework is considered vital for smooth operation of payment systems. In order to provide the regulatory framework for payment systems and electronic fund transfers, the Payment Systems and Electronic Fund Transfers Act 2007 was enacted by the Parliament. This has laid down solid foundations for development and further strengthening of payment systems in the country.

5.3 Real-Time Gross Settlement System (RTGS)

SBP is also in process of introducing numerous reforms, including gradual shifting from traditional paper-based, end-of-the-day settlement system to electronic payment system by implementing a Real-Time Gross Settlement System (RTGS) named PRISM (Pakistan Real Time Interbank Settlement Mechanism) for large value, low volume Interbank Funds transfers and settlements. The PRISM when implemented will provide the capability to settle inter-bank transactions whether clean or against securities on real time basis, minimizing the settlement risk for the participants involved.

The required hardware for PRISM System has been procured and installed at SBP Primary and Disaster Recovery sites. The connectivity arrangements are being finalized with PTCL and testing will start soon. Similarly, contracts with vendors for interfacing RTGS with SBP's internal banking application have been finalized and work in this regard has been initiated. As soon as the interfacing and connectivity aspects are completed, the training phase will start.

5.4 Society for Worldwide Inter-bank Financial Telecommunication (SWIFT)

SWIFT is used by financial institutions around the world for executing cross-border transactions and is considered as a secure communication channel. SWIFT is also used for executing high value local currency transactions such as RTGS and it will therefore be a primary communication channel for RTGS transactions in Pakistan. In order to ensure commercial banks' readiness, SBP is closely coordinating with them to upgrade their systems to handle RTGS transactions. Similarly, SWIFT hardware and software are being upgraded to provide interfaces with RTGS and GLOBUS. In this regard, SBP is preparing three operational sites of SWIFT namely Primary site, Back-up site and Disaster Recovery site with mirroring facilities. Additionally, in order to strengthen SWIFT operations in Pakistan, Eastern Networks SWIFT Service Bureau is being established. This will provide low cost SWIFT connectivity to banks in Pakistan with service level agreements.

5.5 Service Level Agreement (SLA) and Standard Operating Procedure (SOP) for 1-LINK and M-Net Switches

A robust and reliable infrastructure is critical for smooth operations of e-banking. SBP has initiated dialogue with two ATM switch operators i.e. M-Net and 1-Link and standardized Service Level Agreements (SLA) and Standard Operating Procedures (SOP) have also been developed in this regard which will provide improved ATM service in Pakistan compatible to international best practices. The SLA have a built-in mechanism of monitoring compliance through a monitoring committee consisting of representatives of the switches & the banks.

5.6 Management of ATM Cash and Downtime

The ATMs have become a popular mode of e-banking channel in Pakistan, as transactions through ATMs constitute 51% of total e-banking transactions. However, in order to streamline the functioning of ATMs with minimal complaints, SBP has issued guidelines wherein commercial banks have been told to minimize the incidents of cash or service outage and ensure continuous availability of ATM facility particularly during Ramadan, Eid holidays and other long weekends. Instructions were also issued to all member banks of 1-LINK and M-Net Switches to refund the charges deducted on failed transactions including partial/full cash retract along with the amount of such failed transactions.

5.7 Utility Bills Payment through ATMs

A consumer friendly payment system for utility bills has gained critical importance for consumers, utility companies and the banks. In this perspective, SBP took the initiative to leverage the e-banking channels to provide a solution, which meets the requirements of all stakeholders. Since ATM network in Pakistan has gained much acceptance, a plan has been chalked out to offer utility bills payment on ATM network in consultation and agreement with banks and switch operators. Through this initiative, banks will be offering the facility of accepting payment of utility bills via ATMs in a phased manner. Under the first phase, banks will provide this facility through their own ATMs while in the second phase customers would be able to pay utility bills through any ATM linked with any switch. This initiative will significantly facilitate the general public.

5.8 Performance of Retail Payment Systems

The total number of retail payment transactions (paper based and electronic) during FY 2007 increased by 14.1 percent to 423 million and the total value of such transaction increased by 27 percent to Rs.122 trillion against last year’s growth rates of 48 percent in numbers and 33.6 percent in value respectively. The growth witnessed in e-banking transactions during the same period was 42 percent in numbers and 34 percent in value. Consequently, the contribution of e-banking transactions in total retail payment transactions increased to 24.9 percent in numbers and 9.54 percent in value terms from 19.7 percent in number and 9.0 percent in value respectively recorded in FY06. The upsurge in electronic banking transactions is the result of rapid growth in e-banking infrastructure and increased users’ acceptance/ awareness of e-banking channel, which are quick, easy and cheap.

5.9 E-banking Infrastructure

The number of ATM machines has increased to 2,293 with the installation of 681 new machines during FY 2007 reflecting a growth of 42 percent over the previous year. Similarly online branch network has also expanded with the addition of 1,164 new online branches raising the total number of such branches to 4,719. The number of ATM transactions during FY 2007 have also increased by 16.5 million to 51.5 million showing an impressive growth of 47 percent over the preceding year while the value of ATM transactions increased by Rs.141.4 billion to Rs.352.4 billion, registering a growth rate of 67 percent over the previous year. However, ATMs were largely used for cash withdrawals and only marginally for other purposes like Cash Deposits, Payment of Utility bills and Account to Account Fund Transfers.

5.10 Clearing of Paper Based Instruments

The clearing of transactions is one of the major functions of payment systems. This facility has been provided by National Institutional Facilitation Technologies (Pvt.) Limited (NIFT) through its 15 centers, which cover 15 big cities and over 80 satellite cities and towns. Besides NIFT, National Bank of Pakistan (NBP) is also providing clearing and settlement services at all those places where the SBP offices do not exist. The NIFT clearing system is now supported by a PKI secured Web based reporting service. This facility, which has primarily been created to support countrywide multilateral netting, has a number of business advantages for the user. This system is active for all bank branches serviced by NIFT. NIFT is offering the value added services through internet as an additional facility to member banks. This would ultimately support RTGS by facilitating delivery of electronic data and reports to the State Bank of Pakistan and treasury managers.

5.11 Local US Dollar Instruments Collection and Settlement System

NIFT is also providing clearing services for US Dollar denominated instruments. This service is provided only for instruments issued and deposited in US Dollar accounts maintained with commercial banks in Pakistan. Introduction of Local US Dollar Clearing has brought about a profound efficiency in the dollar clearing system. By avoiding routing through New York, the new system facilitates the foreign currency account holders in terms of processing time and cost. The new system has reduced the clearing time of US Dollar cheques from three weeks to only four days along with cost savings to the account holders.

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