HARMONIZATION OF THE BANKING SECTOR IN SAARC REGION

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Harmonization of the banking sector should not be seen as an objective in itself for the member countries of SAARC region but it should be considered as a tool for achieving a large objective. South Asia has the largest number of poor people in the world. Any objective must therefore aim to address this particular issue in a perceptible way. Thus there must be a broad agreement and consensus that the objective should be greater production and exchange of goods and services among the regional countries so that the larger market achieved through intra-regional trading is able to generate economies of scale, lower cost of production, increase efficiency and lead to higher growth rate and reduce the incidence of poverty. Unless all the stakeholders in the countries of the region strike a consensus, forge a strategy and action plan in a sequenced and structured way the likelihood of an enlarged South Asian market becoming fully effective will remain low.

Leaders of SAARC Region have, after a long hiatus and slow start, agreed to weave together the South Asia Free Trade Agreement (SAFTA) in 2006. The practical implementation of SAFTA is therefore a priority for all the member countries. Careful planning and sequencing will be required along with strong political will to move in this direction. Some of the preparatory steps for making SAFTA take off in a meaningful way are:

- Trade facilitation through expeditious border crossings, quick custom clearance, efficient port facilities, improved transport

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links should precede or take place simultaneously with the expansion of volume of cross border trade.

- Domestic tax, tariff and subsidy policies that affect production and trade incentives should be harmonized to avoid recurrence of trade disputes and frequent use of anti dumping laws. As India provides a lot of subsidies to its producers in various forms and shapes the smaller countries are hesitant to allow MFN status to India. The recourse to a long negative list that restricts the volume of trade should be avoided at all costs.
- Macroeconomic policies such as fiscal and monetary policies should be harmonized to achieve a stable, non-discriminating macroeconomic environment for all the countries in the region.
- Supporting institutions to manage and facilitate integration, for example, setting standards, establishing regional development funds and for dispute resolution should be created.
- communication and transport infrastructure between the bordering countries should be improved and upgraded to facilitate increased trade and factor mobility.
- Legal regulations for investor protection, intellectual property rights enforcement, anti-trust law, commercial law, labor relations, financial institutions should be harmonized.
- Financial markets should be widened and regulatory changes introduced to promote cross-border investment, listings, syndication, bond issues etc.

After laying out the entire edifice of the preparatory measures required I will attempt to lay out an analytical framework for financial sector and banking sector harmonization in South Asia and then apply this framework to the case of Pakistan.

Empirical evidence and theoretical literature have now conclusively demonstrated that the more efficiently the financial sector carries out its intermediation role, the greater will be the volume of investment. More efficient financial intermediation also increases the average productivity of investment. Two major determinants of this functional efficiency of financial sector are market structure and the regulatory framework.

Market structure consists of the degree of competition, concentration and interlocking control between financial institutions and business enterprises as well as the degree of specialization within the financial sector. It is influenced by the internal organization and management of the financial intermediaries. These, in turn, are affected by the degree of government ownership and control. The regulatory framework includes regulations imposed both for monetary policy as well as prudential purposes.

Steps taken to stimulate competition are lowering the barriers to entry, abolishing interest rate ceilings, removing directed credit allocation, and privatizing government owned banks. The privatization of government owned banks is still controversial in most of the region but it must be obvious by now that these banks suffer from three terminal diseases i.e. high volume of non-performing loans, high intermediation costs and loss of initiative and entrepreneurship.

Thus harmonization of the banking sector in the South Asian countries should be driven by these two considerations i.e. to eliminate the distortions in the market structure and to strengthen the regulatory framework prevailing in each country. This agenda for market structure improvement should therefore aim to achieve the following outcomes:-

- Freeing interest rates so that they are determined by market forces
- Abolishing or lowering reserve and liquidity requirements
- Removing directed credit regulations and reservation of certain sectors as preferred ones
- Adopting indirect instruments of monetary control instead of credit ceilings
- Liberal branch opening and closure policy
- Opening up or easing entry into the financial sector including privatization of state owned banks
- Restructuring operations and elimination of excess or redundant manpower.

We should also be cognizant that a liberalized system described above would also be more vulnerable including possible systemic breakdown in which many financial firms and businesses may go out of business. If the political leadership have cold feet and do not allow terminally sick and financially unviable firms to die their natural death then the financial sector would always remain saddled with unnecessary burden exacerbating the event risk of banking crisis at some unknown time in the future.

Having discussed the pre-requisites of a market structure that will improve the efficiency of financial intermediation let us now turn to describe the essential elements of a desirable regulatory framework. Banking regulation should ensure that

- adverse selection in bank entry is avoided by making certain that individuals more likely to misuse banks do not get bank charters, banks have adequate capital investment, cross ownership is proscribed and character stipulations for bank ownership are enforced.
- the incentives of bank owners remain aligned with those of the depositors so that bank owners stand to make substantial losses in the event of insolvency. Loans loss provisions and capital adequacy regulations play a key role in bringing about such as alignment.
- excessive risk taking by bank managers is prevented by close scrutiny and supervision of their asset management. This includes measures limiting bank holdings of excessively risky assets, preventing lending to related parties, requiring diversification and making that banks have appropriate loan appraisal, documentation, follow up and classification procedures.

Along with the issues of harmonization of market structure and regulatory environment in the SAARC Region there is another issue that impinges upon the efficient functioning of financial sector i.e. autonomy and independence of the central banks among various countries. Assuming that the countries in the region are able to implement the measures required to achieve harmony in the market structure and regulatory environment the capacity of the central banks to taking appropriate actions on right time without interference, approval or reversal by another layer of decision makers will be quite critical. Thus the imperative of attaining central bank independence at an even keel in each country assumes an important dimension.

After laying out the analytical framework and specifying the characteristics essential for harmonization of banking sectors in the region it may be useful for me to narrate the progress Pakistan has been able to make in respect of each of the three dimensions discussed above. I do not wish to imply by presenting the experience of Pakistan that this should be the reference print for harmonization of banking system in South Asia but only to suggest that other countries should review where they stand at present and what needs to be done in the future.

Market Structure

(a) Four out of five large nationalised commercial banks have been privatized while fourteen private domestic and eighteen foreign banks were allowed to enter the banking sector. State ownership of banking assets has declined from 92 per cent in 1992 to 20 percent at present.

(b) Governance structure of banks has been strengthened, better disclosure and transparency standards have been introduced and credit ratings of banks have been made mandatory and disseminated widely to the public at large. Fit and proper criteria have been prescribed for the directors and senior managers.

(c) Artificially high rates of return on National Savings Schemes run by the Government were putting bank deposits at an intrinsic disadvantage and creating uneven playing field against the banks. These returns have been radically rationalised and aligned with market-based benchmarks so that the choice of the savers between NSS and bank deposits is no longer tilted.

(d) Foreign exchange markets have been totally liberalized. All current account transactions and most capital account transactions have been made convertible while exchange rate is market determined. Formation of exchange companies has encouraged further liberalization of capital movements.

(e) Government borrowing from the banking system is market based and the annual volume of borrowing is limited and pre-announced. Mandatory credit allocations or subsidised interest rates have been abolished and the Central Bank does not have any preferred sectors.

(f) Financial instruments of varying tenure such as Pakistan Investment Bonds have been introduced by the Government to serve as the benchmark enabling a corporate debt market to function.

(g) An online Credit Information Bureau is maintained by the Central Bank for sharing information with the commercial banks on the credit history of the borrowers, and particularly those who are not servicing their debt on time. This information is extremely useful to the banks in making informed credit decisions.

(h) Diversification of risks has been attempted by encouraging bank lending for agriculture, SMEs, consumer financing, mortgages etc. and widening and strengthening the customer base in place of a narrow concentration on public sector borrowers and corporates.

Regulatory Framework

(a) Central bank's capacity to supervise and regulate banks, effectively monitor non-performing loans, enforce actions against banks found violating regulations and laws has been strengthened. In the last four years, licence of one bank was revoked while appropriate intervention resulted in change of ownership and management of three banks. Several institutions were forced to liquidate or merged with strong institutions. If these actions were not taken these banks would have collapsed with disastrous effects for the financial markets.

(b) Several development financial institutions have either been closed, wound up, privatized, converted into a bank, restructured and adequately capitalized for eventual sale to the private sector.

(c) An independent assessment of the financial sector by a joint World Bank-IMF team has concluded that the financial soundness indicators of Pakistani banking system are robust and can withstand exogenous shocks. Observance of internationally accepted standards and codes has found to be quite high.

(d) Minimum capital requirements of banks have been raised twice during the last four years to weed out weak banks and allow mergers and consolidation to take place so that fewer but stronger banks operate in the system.

(e) Stringent measures have been laid and enforced on classification of non-performing loans, loan loss provisioning, tier 1 and tier 2 capital adequacies, write off of unrecoverable debt and allocation of capital against market risk.

(f) Three different sets of regulations specifically tailored to manage the risk profiles of corporate, consumer and SME lending have been issued by the State Bank in consultation with the banks and businesses.

Central Bank Autonomy

Central banks are required to promote the establishment and operation of a safer and sound financial system i.e. the framework of prudential regulations and supervision as well as payment and settlement systems. Central banks also play a critical role in crisis management through provision of emergency liquidity assistance. Finally, price stability has to be assured to lay the foundation for long-term sustainable growth. For these functions to be performed effectively the central banks require a degree of autonomy.

State Bank of Pakistan has gradually won a substantial amount of autonomy and independence during the last several years. The laws governing the Bank have been modified from time to time to provide adequate decision making authority and powers in respect of the conduct of monetary policy, banking supervision and regulation, exchange rate and foreign reserves management and payment and settlement system. A Monetary and Fiscal Coordination Board has been set up to coordinate monetary and fiscal policies. An independent Board of directors consisting of seven eminent individuals drawn from various walks of life oversees the activities of the Bank and formulates policy guidelines. The Ministry of Finance has only one representative on the Board and exercises a single vote in decision-making. The Governor and the Board cannot be removed by the Government until they complete their tenure. The exercise of autonomy is, however, very much a function of the competence and capabilities of the Central bank. Therefore, concerted efforts were made to upgrade the technology, human skill base, reengineer the business processes, and delegate powers, restructure the core and non-core functions, and introduce modern management practices. This improvement in capacity was essential for the Central bank to assert its independence while winning the respect of the stakeholders.

NEXT STEPS

As a practical measure we should begin the process of harmonization of banking sector in our region. The starting point could be that the definition of the soundness indicators, the uniformity of prudential regulations and the availability of financial infrastructure such as payments and settlement system are worked through developed and agreed upon for adoption by all the countries. For example, capital adequacy requirements on the basis of risk-weighted assets vary within the region, the classification rules for non-performing assets differ widely, provisioning criteria are wide apart. Capital reserves representing surplus from the sale of assets are treated differently, the constituents of core capital prescribed by each central bank have large variation. This list can be expanded and enlarged to present a comprehensive picture but the practices in each country can be evaluated and brought in line with international standards. Consolidation of financial information of the banks operating in various countries of the region should be made mandatory so that cross-border risks are fully understood. The bank branch opening by the South Asian banks in each other's countries should be facilitated and encouraged. Payments and settlement system should be linked in order to expedite transfer of payments across the borders in the region.

These four steps alone would take some time but pave the way for other steps in the sequence to be followed subsequently.

CONCLUSION

This paper has set out the analytical framework for harmonization of the banking sector in South Asia region. The three pillars of this framework are market structure, regulatory framework and institutional autonomy of the Central Bank. The paper then applies this framework to the case of Pakistan in respect of each of the three pillars. Although this case study should by no means be used as a benchmark but it provides insights to each country as to how much distance they have already traversed in respect of these three dimensions and how much they have to move further.