1 Financial Sector and Regulatory Profile

The financial sector[1] in 2003 continued to record notable improvements in its size and soundness, both on account of the on-going reforms and the increased economic activities that have propelled the economy into a higher GDP growth trajectory. Overall assets of the financial sector increased to Rs 4.1 trillion in 2003 at a remarkable growth rate of 15.3 percent. In terms of GDP (at current market prices), the size of the financial sector constitutes 84.7 percent for 2003 compared to 80.4 percent for the previous year. However, the growth performance displayed a greater variation among the major segments of the financial sector (see **Table 1.1**). This variation across groups is largely attributable to the differences in their business orientation which resulted in some segments benefiting more from the overall economic growth.

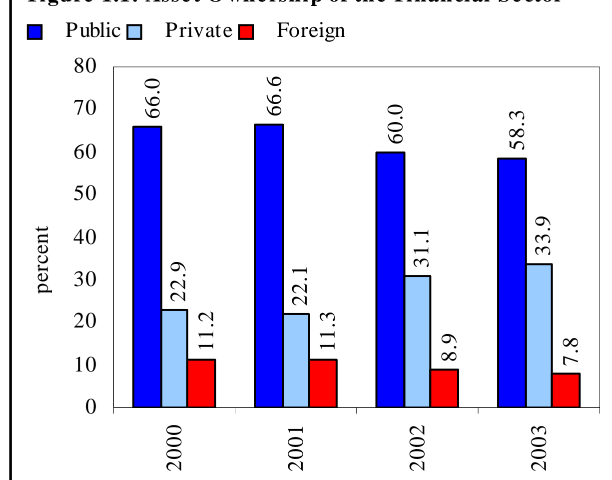
Table 1.1: Asset Dynamics of the Financial Sector

	2000	2001	2002	2003
Assets (billion Rupees)	2,970.6	3,129.2	3,539.1	4,081.8
Asset Shares of Major Institutions				
Banks	60.9	62.1	62.8	62.4
NBFIs	8.1	6.5	6.0	6.3
Insurance	7.0	7.1	7.2	7.3
CDNS	24.1	24.3	23.9	24.1
Financial Sector	100.0	100.0	100.0	100.0
Growth Rates				
Banks		7.4	14.5	14.5
NBFIs		-15.7	5.6	20.2
Insurance		7.2	14.7	16.0
CDNS		6.5	11.1	16.0
Financial Sector		5.3	13.1	15.3
Assets as percent of GDP (at market prices)				
Banks	47.7	46.7	50.5	52.8
NBFIs	6.3	4.9	4.9	5.3
Insurance	5.5	5.4	5.8	6.2
CDNS	18.8	18.3	19.2	20.4
Overall	78.3	75.2	80.4	84.7

1.1 Structure of the Financial Sector

The most significant factor to consider in the composition of the financial sector is the change in ownership structure. Looking at **Figure 1.1**, asset holdings of the privately owned financial institutions continue to follow a rising trend. Their share in the overall financial sector assets has increased to 33.9 percent by end-2003. This persistent rise in the asset share of the private sector financial institutions is largely supported by: (1) on-going privatization of public sector financial institutions; (2) mergers/acquisition of a number of foreign banks with private sector commercial banks; (3) aggressive business activities of the private banks; and (4) surge in activities of existing NBFIs, largely on account of the boom in equity markets. More significantly, this rise in private sector asset share is in the presence of CDNS, which mobilizes funds directly from the public for the government. If we exclude CDNS from the overall financial sector and reclassify HBL (due to its privatization in CY04) from the public sector institutions to private sector, the asset share of the private owned financial institutions jumps to 58.1 percent by end-2003. This means that the private sector, jointly with the foreign banks, holds around 70 percent of overall assets of the financial

Figure 1.1: Asset Ownership of the Financial Sector



[1] Due to the different financial years for various financial entities, data of NBFIs, Specialized banks and CDNS as on 30th June 2003 (i.e. end-FY03) is added to the data of the banking sector and insurance companies as on 31st December 2003 (i.e. end-CY03). To compute ratios of financial assets for CY03 with the GDP at current market prices, data for FY03 is utilized. A similar approach is followed to consolidate data for other years.

institutions. Given this ratio of ownership, it is evident that the financial sector is now largely controlled by the private sector.

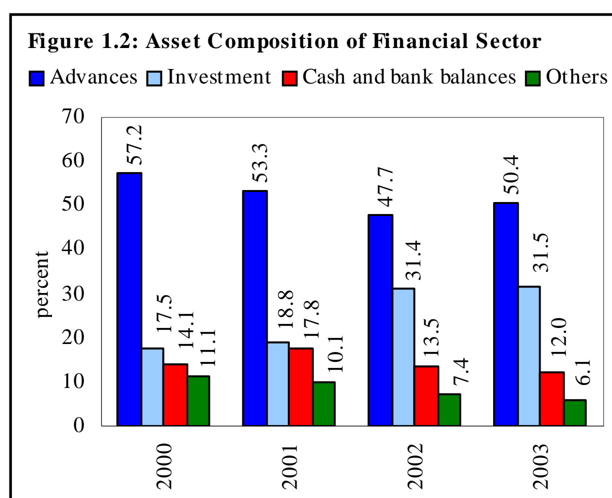
Besides the ownership structure, another noteworthy point is that the size of the financial sector as a proportion of GDP has increased by 4.3 percentage points. This translates into an addition of Rs 542.7 billion in the financial sector during the year. Moreover each segment of the financial sector has increased its size in relation to GDP. A closer look at **Table 1.1** reveals that although a strong rise of 20.2 percent in the assets of NBFIs overshadowed the performance of the banking sector in terms of the yearly increase in asset share in the overall financial system, growth of the banking sector can easily be seen from the assets to GDP ratio, which has witnessed a visible rise of 2.3 percentage points accounting for over 50 percent of the increase in the ratio for the overall financial sector. CDNS was the second major contributor, as the net mobilizations through national savings schemes (NSS) registered a 16.0 percent growth during FY03. Moreover, the relatively higher return on national savings schemes as compared to lending rates led to an interest rate arbitrage possibility which fueled the double-digit growth in these instruments, despite the gradual rationalization of their rates of return.

The institutional shares of the financial sector indicate that although the financial sector continued to be dominated by banks, asset share of banks and NBFIs witnessed considerable changes over the period of assessment, as compared to a steady rise in the asset share of the insurance sector and minor changes in the share of CDNS (see **Table 1.1**). In fact, NBFIs have been gradually losing their market share to banks due to mergers/acquisitions of the NBFIs with commercial banks and banks' increasing business activities in areas where the NBFIs were strong (for example auto finance). However, despite these developments, the asset share of NBFIs increased to 6.3 percent in overall financial assets by end-FY03 compared to 6.0 percent for the last year. The institutional break-up of NBFIs indicates that major contributors to this increase in share were the DFIs and Mutual Funds. The assets of DFIs saw an impressive growth of 15.3 percent during FY03 on account of increasing business activities in general and investment activities in particular. During the same period, mutual funds almost doubled to Rs 56.2 billion primarily due to the boom in the equity market and capital gains on government securities.

1.1.1 Key Indicators of Overall Financial Sector[2]

Asset composition of the aggregate balance sheet of banks and NBFIs changed slightly during 2003. The share of investments in overall assets which surged to 31.4 percent in 2002 inched up marginally to 31.5 percent during 2003 (see **Figure 1.2**).[3] In sharp contrast to the previous year when the share of advances had declined, it surged during 2003 on account of massive credit expansion to the private sector. Specifically, this rise was largely explainable by two factors. First, credit demand from the traditional corporate

Figure 1.2: Asset Composition of Financial Sector



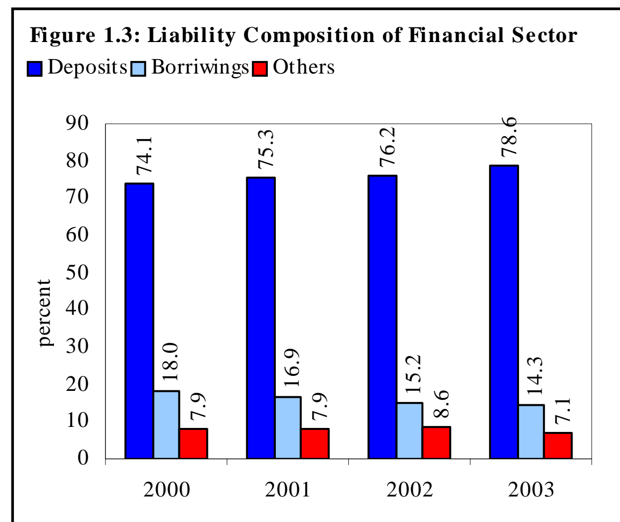
[2] The discussion in this section is based on the consolidated data of the banking sector, micro-finance institutions and NBFIs other than mutual funds. Effort has been made to consolidate only those financial institutions which share a number of similarities such as the ability to mobilize deposits, and to extend credit. CDNS and Insurance companies have also been excluded.

[3] Increase in investment activities of the financial institutions over the past two years reflects their effort to take advantage of buoyant equity markets and to lock their assets at high rates in government (medium to long-term) securities amid falling interest rates.

sector increased, given that it borrowed not only to finance its working capital requirements, but also for Balancing, Modernization and Replacement (BMR) purposes, to take advantage of historically low interest rates. Second, a change in the focus of financial institutions towards non-traditional areas like consumer finance, SME and micro-finance and agri-credit, was another contributory factor. The share of another important component, *cash and bank balances* declined by 1.5 percentage points during CY03. This reduction is due to the extraordinary efforts of financial institutions to channelise funds into earning assets, particularly in the presence of increased competition and declining average spreads.

On the liability side, the share of deposits maintained an increasing trend during 2003 due to continued double-digit growth for the second consecutive year (see **Figure 1.3**). Increased workers' remittances, impressive performance of the real sector and massive credit expansion are some of the major factors which led to this growth during the past two years. The availability of cheaper funds in the form of deposits mainly underpins the declining share of borrowing, which is a relatively expensive source of funds for financial institutions.

Figure 1.3: Liability Composition of Financial Sector



While the above discussion provides useful information about the changes in macro balance sheet variables, an analysis of key financial ratios will be more instructive. A quick glance at **Table 1.2** shows that key ratios have registered a marked improvement during 2003. Equity to liability ratio, an indicator of capital adequacy increased by 0.7 percentage points to 7.5 percent by end-2003. The improvement is more pronounced if the surplus on revaluation of assets is excluded.

Table 1.2 Major Indicators of the Financial Sector

percent

	2000	2001	2002	2003
Equity (excluding surplus/deficit) to liability ratio	4.4	4.7	4.9	5.9
Equity to liability ratio	5.1	5.4	6.8	7.5
Equity to assets ratio	4.9	5.1	6.3	7.0
Borrowing to liability ratio	18.0	16.9	15.2	14.3
Deposits to liability ratio	74.1	75.3	76.2	78.6
Average cost of deposits and borrowing	6.5	6.2	4.4	2.1
Average return on advances and investment	12.5	13.3	9.5	6.6
Average spread	5.9	7.1	5.1	4.4
Net interest margin	3.9	5.0	4.4	4.1
Non-interest income to total income	18.4	15.0	19.1	30.6
Return on average assets (before tax)	0.2	0.2	1.1	2.1
Return on average assets (after tax)	-0.2	-0.4	0.4	1.4
Earning assets to total assets	74.7	72.1	79.1	81.9
Liquid assets to total assets	31.6	36.6	44.9	43.5

Another point to note is the changes in intermediation cost and profitability of the financial sector. The former, generally measured in terms of spreads and net interest margin, witnessed a notable improvement as both the ratios decreased during 2003. A number of factors are responsible for the

decline in spreads. These include: (1) increasing competition among financial institutions; and (2) limited scope for further cuts on deposits rates, as the average cost of funds has already plummeted to 2.1 percent only,[4] significantly lower than the inflation rate during the same period. However, despite squeezed margins, the profitability of the financial sector has increased. Return on average assets (after tax) surged to 1.4 percent by end-2003, which is not only higher than the previous year but is also comparable to generally accepted benchmark of *1.25 percent*. This impressive rise in profitability is largely attributable to the increased business activities of the financial sector, which is quite evident from the substantial rise in credit expansion and investments. Support also came from non-core business activities of the financial sector, as the share of non-interest income spiked to 30.6 percent during 2003 as compared to 19.1 percent for 2002. Besides including normal components such as fee, commission etc., this jump in non-interest income was due to the massive capital gains realized on fixed income government securities and increased trading in equity stocks.

Liquidity position of the financial sector remained comfortable, as the liquid assets to total assets ratio has maintained a sufficient level despite a slight decline. This means that although excess liquidity with the financial sector abated a bit during 2003, the financial sector remained amply liquid.

In sum, the overall financial sector has registered a marked improvement during 2003 and its resilience to both internal and external shocks has increased. Furthermore, the financial system is well equipped to cater to the credit needs of burgeoning economy. However, despite the impressive performance of the financial sector, a word of caution is quite relevant here given the increased exposure to credit and market risks. Easy availability of funds at cheap rates helped the financial sector to explore relatively new areas for growing their asset base. The lack of a sufficient level of expertise to deal with these newly explored areas may undermine the asset quality of the financial sector.[5]

Another point to highlight relates to the investment activities of the financial sector. A substantial holding of fixed income government securities by the banks and NBFIs is a source of concern, as an upward movement in interest rates can lead to capital losses.[6] Similarly, investments in equity may be another potential source of losses. Their share in overall business activities is currently not very high, but a trend reversal in the equity market may lead to further erosion in the capital base.

Finally, although separate set of prudential regulations has been issued for the banks and NBFIs by SBP and SECP to ensure a minimum level of prudence, financial institutions must formulate their own credit and investment policies in line with regulatory guidelines, in order to proactively monitor their overall portfolio risk.

1.1.2 Structure of Financial Savings

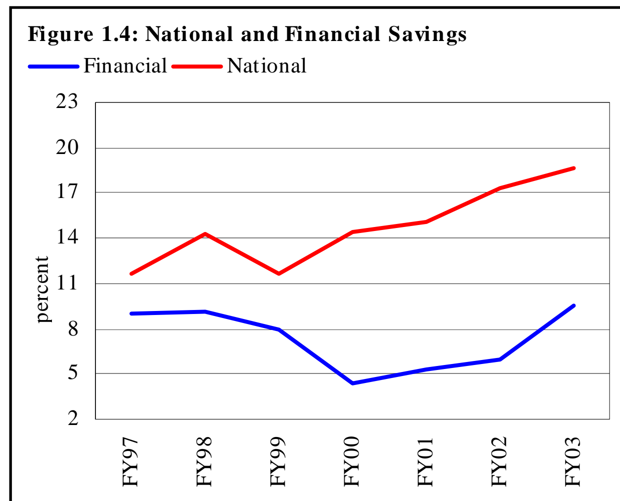
The accumulated momentum of financial savings continued during FY03, as it has registered an increase of Rs 459.9 billion in this period as compared to Rs 264.9 billion during FY02. This was the second year in a row when the growth of financial savings was in double digits (see **Table 1.3).** As a result, financial savings as a percent of GDP increased to nearly 70 percent. Moreover, the financial saving rate during FY03 rose to 9.5 percent, which is almost half of the national saving rate (see **Figure 1.4)**

[4] Average cost of deposits will be even lower than the average cost of funds mobilized which also include funds raised by relatively costly borrowing.

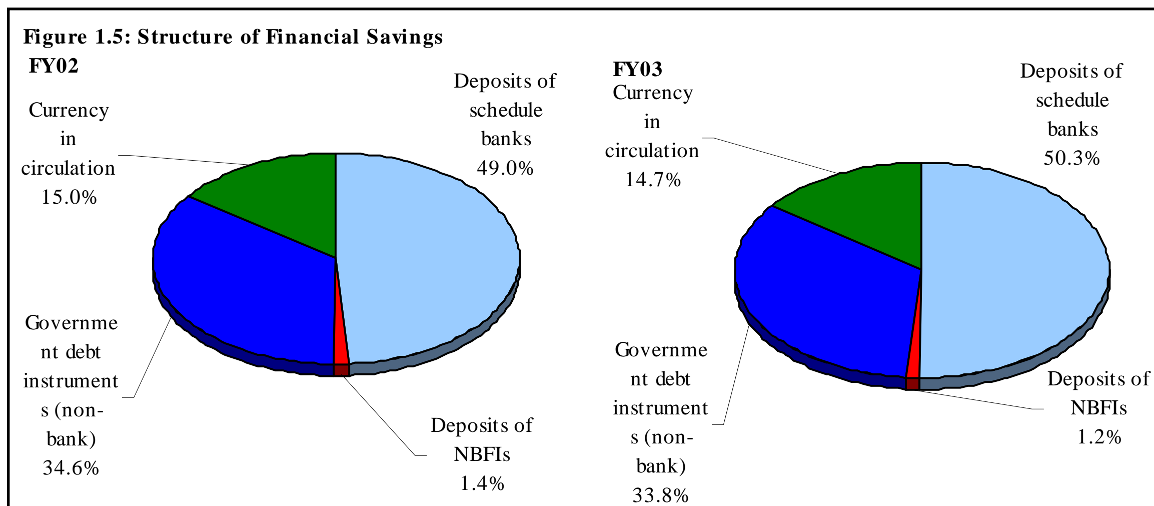
[5] Although Sate Bank of Pakistan has made it mandatory to create general reserves to deal with any adverse shock in these areas, the utmost care must be taken in credit expansion.

[6] As has already been witnessed in the case of some commercial banks

The overall structure of financial savings in FY03 in terms of its components remained almost the same as that of FY02, except for the share of scheduled banks deposits. A comparative analysis of the components of financial savings shows that the share of the scheduled banks deposits has increased by more than 1 percentage points as compared with FY02, at the expense of investments in government debt instruments (see **Figure 1.5**)



Although this shift seems small in quantitative terms, the underlying qualitative change is significant, as it has come in the wake of the changing ownership structure of banks from the public to the private sector. Increasing share of deposits in financial savings, given the low level of returns on deposits on the one hand and relatively higher returns on government debt instruments on the other hand, indicates a change in the mindset of the investors who now seem eager to explore investment alternatives offered by the private financial institutions. This change in the mindset has been shaped gradually by the ban on institutional investment in NSS instruments imposed since March 2000 and the availability of ample liquidity in the financial system.



Furthermore, scheduled bank deposits as a percent GDP have also increased to 35.0 percent at the end of FY03 from 32.3 percent at the end of FY02. This implies that the growth in the deposit base of the scheduled banks is more than the GDP growth. As a result, the proportion of net incremental deposits in GDP increased from 3.3 to 5.5 percent during FY03.

The contribution of government debt instruments declined during FY03. The Federal Investment Bonds (FIBs), which were largely held by the non-bank financial institutions and whose issuance was discontinued in 1998, are now close to their maturity. As an alternative, PIBs were launched in the year 2000. PIBs are largely held by the scheduled banks and due to the maturing FIBs, the share of non-bank savings in overall financial savings has gone down.

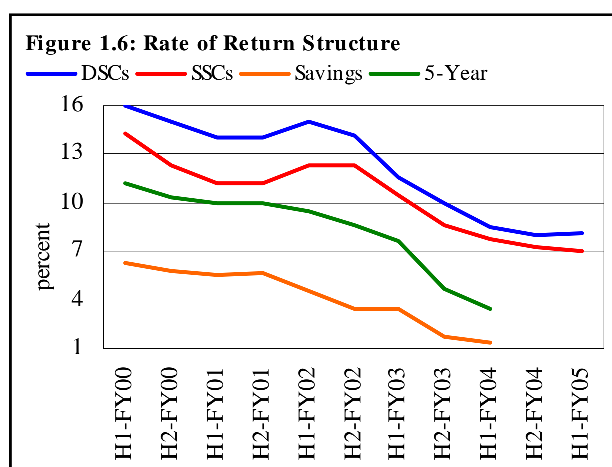
Table 1.3 Financial Savings

	FY00	FY01	FY02	FY03
Financial savings (billion Rupees)	2,401.1	2,634.9	2,899.9	3,359.8
As percent of financial savings				
Deposits of schedule banks	47.2	48.4	49.0	50.2
Deposits of NBFIs	4.3	3.2	1.4	1.2
Government debt instruments (non-bank)	33.7	34.1	34.6	33.8
National savings schemes	29.6	28.9	29.2	29.2
Others securities	4.1	5.2	5.4	4.6
Currency in circulation	14.7	14.2	15.0	14.7
Stock as percent of GDP				
Deposits of schedule banks	30.1	30.7	32.3	35.0
Deposits of NBFIs	2.7	2.0	0.9	0.9
Government debt instruments (non-bank)	22.5	21.6	22.8	23.6
National savings schemes	18.8	18.3	19.2	20.4
Others securities	2.6	3.3	3.6	3.2
Currency in circulation	9.4	9.0	9.9	10.3
Financial savings	63.3	63.3	65.9	69.7
Flows as percent of GDP				
Deposits of schedule banks	0.7	3.3	3.3	5.5
Deposits of NBFIs	0.5	-0.5	-1.0	0.0
Government debt instruments (non-bank)	1.5	2.0	2.4	2.8
National savings schemes	2.4	1.1	1.9	2.8
Others securities	-0.9	0.9	0.5	-0.1
Currency in circulation	1.8	0.5	1.3	1.3
Financial savings	4.1	5.6	6.0	9.5
National Savings	14.4	15.1	17.3	18.6

The share of currency in circulation in overall financial savings has remained stable (around 15 percent) during the last few years. However, the stock of currency in circulation reached Rs 495 billion at the end of FY03 from Rs 356 billion at the end of FY00. This higher stock of currency in circulation as a percent of GDP reached 10.3 percent at the end of FY03 from 9.9 percent at the end of FY00. Interestingly, the proportion of the flow of currency in circulation in terms of GDP remained the same during FY03, which continues to reflect smaller savings in the form of cash holding.

During the last two years, the decline in interest rates continued at an accelerated pace (see **Figure 1.6**). Specifically, the heavy inflow of remittances increased the liquidity of the banking system, which resulted in continuation of this trend. However the pace of decline in banks deposits rates was higher than the decline in NSS rates (for details please see **Chapter 3**).

Figure 1.6: Rate of Return Structure



1.1.3 Payment System Profile

The term 'payment system' refers to instruments, institutions, operating procedures, information and communication systems used to transmit payment information i.e. transfer of money from an individual or corporate to others. In essence, the payment system is a means for carrying out not only funds' transfer related transactions, but also various other economic activities such as trade, commerce etc. An efficient, sound and secure payment system acts as a catalyst for the flow of money in the economy, which in turn, facilitates financial intermediation and economic growth. A sound payment system also helps in minimising various risks inherent in large financial transaction and ensures soundness of the financial system.

Institutional strengthening,[7] as a result of reforms introduced in the financial sector during the last decade, has been the major impetus to the changing payment profile in Pakistan. More importantly, the growing volume of financial instruments exchanged among banks (and individuals through banks) and equities at the stock exchange have been creating problems in terms of book-keeping, settlement delays etc., which also expose the banks and equity markets to various risks.[8] The Core Principles for Systematically Important Payment Systems, issued (in January 2001) by the Bank for International Settlements, also calls for designing and operating safe and efficient payment systems.[9] In order to facilitate safe and speedy flow of funds and to minimise the risks involved in a manual paper-based system, both the SBP and SECP, in collaboration with private sector, have taken various steps to strengthen the mechanism for the payment and settlement of financial transactions. Consequently, the payment system profile of Pakistan has undergone significant changes during the last decade. However, it is still in transition phase i.e. transformation from a manual paper-based system to a highly efficient and technologically driven modern system. Automated and electronic means of financial transactions are gradually replacing the old paper-based system (in which the physical movement of the payment instruments was mandatory). The use of credit, debit and ATM cards has grown rapidly, as well as the infrastructure facilitating them during the last five years (see **Table 1.4).**[10] A few banks have also extended the facility of online access to customers' accounts.

Table 1.4 Statistics on Automation

	CY00	CY01	CY02	CY03	End-June 2004
Number of online branches	322	450	777	1,581	2181
Number of ATMs	206	259	399	552	676
Number of ATM cards (in '000s)	-	-	-	1,161.4	1,599.9
Number of ATM transactions (. in 000)	3,624.5	5,944.3	9,459.0	15,314.3	5,600.9
Value of transactions (million Rs)	12,507.0	22,201.1	38,507.0	68,988.7	49,788.9

The increasing use of credit and debit cards and automated teller machines (ATMs) for cash withdrawals have considerably reduced paper-based payment instruments. Moreover, the clearing system has undergone significant improvement in terms of automation. Another major development during CY03 is the inter-switch connectivity.[11] As a result, the customer has been provided an access to his account through any ATM machine in addition to the card issuing banks' designated ATM machine.[12] In order to further enhance the outreach of ATMs, some of the banks have installed them within or near the premises of major shopping centers. Similarly, few banks are also considering the option of mobile ATM machines.

[7] In terms of regulation and oversight, the payment profile of Pakistan can be divided into two parts: (1) the payment and settlement of the financial transactions carried out in the banking system; and (2) the settlement of equity transactions.
[8] The paper-based payment and settlement system entails three major risks i.e. settlement, credit and systemic risks.
[9] The BIS core principles also emphasize on sound legal infrastructure for the systematically important payment system.
[10] In case of most of the banks, the ATM card can also be used as debit card.
[11] There are two major ATM switches (i.e. M-net and One-link) to which all the banks have been linked facilitating their customers' access to withdraw cash using their respective ATM cards.
[12] However, there is an additional charge that the user has to pay for the use of other banks' machine.

The automation of retail cheque clearing also continued to witness improvements during FY04. The National Institutional Facilitation Technology (NIFT) has gradually extended its services beyond the major cities (i.e. Karachi, Lahore, Rawalpindi and Islamabad) to Faisalabad and Hyderabad during the last year; it is also expected to start operations in Quetta and Peshawar during the course of 2005. The NIFT, however, provides the net balance of the banks by the end of the day, which is finally settled in respective banks' accounts maintained with SBP.[13] The clearing houses, where NIFT has started operations, now cover more than 85 percent of the total cheques cleared in all the clearing houses operated by SBP. The statistics on clearing-house turnover are given in **Table 1.5**

Table 1.5: Indicators of Turnover in Clearing House

Year (end June)	**Checks cleared** (Million No.)	**Value of cheques cleared** (Billion Rs)	**Total no. of accounts** (Million No.)	**Chequeable deposits** (Million No.)	**Cheques cleared/chequeable deposits**	**Currncy/amount of deposits**	**Ratio of turnover to GDP**
FY96	20.4	2590.0	31.5	29.6	0.7	26.4	1.22
FY97	23.6	2773.0	33.2	31.4	0.7	24.5	1.14
FY98	22.7	3023.1	30.0	28.4	0.8	25.5	1.13
FY99	27.8	4098.3	31.1	28.7	1.0	26.4	1.39
FY00	29.6	4900.4	28.8	27.0	1.1	31.2	1.56
FY01	30.4	5631.7	27.8	26.6	1.1	29.4	1.65
FY02	33.8	6119.4	28.3	27.4	1.2	30.5	1.69
FY03	40.4	7654.7	28.8	28.0	1.4	31.9	1.59

The wholesale inter-bank transactions and cash movement of government securities' transactions, however, continue to be settled through a book-based manual entry system. The banks holding accounts with SBP are issued cheque books which they use to transfer funds from their accounts. The banks present cheques physically on SBP counters (by 1:30 pm every day) where the amounts are credited in the payee account and debited from the payer account. This system, however, involves a time lag between the execution of a transaction and its final settlement at SBP. As a result, the beneficiary/borrower bank remains exposed to a *settlement risk* because as long as the amount borrowed, or to be credited in his account, is not settled, any payment activity undertaken on the basis of the unsettled amount remains conditional.[14]

And, if there is a chain of payments to be made, for instance, bank A borrows from bank B who has already borrowed from another bank C and so on, then the failure of one of them to meet its obligations to the other bank, might result into an even bigger risk called *systemic risk*. In order to overcome these risks associated with the paper-based manual system and also in compliance with the BIS core principles for systematically Important Payment Systems[15], the SBP has started to implement a Real Time Gross Settlement (RTGS) system for large value inter-bank payments. The project is expected to be completed by the end of 2005.
In RTGS, the payment information and settlement takes place simultaneously on gross basis, and thus prevents settlement failure and potential systemic consequences. In other words, the banks (holding accounts with SBP) would be able to operate their accounts in real time.

Almost all of the transactions and their settlement in capital markets are computerised. All the three stock exchanges have introduced computerised trading systems, which is linked to the National Clearing and Settlement System (NCSS) managed by the Central Depository Company (CDC). The NCSS then provides the net position of different members to CDC, which is an electronic book

[13] The term settlement refers to transfer of funds from the payer's bank account to the payee's bank account maintained with SBP.
[14] Settlement risk refers to the risk that the settlement may not take place by the time bank needs liquidity. Therefore, the bank may fall short of liquidity and may not be able to honor its obligations regarding transfer of funds to another bank.
[15] Large value payments are called systematically important payments.

keeping system. Similarly, the transfer of shares/stocks is being settled through the Central Depository System (CDS) also controlled and operated by the CDC. The CDS is a software driven system in which the account holders (individuals, banks, corporate etc.) can access their accounts using allotted identification numbers and passwords (for login). The transfers in CDS are also routed through NCSS for clearing, which transmits the net position of different account holders to CDC, where transfers of equities are finally settled.

1.1.4 Monetary and Exchange Policy Environment

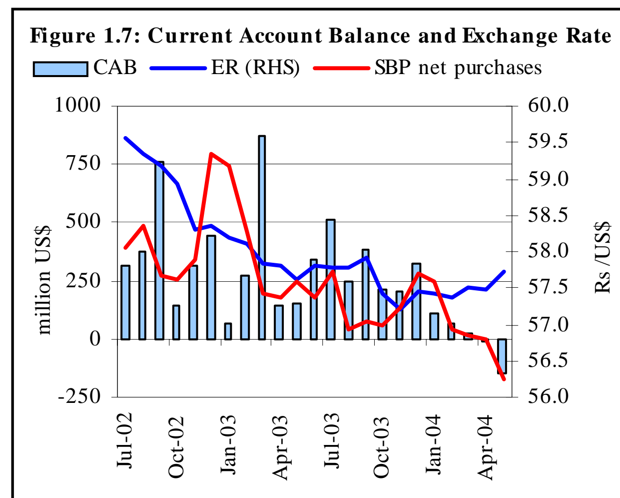
Monetary and Exchange Policy Environment during 2003 was characterized by two distinct elements. First was the continuation of the easy monetary policy stance adopted in July 2003, and second was the continued effort to maintain exchange rate stability. However, both these elements contrasted sharply with the policy environment of a year earlier in terms of : (i) the emergence of the expectations of a rise in interest rates; (ii) the trend reversal of the exchange rate; and (iii) an unprecedented increase in credit off-take by the private sector. While the first two developments were largely caused by a shrinking current account surplus, lowering both the forex and the Rupee liquidity (as SBP moderated its foreign exchange purchases in response) the third was the result of increasing economic activity and competition among the banks for the lucrative emerging consumer credit market. Moreover, the increased appetite for bank borrowing by the government in the face of sharply declining NSS receipts and early repayment of expensive foreign debt strengthened the market view on rising interest rates. These developments along with a sharp rise in inflation posed serious challenges to SBP's policy of containing the rise in interest rates with a simultaneous stabilization of the exchange rate.

Expectations of rising interest rates

Towards the end of September 2003, the market started to have a stronger view on rising interest rates, as it perceived a liquidity shortage in offing due to certain developments in the economy and an inflationary pressure was expected given the emerging overall CPI inflation trend. Such perceptions were based on the following facts:

(i) The current account surpluses had begun to moderate since June 2003 and continued to remain low during most of the months in FY04. Initially the declining workers' remittances and later the widening trade deficit were on the back of this decline. SBP tailored its forex purchases accordingly, which resulted in a decline in Rupee liquidity injections in the market (see **Figure 1.7**). SBP's forex purchases reduced substantially from January 04 and in fact it was a net seller from April to May 2004.

Figure 1.7: Current Account Balance and Exchange Rate



(ii) The government's policy of adjusting the NSS rates in the declining interest rates realm lead to a sharp decline in gross receipts against the various instruments. This decline, along with uptrending re-payments left the government with net negative receipts and accentuated its bank borrowing requirements.

(iii) The announcements of a Rs 25 billion PIB auction in June 2003, a subsequent jumbo issue of Rs 50 billion in September 2003 and an expected re-payment of expensive external debt (which materialized in January 2004) further fuelled the market expectations

of an increase in interest rates and were clearly reflected in the bids of the succeeding T-bill auctions.

(iv) Another source of concern for the expectation of a rise in nominal interest rates was the prevalent negative real interest rates (see **Figure 1.8**). Although interest rates became negative much before the rise in inflation, this was initially due to the sharp decline in nominal interest rates during October 2002 to May 2003. Later on, however, the sharp acceleration in inflation increased the magnitude of negative real interest rates.

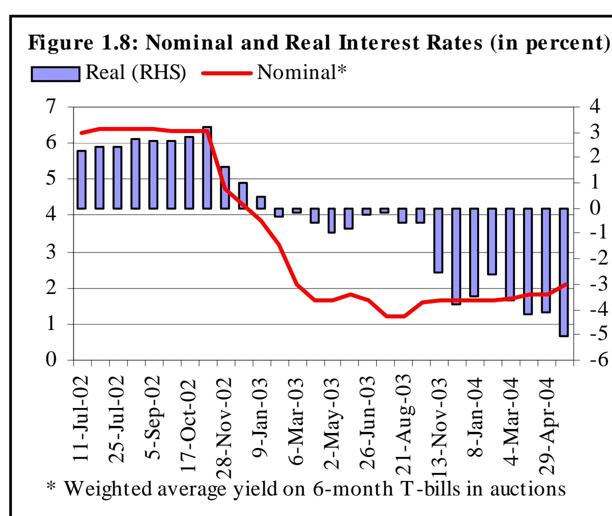
(v) The termination of the Saudi oil facility during H2-FY04 further increased the government borrowing needs, as the facility was a source of income through the sale of oil.

(vi) In addition to the above-mentioned factors, the rising international interest rates also strengthened the expectations of an increase in the domestic interest rates.

Trend reversal of the exchange rate

The Rupee/Dollar parity, which had been declining for the last three years, began to inch up in November 2003 and since then the Rupee has depreciated by over half a percent. As **Figure 1.7** shows, the trend depreciation of the exchange rate is in line with the current account deficit suggesting a genuine pressure on the exchange rate. The kerb premium also began to rise since the beginning of January 2004 but is still low enough to suggest any widespread speculative activity.

Figure 1.8: Nominal and Real Interest Rates (in percent)



* Weighted average yield on 6-month T-bills in auctions

During the second half of 2003, three distinct phases of exchange rate movement could be identified with several contributory factors at play. During the first phase, July – Sept 2003, the exchange rate moved mostly on the upper side of a narrow range (Rs 57.67 – 57.91 per US$) but towards the end of the phase showed some depreciation due to the quarter-end debt related payment pressures. The significant fall in the workers remittances and an increase in net retirement of foreign currency loans during July-December 2003, also reduced the market flows and remained an area of concern during other phases also. The retirement of forex loans reduced forex liquidity in the market as the loans lost their appeal due to the fading interest rate differential between the domestic and international interest rates and expectations of Rupee depreciation.

During the second phase i.e. Oct–Nov 2003, the Rupee again appreciated on the back of rising forex flows due to increased workers remittances, renewed interest in foreign currency loans, absence of debt repayments and more importantly because of a moderate level of SBP's inter-bank foreign currency purchases.

The third phase which started in November 2003, clearly reflects a trend reversal and a depreciating Rupee. During this phase, the most important event was the pre-payment of expensive external debt, which the market had been anticipating since the beginning of the year. Other major sources were the widening of the trade deficit, the termination of the Saudi oil facility, the increasing outstanding export bills and the declining foreign currency loans.[16]

[16] For a detailed discussion of the above-mentioned factors, see SBP 3rd Quarter Report for FY04.

Though the Rupee depreciation appeared to be marginal until the end of FY04, the continuation of this trend may have its own implications for the economy and can pose short to medium-term challenges for the SBP, such as: (i) the depreciating Rupee may become another source of inflationary pressure as most of the imports are of raw material and capital goods, which are much in demand due to a growing economy; (ii) it may kick-off the expectations of a weakening Rupee, leading to a round of speculative activities in the foreign exchange market; and (iii) it may divert the workers' remittances back to the kerb market provided the kerb market premium becomes large enough to give an incentive.[17] The evolution of depreciating Rupee expectations, nevertheless, depends upon market's perception of the SBP policy on the exchange rate. Since the SBP has robust foreign exchange reserves and has been successfully stabilizing the exchange rate so far the probability of the development of such expectations appears to be low.

Unprecedented credit off-take by the private sector

The easy monetary policy stance during the last two years lead to an unprecedented increase in the credit availed by the private sector. The acceleration in credit off-take during FY04 lead to an increase in credit to the private sector almost twice that of the previous year (Rs 301 billion during FY04 against Rs 152 billion in FY03). The increase in private sector credit is encouragingly matched by a parallel growth in large-scale manufacturing – the major recipient of private sector credit. Other major beneficiaries are the agriculture and the consumer finance sector. The credit growth in both the sectors has been phenomenal during FY04.

While the profound impact of the extraordinary growth in private sector credit on the economy is welcome, concerns regarding its trend sustainability and associated risks can also not be ignored, given the following factors :

(i) Since the bulk of the outstanding credit to the private businesses is to the textiles sector (27 percent), the forthcoming challenges in the form of a quota free export environment, loss in competitiveness due to anti-dumping duty on exports to EU and a decline in financial savings (in case interest rates go up) are likely to increase the risk of the inability to service debt.

(ii) As the textiles sector has mainly been investing in BMR activities, their credit demand for such investments is more likely to slow down once the process is complete.

(iii) The growth in consumer finance appears more to be a function of ample liquidity with the banks and the low interest rate environment. The sustainability of such lending trend again hinges upon the same factors. The availability of liquidity with the banks would determine whether the banks would remain engaged in this sector or restrict their exposure to their priority client i.e. the corporate sector. Nevertheless, the relatively higher return on consumer finance would remain an incentive to invest in this sector. A rise in the interest rates is likely to increase the default risk and adverse selection by the banks.

SBP policies and actions

SBP faced two major policy challenges during FY04: (i) to quell the rising interest rates expectations as it held the view that a rise in interest rates would be detrimental to economic growth which was finally on the right track and; (ii) to maintain exchange rate stability, given the inflationary tendencies of a depreciating Rupee.

Quelling interest rate hike expectations

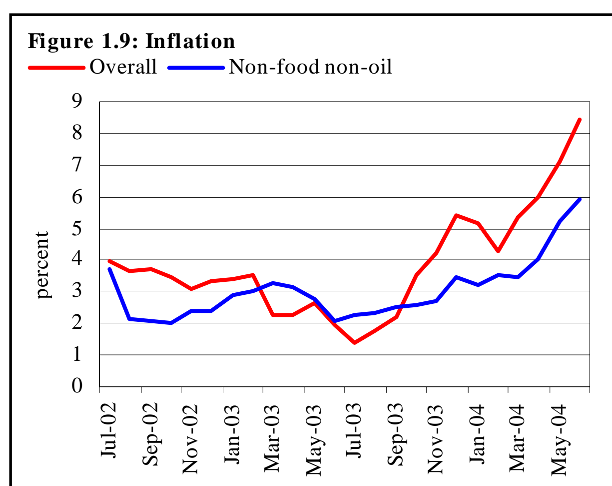
[17] The probability of such diversion is, however, low since the diversion of workers' remittances from the kerb market to the banks was more due to the crackdown on the *hundi* network than the kerb premium.

While the SBP had a common view with the market in terms of receding current account surplus, increasing government borrowing needs from the banking system and rising inflation being the three major sources of concern raising expectations of rising interest rates, it shared little in terms of their effect on the monetary policy stance. SBP, nevertheless, remained mindful of the various developments, which could have potentially led to a liquidity shortage and thereby exert an upward pressure on interest rates, and ready to adapt to the changing situation.

In SBP's view, the fall in the current account surplus was expected given that (i) workers remittances were expected to slow down, as the reverse capital flight was not expected to continue in FY04. Moreover the Hajj sponsorship scheme was also abolished; (ii) the trade deficit rises as a growing economy necessitates higher imports; (iii) the services account deficit was expected to increase as travel related payments through the exchange companies would now be reported in the balance of payments accounts; and (iv) SOF was not expected to continue. However, the fall in foreign exchange flows was not expected to reduce the liquidity in the market substantially enough to justify a U-turn on the monetary policy stance and was expected to be managed by reducing the SBP foreign exchange purchases and the sterilization of forex inflows accordingly. This is evident from the fact that the SBP foreign exchange purchases were moderated substantially when the current account surplus declined sharply after December 2003. Also, the Rupee liquidity management is clearly reflected in the consequent lowering of liquidity absorption. The average absorption since Feb-04 has been just above the half of average absorption during Jul-03 to Jan-04.

Looking at the NSS receipts, SBP was aware that the funding needs of the government would be directed to the banking system, which would exert pressure on the interest rates. SBP, however, absorbed this pressure by accommodating the government's needs itself. This nevertheless increased SBP's Net Domestic Assets but it was kept within target through open market operations.

Figure 1.9: Inflation



The third major concern, which strengthened the market view of rising interest rates, was the increasing inflation during the year which resulted in negative real returns. Though SBP had been wary of the inching-up inflation during the first half of FY04 but it was of the view that:

(i) the headline inflation was dominated by a rise in *food* prices, which are less sensitive to interest rates and required better *supply* management than a change in the monetary policy stance. As **Figure 1.9** shows, the acceleration in non-food non-oil inflation was relatively slower than the headline inflation until March 2003.

(ii) The rise in inflation during the second half of 2003 was tolerable given the negative consequences of rising interest rates on growth.

SBP, nevertheless, noticed the fact that the monetary policy induced inflationary pressures are rising and it proactively stepped forward in adjusting the interest rates, though marginally, in May 2004.

Maintaining the exchange rate stability

The second major challenge to the SBP was the exchange rate stability. Since the beginning of FY04, the rupee was expected to lose some strength due to the expected lower inflows on account of the weakening balance of payment surplus. However, SBP had been vigilant of the situation and moderated its inter-bank purchases with the changing net forex flows during the three phases of

exchange rate movements (mentioned above). During the first phase, SBP reduced its net purchases, as by end-September 2003 there were relatively higher debt payment requirements. As the payment pressure of these lumpy payments eased off and the forex inflows trend remained intact, SBP continued its policy of gradual Rupee appreciation during the second phase. Finally when the current account surplus reduced sharply in January 2004, SBP proactively reduced its forex purchases and in fact it injected forex liquidity substantially during May 2004.

1.2 Regulatory Profile

1.2.1 Regulations for Banks and DFIs[18]

Since 1992, Prudential Regulations have provided comprehensive guidelines to the banking sector, covering a wide range of commercial banking operations. Given the changing business environment both domestically and globally, SBP has modified these regulations from time to time. What has always been meticulously taken care of is the check on various risks that the banks continue to be exposed to in light of expanding banking activities.

While proactively pursuing the developments in the domestic financial market and the international best practices, SBP not only; (a) thoroughly reviewed and revised the prudential regulations for commercial banking operations, but also (b) introduced new sets of prudential regulations for consumer financing and SME financing.[19] These steps were taken in order to ensure a more viable banking system with minimum risk associated with its operations.

Prudential Regulations for Consumer Financing

Given the growth in consumer financing in recent years, and its subsequent impact on the financial sector, SBP devised a separate set of Prudential Regulations for Consumer financing which came into effect from January 2004.

These Regulations provide a comprehensive set of guidelines covering various aspects of consumer financing, as well as specific terms and conditions on a product-wise basis, some of which are described briefly in **Table 1.6**.

Table 1.6 : Prudential Regulations for Consumer Financing

	Credit Cards	Auto Loans	Housing Finance	Personal Loans
Maximum limit	Rs 0.5 mln (unsecured) Rs 2.0 mln (secured)	can vary from bank to bank	Rs 10 million	Rs 0.5 mln (unsecured) Rs 1.0 mln (secured)[20]
Maximum Tenor	Revolving	7 years	20 years	5 years
Minimum equity	Not required	10 percent	15 percent	Not required
Security	Hypothecation	Hypothecation of automobile	Equitable or registered mortgage of the property	Hypothecation in case the loan is for financing durable goods

General guidelines give emphasis on the formation of specific Credit policy in governing these products, prudent approval levels, back-office support for documentation, MIS support for ongoing portfolio management particularly with respect to periodic delinquency reports, and establishment of a trigger mechanism for classification requirements of individual loans and effective recovery procedures.

A maximum limit has been placed on a bank/DFI's exposure against total consumer financing with respect to its equity. Moreover the creation of a general reserve against consumer financing has also

[18] For a more detailed account, please see SBP report on Banking System Review for the year December 31, 2003.
[19] See BPD Circular No. 35 dated October 28, 2003.
[20] Loans secured by liquid securities are exempt from this limit.

been made mandatory to protect financial institutions from the risks associated with the cyclical nature of this business.

Regulations for SMEs

Given the riskier nature of SME business which requires a different credit appraisal approach compared with the large businesses, banks need to be more prudent while lending funds to this sector. Hence, the growing interest of banks for SME financing in Pakistan called for a special consideration from the central bank to develop a regulatory framework within which banks can develop new financing techniques and innovative products meeting the financial requirements of SMEs. SBP has issued 10 regulations for SME financing which mainly include banks' assessment of the source of repayment and the repayment capacity of the borrowers, per party exposure limit, aggregate exposure of a bank, ensuring proper utilization of the loan and classification and provisioning of the non-performing loans.

Revisions in Commercial Banking Operations

The revised set of prudential regulations for commercial banking operations has been divided in four sub-sectors, i.e., risk management, corporate governance, anti money laundering and operations. Most of the revisions in the existing regulations for commercial banking operations were carried out to ensure compliance of data with international best practices, and reporting frequency, preventing the banking system from anti money laundering or other illegal activities, promotion of Islamic banking, a more structured approach towards risk management, deepening of the financial services, minimizing credit risk and ensuring due diligence in the process of mergers and amalgamations.

Specifically, in order to promote Islamic Banking in Pakistan, SBP decided to follow a three-pronged strategy as under:[21]

a. Establishment of full fledged Islamic bank(s) in the private sector.
b. Setting up of subsidiaries for Islamic Banking by existing commercial banks; and
c. Allowing stand-alone branches for Islamic banking in the existing commercial banks.

In addition, scheduled banks were also allowed to open subsidiaries for Islamic Banking operations. Guidelines for setting up of these subsidiaries, opening up of stand-alone branches, enlisting eligibility criteria, and licensing requirements were issued.

Given the risks associated with banking operations and their complex nature, coupled with rapid developments taking place internationally in this area, SBP issued separate guidelines on risk management for banks/DFIs.[22] The framework includes risk identification, assessment, measurement, monitoring, and mitigating/controlling all risks inherent in the business of banking. Once banks formulate and implement an effective risk management strategy based on these guidelines, they would be more prepared in implementing the New Basle Capital Accord. Once the Accord is introduced in Pakistan, these guidelines will converge with the requirements of the Accord and will become an enforceable regulation.

Another area which is given much emphasis is the compliance of statutory/regulatory requirements regarding financial disclosure by banks/DFIs. Frequency and timelines for such disclosures have also been explained specifically. In fact, a master circular was issued on January 7, 2004 containing consolidated instructions on financial disclosure. As per this circular, besides annual financial statements, all banks/DFIs are required to prepare quarterly un-audited financial statements for the 1st

[21] See BPD Circular No. 1 dated January 1, 2003.
[22] See BSD Circular No. 07 dated August 15, 2003.

and 3rd quarter within 45 days of the close of the quarter.[23] Banks were also required to circulate these statements to share holders and to publish an abridged version in the newspapers.

In addition to this, in the light of heightened global efforts to prevent the possible use of the banking system for money laundering, financing for terrorism, transfer of illegal/ill-gotten money etc., SBP issued a set of minimum guidelines to be followed by banks while opening/dealing with the accounts of customers.[24] These include determining the true identity of every customer, assessing the integrity, respectability and nature of business etc of the customer, and considering his background and origin. Each bank is required to formulate and document a comprehensive *know-your-customer* policy for strict compliance.

Besides, with an aim to encourage private sector investment in infrastructural projects, the prescribed maximum debt to equity ratio has been relaxed to 80:20 for projects for the road and rail system, telecommunications, power generation and distribution, natural gas exploration, water supply, port, shipping, aviation project, dams and canals, refinery or pipeline projects and any other infrastructure facilities of a similar nature.[25]

In order to enhance the scope of services offered by banks, it was decided to allow commercial banks to establish subsidiaries for the purpose of Asset Management and Investment Advisory Services after obtaining prior approval of SBP.[26] Likewise, a regulation was also issued allowing banks to conduct brokerage business through their separately set up subsidiaries.[27] Later, in March 2004, in a bid to maintain appropriate regulatory oversight and to facilitate banks/DFIs in establishing subsidiaries for the purpose of diversification of their activities, SBP issued certain instructions for the establishment of subsidiaries.[28]

In addition to these, certain other regulations were also issued covering minimum capital requirements, protecting the interest of depositors, service charges, enforcement of Islamic principles, resolution of disputes between borrowers and banks, strengthening relations between banks and SBP, primary dealer system, etc.

1.2.2 New features of Supervisory Mechanism

Banking is the business of risk taking and therefore importance of risk management can hardly be over emphasized for the banks and supervisory authorities. SBP has been introducing various changes in its supervisory mechanism to ensure a minimum level of prudence. In January 2004, the SBP has introduced a new system of monitoring, surveillance and supervision formally named "Institutional Risk Assessment Framework" (IRAF). This new system is aimed at ensuring a cohesive and proactive monitoring of the risks, and synchronizes energies of banking supervisory departments. According to the IRAF, all banks/DFIs are evaluated on the following four kinds of inputs:

Compliance with Standards, Codes and Guidelines

As evident from its name, this component primarily comprises of compliance with the standards, codes and guidelines adopted in Pakistan, e.g., regulatory and statuary requirements, code of corporate governance and risk management guidelines issues by the SBP. Banks are required to prepare a self assessment of compliance endorsed by their Board of Directors. Based on this self-assessment compliance report, the banks will be rated on a scale of 1 to 5 for each major category and

[23] 2nd quarter or half-yearly financial statements, with limited scope review by the statutory auditors, are to be submitted within two months of the close of the half-year.
[24] See BPD Circular No. 10 dated March 29, 2003.
[25] See BPD Circular No. 25 dated July 4, 2003.
[26] See BPD circular No. 34 dated October 22, 2003.
[27] Se BPD Circular No. 5 dated February 10, 2004.
[28] See BPD Circular No. 8 dated March 8, 2004.

this will contribute to a *Compliance Risk Rating (CRR).* This report will be validated during the on-site inspection by the Banking Inspection department (BID) and carries an aggregate weightage of 20 percent.

Supervisory and Regulatory Information

This component is based on the assessment of Management and Systems & Controls. Findings of on-site inspection by the BID, policy related issues from Banking Policy Department (BPD), and enforcement status from Banking Supervision Department (BSD) are the major inputs for this component. This assessment results in a composite rating on a scale from 1 to 5 and named as *Supervisory & Regulatory Risk Rating (SRRR)* and carries an aggregate weightage of 25 percent.

Financial Performance and Condition

This component is based on CAMELS rating of BID's on-site Inspection Report; Management Letter and Audited Accounts; and Off-site Surveillance Report of BSD which includes CAELS rating. This component carries an aggregate weightage of 40 percent.

Market Information and Intelligence

Basic input for this component is the information received from credit rating agencies, volume and seriousness of complaints, media press reports etc. All this information culminates in a composite *Market Information Risk Rating (MIRR)* on a scale of 1 to 5 and carries an overall weight of 15 percent.

Based on above-mentioned four inputs and information on macroeconomic conditions and financial sector development, an institutional profile is prepared and an overall composite rating is assigned to each institution. In case of serious concerns or poor institutional profile, the institutions are kept on a *watch-list* and some corrective actions are promptly undertaken. Nature of prompt corrective action depends on the gravity of identified weaknesses. For minor problems, corrective action could only be a simple discussion with the management of bank/DFI for its correction. For serious problem, corrective actions include well-defined and time bound corrective action plans implemented by problem institution for addressing the weakness.

Apart from strengthening the supervisory mechanism, the SBP has taken a number of steps to instill a self-regulatory regime by enhancing the corporate governance standards. The most important is issuance of detailed guidelines under "Fit and Proper Tests (FPT)" for the appointment of Board of Directors, Chief Executive Officers and Senior Management of the banks,[29] This test is also applicable for the appointment of other key executives including heads of human resource, compliance, operations, credit and risk management, accounts, internal audit and the country treasurer. It would be the responsibility of banks to ensure that FPT guidelines are followed in letter and spirit, and no prior approval from SBP would be required for such appointments. However, separate guidelines were issued for the appointment/designation of compliance officers in order to keep the activities of banks in compliance with the relevant laws and regulations (especially, with regard to KYC and anti money laundering rules). The SBP has also issued a "Handbook of Corporate Governance" for the banks.[30]

1.2.3 Regulations for Microfinance Institutions

SBP, while regulating the MFIs, is also making serious efforts to expand the outreach of their services to the poor segment of the population.

[29] See BPD Circular No. 11 dated April 5, 2003.

[30] For details on corporate governance, please see "Banking System Review 2003" of the SBP.

Considering the special nature of MFIs, SBP has framed a separate set of prudential regulations[31] for micro finance banks in consultation with the stakeholders and micro finance practitioners. These regulations cover various areas of operations of micro finance banks with the objective to ensure sound risk management systems and focused interests in their core market i.e. the poor and micro enterprises. These regulations have been kept simple to facilitate the regulatory framework for MFIs. .

To reduce the operational cost and increase the outreach of micro finance services, MFIs are also permitted to undertake mobile banking operations. SBP also issued guidelines[32] for mobile banking operations to mitigate the inherent risk of this activity. To assess the performance and health of the MFIs, it is mandatory[33] for micro finance banks to have themselves rated by any of the rating agency on the panel of SBP or an international micro finance rating agency with prior approval of SBP.

To ensure standardization and comparability, SBP has also prescribed the format of financial statements[34] for micro finance banks/institutions.

Role of the Government for Developing Micro finance sector

The Federal Government has created four special funds for the support of the micro finance sector. These funds also provide a risk mitigation mechanism to the poor depositors and borrowers of the MFIs. The Micro finance sector development fund (MSDF) valuing US$ 40 million finances the social mobilization and community capacity building costs of licensed MFIs. The Community Investment Fund (CIF), valuing US$20 million, provides matching grants to community organizations availing micro credit facilities from licensed MFIs, for building small infrastructure projects of common interest. Both CIF and MSDF are endowment funds with their resources invested in Government securities and only the interest revenues earned on the funds' investments are used for the objectives and purposes of the funds.

MFIs have a higher vulnerability to risks due to the special type of their customer base and the poor segment of the target population. Two more funds, the Risk Mitigation Fund (RMF) and the Depositors' Protection Fund (DPF), valuing US$ 5 million each, have been created to protect the borrowers and depositors of MFIs. RMF and DPF are presently serving only Khushali Bank's borrowers/depositors, but the MSDF and CIF are open to other licensed MFIs from February 2004.

The Government under MSDP has also allocated some funds for extending institutional strengthening grants to licensed micro finance banks. Presently, grants equivalent to 2.5 percent of paid-up capital of licensed MFIs are available to new licensed MFIs on a first-come first-served basis.

A New Bank Fund (NBF), valuing US$15 million, has also been established at SBP under the Rural Finance Sector Development Program (RFSDP) to extend grants and soft loans to district and province-based MFIs. This fund would be operational in June 2004.

1.2.4 Regulations for NBFCs

Non-Banking Finance Companies (NBFCs) fall under the regulatory domain of the Securities and Exchange Commission since the separation of regulatory responsibilities between SECP and SBP in November 2002,[35] when an amendment in the Banking Companies Ordinance (1984) was promulgated to this effect. Subsequently the supervisory and regulatory responsibilities of all Non-Banking Financial Institutions (NBFIs), except DFIs, were transferred to SECP in December 2002.[36]

[31] For detail see BSD Circular No. 18 dated October 14, 2002.
[32] For Detail see BSD Circular No4, dated February 14, 2003.
[33] For Detail see BSD Circular No10, dated November 17, 2003.
[34] For Detail see BSD Circular No11, dated December 30, 2003.
[35] Companies (Second) Amendment Ordinance 2002 dated November 15 promulgated in amendment of Companies Ordinance, 1984.

Within the SECP, the NBFC section of the Specialized Companies Division[37] is responsible for monitoring and regulating the NBFCs, in addition to modarabas and modaraba management companies, and mutual funds. The basic functions of the Specialized Companies Division consist of licensing, regulatory compliance and enforcement of all applicable laws, in addition to ongoing assessment of the financial position of the institutions under its purview, through both on-site and off-site surveillance.

Table 1.7: Evolution of NBFC Regulations

Dec-1991	Rules of Business for NBFIs	SBP framed and issued Rules of Business for NBFIs, which became effective from 1.1.1992
Jan-1992	Setting up of NBFIs Regulation & Supervision Department	This department became functional from 1.1.1992. In the subsequent organizational restructuring process of FY97, this became part of the Banking Supervision Department (BSD)
Apr-1995	Credit ratings for NBFIs	Effective from 20.4.1995, all NBFIs were required to have themselves credit rated by an SBP approved rating agency.
Dec-1997	CAMELS framework	This framework was adopted to ascertain the performance of banks and NBFIs on the basis of off-site and on-site surveillance
Jan-1999	Establishment of Securities & Exchange Commission of Pakistan (SECP)	SECP became operational from January 1, 1999 through SECP Act 1997, replacing Corporate Law Authority
Jan-2001	Paid up capital of investment banks, housing finance companies and discount houses	A minimum paid up capital of a) Rs 500 million was fixed for investment banks b) Rs 300 million for housing finance companies and discount houses. Any institution falling short of this requirement on 31.1.2001 was to meet 50% of the shortfall latest by 1.1.2002 and the remaining 50% by 1.1.2003
Nov-2002	Transfer of regulatory responsibility	The regulatory responsibility of NBFCs was transferred to SECP through the promulgation of Companies (Second) Amendment Ordinance, 2002.
April 2003	Issuance of the Non-Banking Finance Companies (Establishment and Regulation) Rules, 2003	Effective from April 1, 2003
January 2004	Issuance of Prudential Regulations for Non-Banking Finance Companies	Effective from January 21, 2004

The Non-Banking Finance Companies (Establishment and Regulations) Rules, 2003[38]

NBFCs are governed by the Non-Banking Finance Companies (Establishment and Regulations) Rules, 2003 (these should be read in conjunction with Companies (Second) Amendment Ordinance, 2002).

On a general level, these Rules pertain to:

a) The functions of each of the various types of NBFCs
b) Eligibility conditions for the establishment of an NBFC
   i. Pertaining to its sponsors, proposed directors, chief executive and chairman of the Board of Directors
c) Mechanism of obtaining permission to form an NBFC, requiring
   i. Pre-defined details regarding the sponsors
   ii. Feasibility report of the proposed company
   iii. Draft of the Memorandum and Articles of Association
d) Conditions for grant of a license
   i. for carrying on one or more of the various forms of specified businesses

[36] SECP Circular No. 15 dated. December 2, 2002.
[37] As specified in Circular No. 5 dated March 16, 1999.
[38] Issued on April 1, 2003

   ii. the minimum equity required for the various types of businesses (with Investment Advisory and Asset Management Services requiring the least amount of paid up capital).
   iii. validity period and renewal requirement of the license
- e) Commencement of operations by an NBFC
- f) Conditions applicable to an NBFC, with respect to
   i. Maintaining books of account and other such records, and preparation of these accounts in line with International Accounting Standards (IAS)
   ii. Minimum qualification and professional experience criteria for appointment of its chief accounting officer
   iii. Appointment of its directors
- g) Opening of branches
   i. An NBFC is allowed to open one branch and needs to take permission from the Commission for opening more than one.
- h) Insurance Coverage
   i. In line with the specifications of the Commission
- i) Prevention of and protection from Exchange Fluctuation Risk
- j) Prohibition on acquiring controlling interest in any enterprise in which an NBFC has invested which would give it primary responsibility for management
- k) Mechanism and conditions for issuance of Certificates of Investment (for leasing or housing finance services) or Certificates of Deposit (for Investment Finance Services)

On a more specific level, the Rules lay down the terms and conditions for undertaking each kind of business, along with functional requirements for each type of service offered.

From an operational point of view, events which can trigger the cancellation of an NBFC's license to operate, appointment of an auditor, requirement of a special audit to ensure compliance with regulations and imposition of penalties for non-compliance, are also covered.

Prudential Regulations for NBFCs[39]

The concept of Prudential Regulations first came into effect in 1992, when SBP introduced these regulations for various aspects of commercial banking as well as Non-Banking Financial Institutions (NBFIs)[40].

Prudential Regulations serve the dual purpose of providing a guiding framework to enable financial institutions in maintaining prudent credit risk management policies, as well as strengthening the supervisory and monitoring role of the Regulatory Authority.

NBFC Prudential Regulations came into effect in January 2004[41], as a culmination of various important measures taken over the past twelve years (see **Table 1.7**). Their issuance was necessitated subsequent to the amendments in the Companies Ordinance 1984, in which all existing NBFIs with the exception of Modarabas and Development Financial Institutions (DFIs) were re-classified as NBFCs.

The objective behind the issuance of these Regulations was to introduce a uniform set of Regulations for all NBFCs in order to improve their effective risk management capabilities and to promote corporate governance in the non-bank financial sector.

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[39] Implemented vide SECP Circular No. 2, January 21, 2004.

[40] The SBP Prudential Regulations covered NBFIs which included DFIs as well. Regulation 1-4, parts of Regulation 10, Regulations 11-12, parts of Regulation 13 & 14, Regulations 20-21, were initially issued vide NBFIs Circular dated December 5, 1991.

[41] However until these updated and collective Prudential Regulations for NBFCs were issued, all previously existing rules and regulations continued to be applicable for regulatory supervision.

The regulations are divided into 4 parts, where Part II and III are not applicable to Asset Management Companies, Investment advisors or Venture capital companies.

Part II[42] is categorised into two sub-sections in line with the type of borrower i.e. Corporate and individual. Part II (A) focuses on limiting the risk exposure of an NBFC to a single person in line with the NBFC's equity by placing an upper limit on both total (funded) and non-funded exposure.

Minimum eligibility criteria for borrowers is detailed in terms of credit worthiness (by obtaining a CIB Report from State Bank), assessment of borrower's financial statements (for customers other than individuals[43]) with respect to the level of exposure, as well as in terms of placing an upper limit on the amount of borrowing with respect to the borrower's equity.

Regulation 4 clearly defines the required levels of a borrower's debt and liquidity ratios, to prevent taking exposure on over-leveraged and/or insolvent entities. It also specifies the type of facilities on which this condition is not applicable, for example, fully secured exposure.

Minimum Margin requirements against different kinds of facilities and associated securities have been laid out in detail. Regulation 6 also specifies the kinds of exposures that an NBFC is prohibited from taking, for example against un-listed TFCs or shares, whereas Regulation 7 lays down restrictions on certain types of transactions, one example being extension of facilities for speculative purposes.

Part II (B) covers regulations for housing finance for individuals in terms of specifying the maximum tenor and amount as well as minimum margin requirements, a maximum income / installment ratio, along with the requirement of establishing a legal charge on the underlying security. It particularly refers to the importance of asset-liability matching given the longer tenors associated with mortgage loans.

Part III provides guidelines regarding the limit of NBFC's exposure against liabilities with respect to its equity including contingent liabilities. Issues such as creation and building up of reserves, return on deposits and deposit insurance are also covered.

In addition to defining what constitutes a default, a time-based criteria for the classification and provisioning of non-performing assets is laid out in detail in Regulation 5, for both short term as well as medium to long-term financing facilities. Additionally, the importance of an ongoing subjective assessment of the risk portfolio has also been emphasized. Specific directions regarding the impact of restructuring/rescheduling of non-performing facilities on their classification is part of this regulation.

With respect to the above criteria, guidelines regarding the determination of the forced sale values of different types of securities pledged against facilities extended by NBFCs, as well as the validity period of their valuation is specified in detail, in order to consider the realizable value of the assets before making any provisions. Valuation details of the various types of assets pledged form part of this guideline, which also specifies the eventualities which enable a reversal of provisions held against classified assets.

Emphasis has also been given to recovery efforts with respect to overdue loans as well as to ongoing monitoring of recovery targets.

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[42] Part I covers definitions.

[43] For individuals, NBFCs requires documents such as a wealth statement, statement of assets and liabilities or any other statement which may be considered appropriate by the management of the NBFC.

Part IV of the Regulations provides guidelines for conducting internal audits, submission of statistical returns, abiding by a code of conduct, ensuring prevention of money laundering activities during the course of its business and laying down a procedure for appointment of directors and chief executives.

Regulations for Modarabas and Modaraba Management Companies

Since Modarabas form a separate entity and are not categorized with NBFCs, their regulatory aspect is being covered separately.

Subsequent to the amendments in the Banking Companies Ordinance 1962 by the Banking Companies Amendment Act, 1997, the State Bank of Pakistan ceased to be the regulatory authority for Modarabas and the monitoring and supervising functions of the Modarabas, being non-bank financial institutions, were transferred to SECP under the Modaraba Companies and Modaraba (Floatation & Control Ordinance), 1980.[44]

Modarabas come under the regulatory purview of the Modarabas sub-section of the Specialized Companies Division of the SECP, which is responsible for the regulation and enforcement actions pertaining to modarabas and modaraba management companies.

Modaraba is a mode of Islamic Investment, and facilitating Islamic Shariah compliant modes of financing has been one of the major objectives of the SECP. It has taken a number of initiatives to facilitate a comprehensive Islamic Investment Legal Framework and to make the existing provisions of the laws and rules governing the Modaraba Companies, and Modarabas, more practical. In order to enhance the risk absorption capacity of the components of this sector, the SECP encourages the voluntary mergers of modarabas, which can help reduce their overheads and operational costs, in addition to providing opportunities for growth.

The Modaraba Companies and Modaraba Rules, 1981

Modarabas are governed by a set of rules which were first issued in 1981, and recently amended by the SECP in June, 2003.

These rules specify the modalities of the registration of a Modaraba company, significance and constituents of the Religious Board and the Advisory Committee for Modarabas, maintenance of books of accounts as well as periodic submission of such records, decisions regarding capitalization of profits, distribution of profits and reserves, appointment and removal of auditors, power to increase the modaraba fund, maintenance of a register of certificate holders and prosecution of delinquent directors of a modaraba company.

Amendments in the Modaraba Rules have further strengthened the Regulatory Regime for Modarabas with an emphasis on increased disclosure requirements including quarterly submission of financial statements. Additionally, Modarabas have been permitted to issue Musharika-based Term Finance Certificates (TFCs) to facilitate them in mobilizing funds.

Prudential Regulations for Modarabas

Modarabas are required to comply with the revised set of Prudential Regulations issued by the Securities and Exchange Commission in January, 2004.[45]

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[44] Implemented vide Finance Division Circular dated December 12, 1997

[45] Implemented vide Circular No. 4, dated January 28, 2004. The previous regulations were issued by the SECP vide Circular No. 5 dated April 20, 2000.

These regulations are structured along the same lines as those for NBFCs discussed above, with additional guidelines for matters such as appointment of Special Auditors, appointment of Chief Executive, distribution of profit, and holding of the Annual Review Meeting, to improve transparency in the sector.

1.2.5 Insurance Regulations

The insurance sector of Pakistan was initially regulated under the Insurance Act, 1938, which itself was the combination of Indian Life Assurance Companies Act, 1912 and other earlier legislations and amendments. The reason for the formulation of the Insurance Act, 1938 was to enable the government to have effective control over the insurance companies and to collect and monitor statistical information for both life and non-life insurance companies. Moreover, the Act was formulated to safeguard the interests of the policyholders. In order to implement and administer the provisions of the Insurance Act, 1938, Government established a department of Insurance within the ambit of Ministry of Commerce in April 1948.

However, there were certain discrepancies in the Insurance Act, 1938 as several amendments were made at different points in time, primarily due to the changing business environment. This necessitated a complete amendment of the Act so as to ensure an unambiguous framework for the regulation of the insurance sector. As a result, the National Insurance Reform Committee was created to remove the discrepancies and to propose new amendments that were acceptable to all the insurance companies. The committee advised the Government to formulate new legislations governing the business of insurance companies.

New Insurance Ordinance Framed

The Government of Pakistan, while formulating the reforms in the insurance sector passed on the responsibility of administration of Insurance Law to the Securities and Exchange Commission of Pakistan (SECP) in August 1999 after dissolving the Controller of Insurance. A new regime for insurance regulation began when the government repealed the Insurance Act, 1938 and replaced it with Insurance Ordinance 2000 formulated by SECP on August 19, 2000. The ordinance aimed to protect the interests of policyholders and envisaged the development of an efficient and sustainable insurance market by raising capitalization standards and strengthening solvency of insurers. The distinct features of Insurance Ordinance, 2000 are as follows:

Restructuring of regulatory functions

In order to address the issues of insurance sector, the SECP in accordance with power vested by Insurance Ordinance, 2000, established the Insurance Division on January 1, 2001 by replacing it with the Department of Insurance under the ministry of commerce. These changes enabled the Insurance Division to perform functions of (1) Regulation and monitoring of insurance companies; (2) Registration of Insurance companies; (3) Monitoring of reinsurance arrangements/treaties; (4) Framing new insurance rules; and (4) Supervision of insurance intermediaries.

Recapitalization

Realizing the diversified nature of services provided by insurance companies, which expose them to various risks, there was a need to strengthen and improve the capital base of the insurers. Therefore, capital requirements for life insurance and non-life insurance companies were raised from Rs 100 to Rs 150 million and from Rs 40 to Rs 50 million by December 31, 2002 and finally to Rs 80 million respectively.

Accountability System

With a view to redressing the complaints of policyholders particularly regarding the settlement of claims, an office of Insurance Ombudsmen has been established. The ombudsmen office takes action

when an insurer (1) fails to comply with the Ordinance; (2) fails to act in good faith; and / or (3) acts in a manner which intends to disrupt the insurance industry.

Broader Purview
Since the ownership structure of the Insurance sector has been highly skewed towards public sector insurance companies, Insurance Ordinance, 2002 brings State Life Insurance (SLIC), National Insurance Company (NICL) and Pakistan Reinsurance Company Limited (PRCL) within its purview so as to ensure effective monitoring of the public sector insurers alongwith the private sector insurance companies so as to have a financially sound aggregate insurance sector.

Securities and Exchange Commission (Insurance) Rules
In order to strengthen the regulatory system of insurance, improve the administration of insurance industry, remove prevailing malpractices, ensure adequate disclosure of financial statements, strengthen the role of insurance intermediaries and to improve the quality of services, Insurance Rules were promulgated by SECP on December 12, 2002 after incorporating the concerns of the insurance industry subsequent to the introduction of Insurance Ordinance.

These comprehensive rules encompass the operational matters relating to accounting and reporting, actuarial reports, reinsurance arrangements, independent survey and market conduct. Similarly, solvency and capital requirements were also specified in these rules. For the purpose of transparency and proper disclosure, new formats for annual returns were prescribed under the insurance rules.

Since the agents act as a liaison between the insurer and insured, therefore the role of an agent was required to be streamlined. With this view, the eligibility criteria for insurance agents/intermediaries has been prepared taking into account the minimum educational qualifications, practical on-job training, and adherence to code of conduct and capital requirements for insurance brokers.

Another important aspect of insurance rules is that it lays down the independent and professional role of surveyors in order to improve the quality and timeliness of survey reports issued by them. These rules ensure reduction in the delivery time of the reports to policyholders and also expedite the insurer in settling claims. In accordance with the insurance rules, surveyors are required to strictly meet the minimum paid-up capital requirement. Moreover, to safeguard the interests of policyholders, surveyors are also required to formulate a professional indemnity policy, which is expected to promote an unbiased approach in the conduct of their operations.

Code of Conduct for Surveyors and Loss Adjusters
Surveyors and loss adjusters play an important intermediation role and constitute an integral part of the financial sector that includes a wide cross-section of institutions, including banks, non-bank financial institutions and insurance companies. Normally intermediation is the yardstick by which the responsiveness of the industry to the customer can be gauged. Therefore, the role of surveyor and loss adjustor has a direct implication for the policyholders.

The system of licensing of surveyors and loss assessor dates back to 1984. However, with the promulgation of the Insurance Ordinance 2000, the role of surveyors and loss adjusters has been enhanced further to cater to the needs of insurance companies. Following this, the Investment Division of SECP, in order to encourage professionalism and bring uniformity and discipline in the conduct of surveyors and loss adjuster, devised a Code of Conduct in major consultation with the Institute of Surveyors and Loss Adjusters of Pakistan (ISLAP).

The code of conduct has two general guiding principles, fundamental principles and guidance notes. The salient features of the code are as follows:

- All members must behave ethically and with integrity in all professional and business relationships;
- All members must act impartially when acting on instructions from an insurer in relation to a policyholders' claim;
- All members of ISLAP are liable to disciplinary action if they commit any act or default likely to bring discredit to the member;
- Surveyors, at all times, maintain a register of survey work, containing relevant information and also keep records of the survey reports, photographs and other important documents for a period of three years;
- Surveyors and loss adjusters are required to maintain the confidentiality of the information that they may acquire during the course of survey; and
- A restriction has been placed on receiving and providing hospitality to and from the employees of the client.

Corporate Governance

In recent past, all over the world, a growing number of financial scandals associated with accounting and other frauds has highlighted the issue of corporate governance. In fact, regulators learning from these experiences have pressed the need to enhance the corporate governance framework of the financial system. Following this code of ISLAP, the SECP has also taken various measures to protect the interest of investors and has issued ‘Code of Corporate Governance’ for listed companies on March 28, 2002 under the supervisory role.

While there was a need to ensure transparency and accountability within the insurance sector, SECP established an improved corporate governance framework in line with the Code of Corporate Governance of listed companies. Given the diversified corporate structure of insurance companies, the framework was developed with the objective of promoting good business practice and brings uniformity in the insurance industry in Pakistan. Therefore, in accordance with the powers bestowed under section 60 of the Insurance Ordinance, SECP introduced the ‘*Code of Corporate Governance*’ separately for both listed and non-listed insurance companies on January 21, 2003. Accordingly, all registered insurance companies incorporated this code of conduct in their business practices with effect from March 01, 2003.

These comprehensive guidelines are aimed at developing a system that encourages Directors to exercise best practices in order to protect the interests of stakeholders as well as policyholders. It envelops diverse area of cooperate governance including guidelines on the constitution of the Board of Directors of the insurance company; framework of internal audit; compliance procedures; rules on financial and accounting responsibilities of Directors; composition of audit committee; reporting procedures, etc.

The law is focused on broad-based representations of executive and non-executive directors on the board with especial emphasis placed on the qualification and eligibility to act as a director, tenure of the office of directors, responsibilities, powers and functions of Board of Directors. Similarly, rules related to the appointment and approval of the chief financial officer and company secretary and their qualification requirements are also specified. Moreover, to make the financial affairs more transparent and also to flourish openness, comprehensive guidelines are given regarding the format of directors’ report to shareholders and frequency of financial reporting. It also provides a system to registered insurers for the formulation and evaluation of their internal practices and procedures. The guidelines are specified for setting up of underwriting, claim settlement, reinsurance, co-insurance and audit committees. In addition, the code also makes mandatory the rotation of auditors after five years. Similarly, it also imposes restriction on auditors as well as appointed actuaries to hold, purchase, sell or take any position in shares of the company.

It is expected that proper adoption and implementation of the Code of 'Corporate Governance' will act as a catalyst in encouraging and enhancing the integrity and capacity of insurance industry.