1 Financial System Strengthening

The ten year assessment of the financial system undertaken by the State Bank of Pakistan identified four areas of reforms to move forward in the direction of better soundness, efficient supervision, effective monetary policy, and deepening of financial system and services.[1] This chapter presents a detailed analysis of developments encompassing the first three areas.

1.1 Financial System Soundness

Soundness of financial system is affected both by its structure and performance in the short-term and the long-term changes induced either by conscious policies or technological change. This section assesses the changes in structure of financial system, performance in terms of key financial indicators, impact of privatization, and nature and consequences of consolidation in the financial system.

1.1.1 Structure of Financial System

Structure of financial system has substantially changed over the last two years, particularly following the privatization of UBL and restructuring of DFIs. As a result, the share of private sector in both ownership and deposit mobilization of overall financial system witnessed visible changes by the end of 2002 (see **Table 1.1**). Moreover, the intermediation activities of deposit mobilization and credit expansion have considerably increased for banks as compared to NBFIs over the last two years.

Table 1.1: Dynamics of Financial System Assets

	Assets (billion Rupees)		CAGR (%)	Asset shares (%)		As percent of GDP	
	2000	2002		2000	2002	2000	2002
1. Banking sector							
Private	794.1	1,249.2	25.4	28.8	38.1	25.2	34.4
Public	1,013.6	976.0	-1.9	36.7	29.7	32.2	26.9
Sub-total	1,807.6	2,225.2	11.0	65.5	67.8	57.4	61.3
2. NBFIs							
Private	144.6	143.5	-0.4	5.2	4.4	4.6	4.0
Public	94.1	66.2	-16.2	3.4	2.0	3.0	1.8
Sub-total	238.7	209.7	-6.3	8.6	6.4	7.6	5.8
3. CDNS	715.0	846.6	8.8	25.9	25.8	22.7	23.3
Grand total	2,761.3	3281.6	9.0	100.0	100.0	87.7	90.4
Private	938.7	1,392.8	21.8	34.0	42.4	29.8	38.4
Public	1,822.7	1,888.8	1.8	66.0	57.6	57.9	52.1

Note: Data for banks (end-December) is aggregated with the data for NBFIs and CDNS (end-June).

Overall assets of the financial system registered a compound annual rise of 9.0 percent, primarily on the back of strong growth in asset holdings of the banking industry. This notable growth in asset holding of the banking sector is largely explainable by the improving financial position of banks and shifting of assets from NBFIs toward banking sector mainly on account of a number of mergers/acquisitions that have taken place in the financial sector in the past couple of years (see **Section 1.1.4**). As a result, the share of NBFIs in overall assets of financial sector has dipped down to 6.4 percent by end 2002 from 8.6 percent in 2000.[2] However, the share of CDNS remained almost unchanged over the same period.[3]

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[1] For a detailed exposition, see **Chapter 7** of **Pakistan: Financial Sector Assessment 1990-2000**, SBP, 2002.

[2] Although insurance sector is also an important part of the financial system, it is not included because of lack of availability of data. In FY99, assets held by insurance companies constituted 3.9 percent of total assets of financial system.

[3] CDNS is an attached department of Ministry of Finance. Funds mobilized by CDNS are the liability of the government. Flow of funds from certificate holders to CDNS and the government can be viewed as generating financial liabilities and financial assets for CDNS.

Ownership of financial assets showed that the privatization drive, which gained momentum over the last few years led to a considerable rise in asset holding of the private sector. Its share in total assets has gone up to 42.4 percent by end 2002 as compared to only 34.0 percent in 2000. This rise looks even more impressive in the presence of CDNS, which mobilizes funds for the government at considerably higher rates as compared to the returns offered by the banking sector. The rise in private sector is primarily attributed to the privatization of UBL. Moreover, the government has also off-loaded its remaining stake in MCB, while divesting 20 percent of its share holding in NBP over the same period. The asset holding of private sector will further rise after the expected privatization of HBL.

Closely following the changes in overall asset holding of the financial sector, deposits of the financial sector also exhibited a similar trend (see **Table 1.2**). However, the growth pattern of deposits contrasted sharply between banks and NBFIs. While the banking sector deposits grew at a compound annual rate of 11.8 percent over the last two years, NBFIs saw an erosion of deposits at a rate of 31.3 percent per annum.[4] As a result, the share of banking sector in overall deposits surged up to 65.4 percent by end 2002 as compared to 62.7 percent in 2000.

Table 1.2: Dynamics of Financial System Deposits

	Deposits (billion Rupees)		CAGR (%)	Deposit shares (%)		As percent of GDP	
	2000	2002		2000	2002	2000	2002
Banking sector							
Private	581.6	938.3	27.0	27.2	36.6	18.5	25.9
Public	759.3	738.3	-1.4	35.5	28.8	24.1	20.3
Sub-total	1,340.9	1,676.5	11.8	62.7	65.4	42.6	46.2
NBFIs							
Private	50.1	39.0	-11.7	2.3	1.5	1.6	1.1
Public	33.9	0.6	-86.3	1.6	0.0	1.1	0.0
Sub-total	84.0	39.7	-31.3	3.9	1.5	2.7	1.1
CDNS	715.0	846.6	8.8	33.4	33.0	22.7	23.3
Grand total	2,139.8	2,562.8	9.4	100.0	100.0	68.0	70.6
Private	631.7	977.3	24.4	29.5	38.1	20.1	26.9
Public	1,508.1	1,585.5	2.5	70.5	61.9	47.9	43.7

Note: Data for banks (end-December) is aggregated with the data for NBFIs and CDNS (end-June).

Looking at deposit mobilization of the financial sector, it is the private sector whose share in overall deposits has increased from 29.5 percent in 2000 to 38.1 percent by end 2002. This also highlights the increasing role of private sector in overall financial sector. Moreover, this changing composition of financial structure toward the private sector is in line with the government policy to enhance the role of this sector in shaping the overall financial sector.

1.1.2 Performance of Overall Financial System[5]

Financial soundness indicators have shown a marked improvement for the overall financial sector during 2001 and 2002. A closer look on key financial ratios related to capital adequacy, management soundness, earnings and liquidity reveals significant improvement in the financial health (see **Table 1.3)**. In terms of capital adequacy, equity to liability ratio for the whole financial sector has increased to 7.9 percent by end CY02, as compared to 6.3 percent in CY00. The ratio improves further if we

[4] This rise in deposits of banking sector was primarily attributed to the improvement in external front and shifting of deposits from NBFIs toward banking sector due to mergers/acquisitions.

[5] To gauge the financial health of overall financial sector, we consolidated data on all scheduled banks and NBFIs including DFIs, Investment Banks, Leasing, Modaraba, Mutual Funds, Discount Houses, Venture Capital Companies and regulated Microfinance Institutions. CDNS and insurance sector are not included in this analysis.

adjust the financial sector for specialized banks, which are in process of restructuring due to their weak financial health. This rise in ratio is largely explainable by increased minimum capital requirement for most of the financial institutions and resultant consolidation that took place in the financial sector (see **Section 1.1.4**).[6]

Intermediation cost, an indicator of financial sector efficiency, both with and without provisions has seen marginal improvement over the period of analysis. The difference between two ratios highlights the impact of non-performing loans on its efficiency. Although this difference has slightly narrowed during CY02, it is likely to decrease further in future, as the burden of NPLs has substantially been decreased and these loans are largely provided for. Moreover, addition of fresh NPLs is quite minimal due to relatively prudent lending by the financial sector.[7] Besides this, heavy investment in the government securities that led to a rise in share of investment in asset portfolio also reflects better capital adequacy, as the government securities do not entail any credit risk.

Table 1.3: Key Indicators of Financial Sector
percent

	2000	2001	2002
Capital Adequacy			
Equity to liability ratio	6.3	6.4	7.9
Growth rate of capital	4.6	6.8	37.8
Growth rate of assets	9.4	4.8	13.6
Management			
Expenditure to income ratio	98.1	98.2	87.9
Intermediation cost	3.8	3.5	3.5
Intermediation cost (including provision)	5.0	4.9	4.6
Earnings and Profitability			
Average cost of deposits & borrowings	6.9	6.3	4.6
Average return on advances & investments	11.3	11.3	9.3
Average spread	4.4	5.1	4.7
Non-interest income to total income	18.4	15.0	18.5
Net interest income to average earning assets	3.4	4.3	4.2
Operating cost to deposits	4.5	4.2	4.0
Return on average assets (after tax)	-0.2	-0.4	0.4
Return on average equity (after tax)	-3.5	-6.4	5.3
Liquidity			
Liquid assets to total assets	32.5	37.4	45.6
Loans to deposits ratio	69.9	65.3	58.0
Liquid assets to total borrowings	192.2	236.5	325.6
Earning assets to total assets	79.8	77.7	83.6

Earnings and profitability indicators have also shown a significant improvement in return on assets (ROA) of the financial sector as a whole during 2002. ROA was negative for both 2000 and 2001. With rising adequacy of capital, increase in efficiency and decline in expenditure to income ratio, ROA of financial sector has become positive 0.4 percent for 2002. In fact, if we adjust for the dismal performance of specialized banks, ROA improves to 0.9 percent. This notable variation in adjusted and unadjusted ROA reflects exceptionally weak position of specialized banks. Since their share in overall financial sector is less than 4 percent and these are state owned financial institutions, therefore they do not generate any systemic risk in overall financial sector. It may also be noted that if we apply this adjustment for specialized banks in 2001, ROA of financial sector becomes positive 0.1 percent.

The turnaround in ROA, despite declining interest rates and squeezed average spreads, was the upshot of increased business activities of the financial sector. In other words, the financial sector succeeded to offset the negative impact of squeezed average spread by increasing its earning assets. This is also evident from the fact that earning assets to total assets ratio has increased from 79.8 in 2000 to 83.6 percent in 2002.

Liquidity position of the overall financial sector also improved considerably over the period of analysis. Substantial rise in liquid asset to total asset ratio during CY02 is primarily attributed to

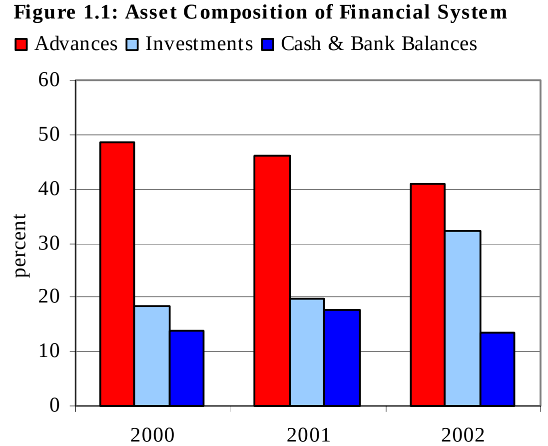
[6] Minimum paid-up capital requirement for various groups of institutions was increased with the aim of strengthening the capital base of financial sector, however it also proved to be a major factor behind consolidation of the financial sector.
[7] As most of the NPLs pertain to banking sector, see **Section 3.4** for a detailed discussion on NPLs. Moreover, NPLs of overall financial sector are discussed in **Section 7.2**.

increased investment in government securities during the year.[8] Another indicator of liquidity, a loan to deposits ratio has significantly declined over the period of analysis. This decline was mainly on account of stronger deposit growth that stemmed from improvement in the external front. Consequently, loaning activities of the financial sector could not keep pace with the influx of funds. As a result, a major portion of these funds flowed towards cheaper government securities.

In sum, overall financial sector is now well-placed to cater to the needs of the growing economy. However, prolonged excess liquidity in the system may force financial institutions to take some extra risk. A word of caution is necessary here. Utmost care must be exercised in extending funds to new areas, particularly for consumer financing, housing sector and SMEs. Failing to do so may result in deteriorating the quality of assets. Another risky area, where financial institutions have recently increased their stakes is the investment in equity markets. Although its share in investment portfolio is not so alarming yet, this may create problems going down the road, as the market is highly volatile. Besides these two challenges that may emerge in near future, overall financial sector is well-equipped to provide financial services and enjoys good financial health.

Improvement in financial health was witnessed as a result of continued efforts of supervisory authorities--both the State Bank of Pakistan (SBP) and the Securities and Exchange Commission of Pakistan (SECP). Overall assets of financial sector witnessed 9.0 percent compound annual growth over last two years, primarily on the back of strong growth in the banking sector, which grew by 11.0 percent over the same period. This strong asset growth was largely funded by impressive growth in deposits and equity. While the rise in former was largely attributed to exceptional developments on the external front, SBP and SECP efforts to strengthen capital base of financial institutions explained the surge in latter. Equity growth is also supported by the falling burden of NPLs, which was a major drag on retained earnings of the financial institutions (see **Section 7.2**).

Figure 1.1: Asset Composition of Financial System



On the asset side, composition of financial sector has significantly changed over the last couple of years (see **Figure 1.1**). The share of advances in overall assets has dropped significantly to 40.9 percent by end-2002 as compared to 48.6 percent in 2000, while the investment activities have increased. As a result, the share of investment has spiked up to 32.2 percent in total assets from only 18.5 percent in 2000. This change in asset composition suggests that the financial sector has tilted away from traditional banking activities, particularly from extending loans. However, this change was facilitated by: (1) less than stronger private sector demand; (2) efforts of the financial sector, particularly of banks to book high worth assets in declining interest rate scenario; and (3) improved financial position of public sector enterprises and cap on lending to these enterprises.

A notable trend was observed during 2000-2002 with regard to the utilization of financial system resources by the public sector (see **Table 1.4**). The share of public sector has gone up from 56.5 percent in total advances and investments of the financial system in 2000 to 62.9 percent in 2002. The rise in government use of financial resources is largely brought about by the increase in liquidity, whose greater part was sterilized through investment in government securities. Extent of sterilization

[8] For details, see **Section 6.1.1** on **Financial System Liquidity and SBP Interventions**.

is also an indication that the concomitant demand in the private sector does not seem to exist. This points towards the need for revision in credit extension policies of financial institutions for various financing needs of private sector including project, housing, consumer and working capital financing. This also calls for the need to implement various demand inducement policies for investment as well as consumption, at the national level, to divert a greater part of available liquidity to productive sectors of the economy.

1.1.3 Privatization of Financial Institutions

Despite the opening of new banks in the private sector during 1990s, the banking sector continued to be dominated by three nationalized and two partly privatized banks by the end of 2000. The structural drawbacks in these big banks constrained the overall banking system from fully achieving the objectives of banking sector reforms. The higher operating cost of nationalized banks created an upward bias in the intermediation cost of the banking industry. Huge infected portfolio; overstaffing and over branching; and disproportionate tax burden were some of the main factors that caused increase in interest rate spread of banks in this group and ultimately for overall banking industry during 1990s.[9]

Table 1.4: Financial System Resource Utilization

billion Rupees

	2000	2001	2002
Public sector	1,207.2	1,320.0	1,737.7
NSS	761.7	846.6	981.6
Government securities	236.3	266.8	583.7
Commodity operations	91.1	89.9	79.6
Autonomous bodies	59.5	81.3	58.8
Public sector corporations	58.6	35.4	34.1
Private sector (residual)	929.0	940.1	1024.5
Total advances and investments	2,136.2	2,260.2	2,762.2
Shares (percent)			
Public sector	56.5	58.4	62.9
NSS	35.7	37.5	35.5
Government securities	11.1	11.8	21.1
Commodity operations	4.3	4.0	2.9
Autonomous bodies	2.8	3.6	2.1
Public sector corporations	2.7	1.6	1.2
Private sector (residual)	43.5	41.6	37.1
Total advances and investments	100.0	100.0	100.0

Note: Due to different dates of closing accounts, NBFIs data of end-June are consolidated with the banks' data of end December. Besides using audited balance sheet data, monetary survey data are also used.

In order to minimize the organizational weaknesses of nationalized banks and to improve the financial soundness of the overall system, privatization of these units have become inevitable. To facilitate the process of privitazation, a vigilant restructuring of these institutions has remained on the reform agenda since the introduction of a more focused banking sector reform in 1997. Although a lot had been done in this regard till 2000, the process gathered pace during last two years. The promulgation of privatization ordinance, introducing a multi-pronged approach to deal with non-performing loans (NPLs), further rationalization of staff and branch network, reduction in tax rate and partial settlement of long outstanding issue of advance taxes, curtailment of trade union practices and re-capitalization of banks in this group were some of the measures taken to ensure that the privatization process of these banks would be smooth and speedy (see **Reform Matrix**, **Annexure 2.1**).

In September 2001, a 6.4 percent government stake in MCB has been off-loaded and the remaining 10.2 percent was divested. The process for privatization of UBL through sale of a 51 percent stake has been completed in November 2002. Recently, the Privatization Commission (PC) invited Expressions of Interest (EOI) from the investors for acquiring a minimum 26 percent stake in Habib Bank Limited. Also, the government off-loaded 20 percent shares of National Bank of Pakistan through public offering in the local stock exchanges. In addition, all the ICP Mutual Funds have been privatized.

[9] For a detailed discussion, see **Special Section 6.1** on "Long-run Dynamics of Interest Rate Spread and Banking Efficiency in Pakistan" in **SBP Annual Report 2001-2002**.

With the privatization of UBL, the ownership structure of the banking industry has changed significantly. As reported in **Table 1.5**, the combined share of private and foreign banks in the total assets of banking sector has gone up from 43.9 percent in 2000 to 56.1 percent by the end of 2002. After completion of privatization process of HBL, this share is expected to go up significantly to about 75.0 percent.

Table 1.5: Group-wise Composition of Banks' Assets
percent

	CY00	CY01	CY02
Public sector commercial banks (PSCBs)	49.9	48.7	39.4
Domestic private banks (DPBs)	28.4	29.1	43.5
Foreign banks (FBs)	15.5	16.7	12.6
Specialized banks	6.2	5.5	4.4
All banks	100.0	100.0	100.0

Note: Total may differ due to separate rounding off.

1.1.4 Financial System Consolidation

The initial spate of liberalization in the financial sector, which started in mid-1980s for NBFIs and late-1980s for banks, resulted in increased fragmentation of the financial sector. Not only the prime objective of reforms--promotion of competition through a level playing field--was being undermined by the increased fragmentation but the concerns about the health and soundness of newly entering smaller financial institutions were also coming to the fore. In order to avoid the mushroom growth of banks, a moratorium was imposed in 1995 and no new bank was allowed to open till April 2002.[10] Rapid growth of investment banks, leasing, and modarabas that started a little earlier than that of banks, also added to growing fragmentation of the financial sector. Despite the increase in number of institutions, financial resources remained concentrated in a few larger public sector banks and NBFIs.

By the end of 2000 there were too many small financial institutions in different categories. This fragmentation rendered the financial sector with absence of economies of scale; failure in offering enough competition for already established bigger institutions; and limited success in upgrading the technology. It was imperative to address these weaknesses with more vigor, as the financial institutions and markets are becoming more and more integrated around the globe; this implied existence of opportunities as well as threats to domestic financial institutions (see **Box 1.1**). At the positive end, restrictions on capital movement are being relaxed and technological advancements are facilitating quick information flows; thus reducing transaction cost. This offers an opening to domestic institutions to operate in a bigger market. On the downside, this integration has increased the volatility in the global financial markets and the systemic risk for its players. In this more competitive environment, where margins of profits may go down and chances of failure may increase, the survival of small and weak banks will become much more difficult.

In order to cope with challenges of changing scenario and to enhance the competitive efficiency of domestic banks, consolidation of smaller financial institutions into bigger units becomes inevitable. Following important measures were required to trigger the process of consolidation in a smooth manner:[11]

- (a) raising the minimum paid-up capital requirements for each type of financial institutions to a certain level to ensure their soundness;
- (b) facilitating the consolidation deals by making the necessary amendments in the legal framework for this purpose;
- (c) liberalizing the branch opening and closing policy to promote natural growth and mergers;
- (d) pursuing the market players for voluntary and mutually agreeable mergers; and
- (e) providing tax incentives to facilitate mergers between financial institutions.

[10] Meezan Bank Limited was the first bank after 1995 that was granted a license on April 30, 2002 to operate as a full-fledged Islamic Commercial Bank.
[11] See **Pakistan: Financial Sector Assessment 1990-2000**, SBP, 2002, p. 129.

Box 1.1: Consolidation in the Financial Sector

Consolidation, in general, refers to the tightening of control of resources of an industry due either to reduction in the number of firms, growth among leading firms, or exit of weaker firms. More specifically, it refers to the combining of existing firms through: (1) mergers and acquisitions and (2) joint ventures and strategic alliances.

A distinct wave of consolidation was witnessed in the financial sector of industrial countries during 1990s. A comprehensive report[1] on the subject prepared by the Bank of International Settlements (BIS) shows that there was a considerable increase in mergers and acquisitions (M&As) during 1990s, especially in the last three years of the decade. Most of M&As occurred in banking industry and the number of banking firms decreased in many countries and consequently, the concentration of deposits controlled by largest banks increased. The number of joint ventures and strategic alliances also increased during 1990s.

In order to assess the implications of consolidation in the financial sector, it is worthwhile to identify the causes of consolidation and isolate the effects on financial risk, monetary policy, efficiency, competition, credit flows, and on payment and settlement system.

Causes of Consolidation: The primary motive for financial consolidation is the expected increase in future profits either through expected reduction in costs or expected increase in revenues. Mergers can lead to reduction in costs in several ways including: realization of economies of scale and scope, increased managerial effectiveness, risk reduction due to diversification, reduction of tax obligations, increased monopsony power that may decrease prices of inputs, increased potential of rating enhancement and increased potential penetration in new geographic or product markets. Similarly, mergers can lead to increase in revenues for different possible reasons including: increased size after mergers, larger market share for attracting more customers, increased monopoly power to raise prices and increased ability to take larger risks on investment portfolios.

Several non-pecuniary factors can also cause consolidation, the most important of which is the financial regulatory and government policy environment. Financial sector regulation and fiscal policy can either induce or hinder consolidation. Mergers can be encouraged or liquidation undertaken while resolving institutions in extreme financial distress. Laws requiring regulatory approval of mergers and acquisitions or prohibiting certain types of mergers and acquisitions also have the potential to hinder consolidation.

Effects of Consolidation on Financial Risk: Consolidation can lead to significant changes in systemic financial risk. In this context, the question -- whether consolidation leads to a situation where financial institutions are more or less risky before mergers and acquisitions --becomes very important. "*Systemic financial risk* is the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy"[2]. Here an event can be viewed as a shock that carries with it a high probability of distorting resource allocation and risks not only in the financial system but real economic sectors as well. In this respect the potential effects of consolidation have to be seen on critical features of economic shock that may become a systemic event. These features include: (1) direct interdependencies that exist between firms and markets due to inter-firm exposures (both on-and off-balance sheet), (2) indirect interdependencies that exist due to correlated exposures to non-financial sectors and financial markets, and (3) the degree of transparency of firms and markets, including the role played by market discipline.

Impact of Consolidation on Monetary Policy: Effectiveness of implementation as well as transmission of monetary policy depends, to a larger extent, on the behaviour of financial institutions and markets. To the extent that consolidation may alter this behaviour, implications for monetary policy can become important. The potential effects of consolidation on the implementation of monetary policy depend on whether consolidation has an impact on the money market which is used by the central bank to adjust the supply of central bank balances. Competition in money market could be reduced by consolidation with consequent rise in the cost of liquidity for some institutions. Consolidation may also alter the linkages through which the monetary policy transmits its effects on the real economy.

Effects of Consolidation on Efficiency: Cost and profit efficiency should increase after M&As due to expected reduction in costs and expected increase in revenues. However, empirical evidence for industrial countries covered in BIS Report is mixed. In case where better banks acquire banks in worse shape, there are some gains in cost and profit efficiency but those gains are not very significant.

Extent of gains in technological efficiency is driven by the extent of realization of scale and scope economies after M&As. Institutions that significantly increase their size by merging with others may have the opportunity to access cost saving technologies or to spread fixed costs over a larger base, thus reducing average costs and improving profitability. Empirical evidence shows that technological efficiency gains from the exploitation of scale economies disappear once a certain size is reached.

Empirical evidence of efficiency gains in terms of increase in shareholder value is also negative. Although M&As imply a transfer of wealth from the shareholder of the bidders to those of target, they do not seem to generate significant shareholder value.

Effects of Consolidation on Competition: Consolidation increases market concentration and, therefore, affects competition. The extent of change in competitive structure depends on the likelihood of market entry and on firm behaviour. Regulation may limit market entry, leading to intensified oligopolistic behaviour when concentration becomes higher due to consolidation. Empirical evidence of BIS Report shows that more concentrated markets are less competitive and that large in-market mergers may significantly increase market power, thus harming customers, especially in retail banking markets and market for some investment banking services.

Effects of Consolidation on Credit Flows: One of the major concerns of consolidation in the financial sector is the increased likelihood of reduction in the availability of credit to small and medium-sized enterprises due to the decrease in the number of small banks that specialize in this type of lending. This concern stems from the fact that larger and more complex financial institutions have a lower propensity to lend to small firms. Moreover, smaller banks rely on soft information while lending to small firms. Their merger with larger banks can disrupt the use of soft information based on relationship-banking. Larger banks rely more on hard information of balance sheets and income statements.

However, there is also a possibility that larger banks, due to greater diversification opportunities, can fund a larger number of small and riskier firms. Furthermore, in periods of financial distress, larger banks are more likely to keep providing credit and other services to their customers compared with smaller banks. Therefore, the effects of consolidation on small lending have to be assessed empirically. A general finding is that higher concentration leads to less favourable conditions for small loans.

Effects of Consolidation on Payment and Settlement Systems: Inter-bank transactions have a considerable likelihood to become in-house transactions after consolidation. Therefore, greater concentration of payment and settlement flows is more likely among fewer parties in the financial sector. Moreover, large institutions resulting from consolidation may be better able to invest in costly technologies and to decrease unit costs by capturing economies of scale. Risk implications for payment and settlement system may also change after consolidation. On the positive side, consolidation may help improve the effectiveness of institutions' credit and liquidity risk controls. On the negative side, consolidation may lead to a greater proportion of large-value payment transactions which may increase concerns about systemic implications.

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[1] Report on **Consolidation in the Financial Sector**, Group of Ten, Bank of International Settlements (BIS), January 2001.
[2] Ibid., p.126.

Since the last couple of years, considerable progress has been made in this area; capital requirement for scheduled banks has been doubled to Rs 1 billion, legal and regulatory framework is under review; branch policy for private and foreign banks has been liberalized, and on different occasions, SBP has repeatedly emphasized the need for well-capitalized institutions (for details see the **Reform Matrix**, **Annexure 2.1**). As a result, financial system saw a number of mergers and acquisitions during the last two years (see **Table 1.6**).

Table 1.6: Consolidation of Financial Institutions during 2000-2002

Date	Institutions	Merged into/acquired by
During 2000		
07-Mar-00	Union Bank and Bank of America	Union bank
	First Ibrahim Modaraba and Ibrahim Leasing	First Ibrahim Modaraba
During 2001		
03-Jan-01	Universal Leasing Corporation and Mercantile Leasing	Universal Leasing Corporation Ltd.
07-Jan-01	Atlas Investment Bank and Atlas Lease	Atlas Investment Bank
07-Jan-01	Trust Investment Bank and Pakistan Industrial Leasing	Trust Investment Bank
19-Oct-01	RDFC and SBFC	SME Bank
31-Oct-01	NBP and NDFC	NBP
03-Nov-01	Gulf Commercial Bank	PICIC Commercial Bank
05-Nov-01	Prudential Commercial Bank	Saudi Pak Commercial Bank
14-Sep-01	Guardian Leasing Modaraba and First Providence Modaraba	Guardian Leasing Modaraba
05-Dec-01	Alzamin Leasing Modaraba and Ghandara Leasing	Alzamin Leasing Modaraba
During 2002		
01-Jan-02	Faysal Bank and Faysal Investment Bank	Faysal Bank
30-Apr-02	Meezan Bank and Societe Generale	Meezan Bank
02-Nov-02	Union Bank and Emirates Bank	Union Bank
17-Oct-02	Platinum Commercial Bank	KASB Commercial Bank
30-Nov-02	Standard Chartered Bank and Standard Chartered Grindlays Bank	Standard Chartered Bank
26-Aug-02	First Prudential Modaraba and Second Prudential Modaraba	First Prudential Modaraba
26-Aug-02	First Prudential Modaraba and Third Prudential Modaraba	First Prudential Modaraba
04-Mar-02	Capital Assets Leasing Corporation and International Multi Leasing	Capital Assets Leasing Corporation

Although the regulatory increase in minimum paid-up capital requirement was made primarily to improve soundness of the financial institutions, it became the main force that induced the process of consolidation in the financial sector of Pakistan. This is in contrast to the recent experiences of financial institutions in industrial countries, where the primary motive for consolidation was the expected increase in profits through reduction in costs and rise in revenues (see **Box 1.1**). However, this is not to say that these motives are not at work here. Only the major push has come from the enhanced capital requirement within the regulatory push. Other motives are obviously at work in initiation and consummation of mergers and acquisition deals.

Table 1.7: Number of Financial Institutions

numbers

	At the end of		
	2000	**2001**	**2002**
Banks	43	43	40
NBFIs	154	155	138
Total	197	197	178

Process of consolidation is clearly visible from reduction in the number of financial institutions during the last couple of years as shown in **Table 1.7**. However, this reduction (consolidation) has not resulted in the increase in market concentration of the few largest banks in contrast with the experience of consolidation in the financial sector of industrial countries (see **Box 1.1**). **Table 1.8** shows trends in market concentration in terms of asset concentration for the banks and the NBFIs. Concentration in terms of assets of the largest and top five banks has gone down during 2002. This is an indication of increased competition in the banking sector. However, the asset concentration for the NBFIs has increased during FY02, largely due to mergers of small institutions.

Table 1.8: Market Concentration of Financial Institutions
percent

	2000	2001	2002
Assets of the banks			
Largest bank	20.6	21.4	19.4
Top 5 banks	63.2	61.2	60.7
Top 10 banks	76.5	75.8	76.7
Top 15 banks	84.1	84.3	87.0
Assets of NBFIs			
Largest institution	9.1	11.6	10.7
Top 5 institutions	40.7	40.0	43.3
Top 10 institutions	61.3	60.5	62.9
Top 15 institutions	73.9	71.2	73.3

1.2 Supervisory System Strengthening

Efficacy of financial system supervision depends on the capabilities of supervisory and regulatory authorities of both the SBP and SECP. Supervisory responsibilities between the two have been demarcated legally.[12] Mandate given to the SBP is to regulate and supervise the banking companies and development finance institutions, while the SECP is entrusted to regulate the non-bank financial companies (NBFCs), the insurance and corporate sector. Together with the capabilities of supervisory authorities, improvement in corporate governance, legal infrastructure, prudential regulations for banks, and rules of business for NBFCs would promote the effectiveness of supervisory system.

1.2.1 Corporate Governance

In recent years, corporate governance has emerged as the leading issue confronted by the financial markets throughout the world. Pakistan is no exception. The strengthening of the corporate governance framework was deemed important for the healthy growth of the corporate sector, whereby the interest of investors are protected. For this reason, the issue of corporate governance occupied the highest priority on regulators' agenda of reforms.

In this regard, both SECP and SBP took various steps to strengthen the framework of good governance, the former concentrating on NBFCs and listed companies and the latter on the banking system. Therefore, SECP issued a "Code of Corporate Governance" on March 28, 2002, to provide a framework of good corporate governance, whereby a listed company is managed in compliance with best practices. Accordingly, all stock exchanges included this code of conduct in their respective listing requirements.

This comprehensive law is aimed at enhancing investor confidence by increasing transparency in the business practices of listed companies. It envelopes diverse areas of corporate governance including guidelines on the constitution of the Board of Directors of the company; a framework of internal control; rule on financial and accounting responsibilities of directors; disclosure regarding pattern of shareholding; scope of internal audit; directors' report, etc.

Since an effective board of directors is a sine qua non for good governance of the company, special emphasis is placed in these guidelines on the qualification and eligibility to act as a director, tenure of the office of director, responsibilities, powers and functions of the board of directors, and appointment of the chief financial officer and company secretary. In addition, guidelines were provided regarding the corporate and financial reporting framework. In this regard emphasis was placed on the format of directors' report to shareholders, and frequency of financial reporting. Listed firms are now required to publish unaudited financial statements and circulate these along with directors' review on the affairs of the listed company on quarterly basis.

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[12] Demarcation of responsibilities has obviously increased the need for coordination between SBP and SECP. Towards this end, quarterly meetings are held between senior management of both supervisors to take joint or separate action where needed.

In addition to the guidelines by the SECP, the SBP being the regulator of the banking system also issued various guidelines for the banks to improve their governance. Although the guidelines issued by the SECP were very comprehensive and robust, they were limited to listed companies. Since various banks are still unlisted, a separate set of bank specific guidelines was deemed necessary. Also, in case of banks, Banking Companies Ordinance, 1962 (BCO) supersedes the Companies Law (1984).

In this regard, the SBP issued a number of instructions to strengthen the governance, disclosures, and transparency in the practices of the commercial banks. To ensure transparency in financial statements, banks are required to report data on new formats in accordance with international standards. In addition, banks have become liable to take prior clearance of SBP before appointment of CEOs. Furthermore, to encourage an effective role of CEO/BOD, certain guidelines under "Fit and Proper Test" have been formulated for their appointment. These guidelines include conforming to the parameters like honesty, reputation, experience, track record, management and financial integrity.

In order to ensure sound banking practices and existence of proper checks and balances in each institution, SBP has also defined clear lines of responsibilities and proper guidelines for the functioning of board of directors. They have been made responsible to review and update policies in areas like internal audit, compliance, risk management, credit disbursement, management information system, etc., so as to enhance effective governance in the financial institutions. Also, the panel of auditors that plays an important role in promoting good governance in the banking sector, is being revised from time to time so as to improve the quality of audit services. External auditors are evaluated annually and classified in various categories based on their performance and other prescribed criteria.

1.2.2 Legal Infrastructure

The main laws which provide the necessary legal infrastructure for banking, non-banking and corporate entities include the State Bank of Pakistan Act, 1956; the Banking Companies Ordinance, 1962; the Companies Ordinance, 1984; the Securities and Exchange Commission of Pakistan Act, 1997; and the Securities and Exchange Ordinance, 1969.[13] The intent of these laws is to provide a legal framework for the regulation of monetary, credit, financial and corporate policies in order to promote growth and development besides providing protection to depositors, creditors and investors.

In order to keep the laws effective and attuned to latest developments and modernization taking place in the financial sector domestically as well as globally, process of amendments and modifications is almost continuous. In the past couple of years, conscious amendments were made in above laws in order to implement the reforms that were found wanting with an assessment of earlier financial reforms during 1990-2000.[14] In particular, amendments were made to support the following:

- Help financial institutions meet minimum capital requirements and facilitate the process of consolidation in the financial sector;
- Facilitate smooth exit of institutions under liquidation; and protect depositors, especially of banking companies under liquidation;
- Implement the strategic bifurcation of supervisory responsibilities between SBP and SECP;
- Implement the process of Islamization of financial system on parallel basis; and,
- Strengthen SBP autonomy and its core central banking capabilities.

[13] This is by no means an exhaustive list of laws affecting the financial sector.
[14] For details, see **Pakistan: Financial Sector Assessment, 1990-2000**, SBP, 2002, especially **Chapter 7**.

Facilitate the process of consolidation in the financial sector

Mergers and acquisitions of the institutions with low capital base were considered vital for the consolidation of the industry. As a matter of policy, SBP encouraged small institutions to raise their capital base by mergers with other institutions. To achieve both of the above-mentioned objectives amendments were made in the BCO, 1962. Amendments in section 3A enlarged the limited application of BCO to selected NBFIs (mentioned in section 3A) to cover the procedure for amalgamation of banking companies.[15] This amendment also empowered SBP to prepare scheme of reconstruction or amalgamation of selected NBFIs, or for their suspension of business.

Facilitate smooth exit of institutions under liquidation; and protection of depositor

Amendments were also made in the BCO to facilitate the liquidator in case of banks liquidation and to protect the depositors' interest in case of liquidation of the bank. Specifically, section 54 and 58 were substituted with new sections that would help in facilitation of payments to the depositor on the priority basis in case of liquidation of a banking company as follows:

- Substitution of Section 54: Through the amendment in the said Section, period of 2 months for submission of preliminary report to the High Court by the official liquidator has been enhanced to 90 days. Further the provision as to the application of assets of the company under liquidation in accordance with section 230 of the Companies Ordinance, 1984 has been replaced with the application of assets towards making priority payments under Section 58 of BCO, 1962. This amendment would help in facilitation of payments to the depositor on the priority basis.
- Substitution of Section 58: Through the substitution of the said section, mechanism of priority payments to depositors has been ensured clearly indicating the financial limits. Section 230 of Companies Ordinance, 1962 no more applies on the banking companies under liquidation. After this amendment, depositors would be paid a maximum of Rs 100,000, whereas under companies ordinance this limit was Rs 250.

Implement the strategic bifurcation of supervisory responsibilities between SBP and SECP

In order to demarcate supervisory responsibilities between SBP and SECP for regulation of financial institutions, subsection (1) of section 3A of BCO, 1962 was substituted.[16] Accordingly, in addition to banking companies, SBP would also supervise a select number of NBFIs, which are working as DFIs.[17] All other NBFIs would come under the purview of SECP.

Implement the process of Islamization of financial system on parallel basis

Amendments were made in the BCO, 1962 [18]to implement the process of Islamization of financial system on parallel basis with that of the conventional system. Accordingly, new sub-section 'aa' was inserted in the Section 23 of BCO, thereby, allowing the formation of Islamic Banking subsidiary for the purpose of carrying on of banking business in conformity with Injunctions of Islam. Furthermore, Section 22 of SBP Act, 1956 was also substituted to provide financial accommodation to the borrowing entities with service charges.

Strengthen SBP autonomy and its core central banking capabilities

In order to strengthen the SBP autonomy regarding its monetary and exchange rate policies, the State Bank of Pakistan Act, 1956, was amended and a new sub-section (6) was introduced in section 9B.[19]

[15] Section 3A of BCO, 1962 was amended vide Ordinance No. XLVII of 2001 dated August 30, 2001. Accordingly, section 47 and 48 were included in section 3A to enable merger/amalgamation of selected NBFIs already mentioned therein. Section 47 and 48 were also amended to become consistent with amendment in section 3A.

[16] Vide ordinance No. CX of 2002 dated November 4, 2002.

[17] These are named in section 3A that includes PICIC, NDFC, BEL, Pak-Libya Holding Company, Pak-Oman Investment Company (Pvt) Limited and Pak-Kuwait Investment Company.

[18] Vide ordinance No. CX of 2002 dated November 4, 2002.

This further clarified the role of monetary and fiscal policies co-ordination board. More specifically, it says " …the coordination board shall not take any measure that would adversily affect the authority of the State Bank of Pakistan as provided in the Act". Furthermore, the power of the appointment and removal of the Governor was entrusted to the president of Pakistan through amendments in section 10 and 15 of SBP Act, 1956.

In order to strengthen the SBP's core central banking capabilities and pave the way for creation of SBP Banking Services Corporation, a new section 8A was added in SBP Act, 1956 along with the amendment in section 48 and 49. Consequently, SBP(BSC) was entrusted with the following functions:

- For handling the functions of receipt, supply and exchange of bank notes and coins which are legal tender;
- For issue, supply, sale and purchase of prize bonds, holding draws thereof and other National Savings instruments; and
- Generally for carrying out any other business or discharging any functions incidental to, or connected with, the affairs of the Bank.

The creation of SBPBSC enabled the SBP to concentrate on its core central banking functions namely

1. Formulate the monetary policy, and improvement in analysis, research and data collection for maintaining price stability with growth.
2. Pro-active supervision and regulation to ensure soundness of banking and non-banking financial institutions.
3. Prudent management of exchange rate and foreign exchange reserves to provide incentives for production, investment and exports.
4. Strengthen the payment system to facilitate orderly transactions in the economy.

1.2.3 The SBP Prudential Regulations for Commercial Banks

The Prudential Regulations (PRs) in respect of various aspects of commercial banking operations were introduced by the SBP in 1992. These were issued with a view to ensuring a financially strong and viable banking system capable of providing adequate resources to the trade and industry. Prudential Regulations aim not only at an equitable distribution of credit but a reasonable dispersal of banks' risk as well.

By the end of 2002, there were in all 28 Prudential Regulations that cover a wide range of operations of commercial banks. Major thrust of these regulations is on the exercise of prudence in bank's lending by restraining them from concentration of exposure to a single entity and to minimize the associated risks involved. These regulations place a limit on bank's exposure to a single person (funded & non-funded) as well as on banks exposure against contingent liabilities. They also create a linkage between a borrower's equity and total borrowings from banks.

Prudential regulations also provide guidelines in respect of various banking business including: granting unsecured loans; dealings with major shareholders and employees of banks; criteria for classification of assets and provisioning requirement there against; bank charges for different services; opening of accounts; lending to defaulters; reconciliation of inter-branch accounts; asset management; financial and investment advisory services; credit rating of financial institutions; role and responsibilities of Board of Directors, etc. It is important to mention here that these regulations do not

[19] Sub-section (6) of section 9B was introduced on November 4, 2002 vide ordinance No. CX of 2002.

supersede margin restrictions and other directives issued by the State Bank of Pakistan from time to time in respect of the areas not covered by these regulations.

Since January 2000, four new regulations were introduced (for details see **Annexure 2.2)**. First, was to make it mandatory for banks to have themselves credit rated by the SBP approved credit rating agencies.[20] This regulation was aimed to further help in achieving the objective of safeguarding the interest of prospective investors, depositors and creditors. Second, with a view to expedite credit processing, minimizing the risk of default and effective monitoring after disbursement of funds, it was made obligatory for banks to obtain information for each borrower before extending any credit facility.[21] Third was to allow the banks to utilize the FE-25 deposits for financing the trade related activities in Pakistan and abroad.[22] Further, banks were required to maintain a prescribed ratio of cash reserves requirement to 25 percent of these deposits in US Dollars, which was cut down to 20 percent in the changing scenario after September 11 events. The last was introdued with an aim to improve the corporate governance and to make the Board of Directors more effective. In this regulation, clear guidelines were issued to define the role and responsibilities of banks' Board of Directors.

In addition to these new PRs, amendments were also made in the existing regulations during CY00-CY01 to cope with the changing scenario, for details see **Annexure 2.3**. Moreover PR-XIX, whereby banks were required to submit the half-yearly data on the SBP approved format, has been withdrawn.[23] The objective of providing this ease was to free-up the resources of banks, so they can focus on improving the quality, reliability, accuracy and timelines of the other required data sent to SBP.

The SBP keeps a continuous watch on the emerging scenario by monitoring the impact of PRs on banking business. PRs are modified in a manner to accommodate new and expansionary business needs within a sphere of reasonable exposure of various risks. Sometimes amendments are also made to harmonize these with similar regulations of international institutions, e.g., Basle Committee or the World Trade Organization (WTO). For making a change or introducing a new regulation, draft of the proposed amendments/new regulations is discussed under a consultative process with the banks' representatives and after taking care of their suggestions the regulations are issued for meticulous compliance. Prudential regulations for microfinance institutions were recently introduced whereas regulation for consumer and SME financing are at consultative stage.

Prudential regulations for microfinance banks/institutions

As a part of the overall poverty alleviation strategy, microfinance has been identified as a key instrument to address the issues of lack of affordable finances and ineligibility for regular borrowing avenues (such as from commercial banks) for the poor. Since the focus and requirements for microfinance are quite distinct form the regular commercial banks' operations, it required an enabling environment ensuring orderly development of the microfinance sector and catering to the needs of this special kind of financing. In this backdrop, the SBP devised a set of prudential regulations specifically for the microfinance banks/institutions.[24] These regulations have been kept as simple as possible to make the overall regulatory framework for MFIs facilitating and problem solving. Earlier, the microfinance banks/institutions were regulated under the Microfinance Rules 2000.[25]

[20] For details, see BPRD Circular No. 15 dated June 6, 2000.
[21] For details, see BSD Circular No. 10 dated March 15, 2001.
[22] For details, see BSD Circular No. 21 dated May 14, 2001.
[23] For details, see BSD Circular No. 17, August 28, 2002.
[24] For details, see BSD Circular No. 18, dated October 14, 2002.
[25] For details, see BSD Circular No. 29, dated October 13, 2000.

Prudential regulations for consumer financing

Although the banks had always been allowed to extend credit for personal uses, the volumes of such lending were not so significant. As the banks extended their operations in this area and their financing increased significantly, it was felt that the existing regulations might not serve well to ensure prudence due to their peculiar nature. The SBP took proactive steps to prepare separate prudential regulations particularly for consumer financing.[26] These regulations cover banks' activities under credit cards, auto loans, housing finance and personal loans and provide guidelines and restrictions applicable for such lending.

Prudential regulations for SME financing

With the growing awareness about the role of small and medium enterprises in a country's development, banks have been encouraged to pay exclusive attention to this sector. Since the nature of lending to this sector is quite distinct from ordinary lending, special attention is required by both banks and the central banks to ensure prudence. In view of this, the SBP has developed a separate set of prudential regulations[27] for SME financing, encouraging banks to innovate and tailor financing products for various SMEs in different economic sectors keeping in view their needs and cash flows. Banks are also encouraged to develop close association with the SMEs. Apart from the usual regulations, banks are required to specifically identify the source of repayment and assess the repayment capacity of the borrower on the basis of asset conversion cycle and expected future cash flows.

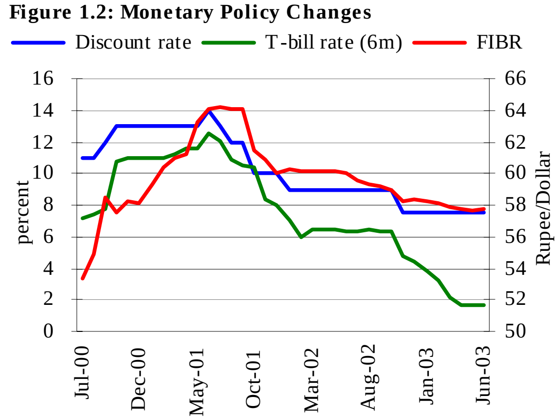
1.3 Effectiveness of Monetary and Exchange Rate Policies

Institutional capability and independence of a central bank are the two most important factors that determine its effectiveness in formulation and implementation of monetary and exchange rate policies. SBP independence was first legislated in 1993 and strengthened in 1997, which also saw a beginning of measures by SBP to strengthen its capabilities. These measures got renewed vigor and pace from 2000 and onwards that substantially enhanced the performance of SBP as a central bank.[28] SBP independence was also strengthened in 2002 as described in **Section 1.2.2**.

1.3.1 Monetary Policy Developments

The period FY01-FY03 saw the monetary policy going through both the contractionery and the expansionary phase. During FY01 the monetary policy was first tightened to effectively curb the depreciation of Rupee. As soon as the tightening led to the desired stability in the value of Rupee, stance of monetary policy was changed from the beginning of FY02. With the monetary policy getting easier, FY03 saw a historic decline in interest rates. The significant easing during the last two years can be gauged from the movements in SBP discount rate, which has been gradually reduced from 14 percent in July 2001 to 7.5 percent in November 2002 in a series of interest rate cuts. Resultantly, the benchmark 6-month yield has declined from 12.8 to 1.6 percent during the same period (see **Figure 1.2**).

Figure 1.2: Monetary Policy Changes



[26] At the time of this writing, a draft of these regulations was in circulation for comments by the banks and available at SBP website.

[27] Prudential regulations for SME financing are also in draft stage and are available at SBP website.

[28] For detailed exposition of institutional capability measures, see **SBP Annual Report 2002-2003 Volume 2**.

The contractionary phase of monetary policy was preceded by the unique challenges to the monetary managers of the country during FY01. The challenges were mostly the outcome of SBP decision to float the Rupee in July 2000. The short-term challenge was to neutralize the devaluation expectation, curb speculative pressures on exchange rate and meet the target on government borrowing from SBP under IMF program. The medium-term challenge was to build-up foreign exchange reserves to restore confidence of public on the economy at large.

The dismantling of the Rupee/Dollar band imposed prior to July 2000 put an enormous pressure on the exchange rate. This implied that SBP's monetary policy stance became the first line of defence to defend the Rupee. The SBP responded to the challenge by increasing the discount rate twice from 11 to 12 percent and from 12 to 13 percent in September and October 2000, respectively. In addition, cash reserve requirement was increased by 2 percent (from 5 to 7 percent) to further tighten the money market in order to curb the speculative pressures on the exchange rate. The SBP was successful in arresting the Rupee slide through these steps.

The second quarter of FY01 was arguably the most challenging period for the monetary management due to (a) exceptionally tight money market conditions, (b) seasonal peak of the credit to the private sector, and (c) the IMF end-December 2000 NDA target. The SBP was able to achieve the NDA target by taking special steps like shifting SBP holdings of T-bill to the commercial banks against the FE-45 deposit. However, the second half of FY01 was relatively less difficult both in terms of meeting IMF criteria and pressures on Rupee.

The harsh policy decisions coupled with macroeconomic discipline during FY01 and a benign inflation rate during the corresponding period laid the basis for an easy monetary policy in the subsequent years (FY02-FY03). In addition, the huge surge in foreign exchange inflow owing to a phenomenal growth in remittances during FY02-FY03 resulted in availability of ample liquidity with banks that effectively complimented the SBP efforts to pursue an easy monetary policy (for details, see **Section 6.1**).

In short, the monetary policy has been reasonably effective during the period FY01-FY03. During FY01, the challenges of free float and stiff IMF conditionalities were managed without jeopardizing the long-term growth perspective. And during the past two years, the SBP has effectively managed the huge inflow of foreign exchange by (a) purchasing the excess supply of Dollars to stabilize the Rupee appreciation, (b) sterilizing the rupee injections of these purchases through retirement of government debt held by SBP, and (c) leaving ample liquidity with banks in order to give sufficient supply of credit to the private sector without putting any visible pressure on inflation rate. The effectiveness of monetary policy in recent years was reflected in low inflation, phenomenal growth in credit to private sector by the commercial banks during FY03 and last but not the least, rebound in real GDP growth.

In order to make monetary policy more transparent, an important step was taken by SBP to explain the monetary, credit and interest rate situation more effectively to the public. More specifically, a six-monthly "Monetary Policy Statement" was started to be released on January and July of each year. The first statement was released in January 2003 and the second in July 2003. Release of this statement has a salutary impact on perceptions of financial market participants about the present and future stance of monetary policy.

1.3.2 Exchange Policy Developments

Since the free float of Rupee in July 2000, although the exchange rate experienced contrasting movements, the overriding priority for the SBP remained its stability. The macroeconomic imbalances, rigid market expectations and constraints in the form of IMF conditionalities posed immense challenges to the SBP in maintaining its exchange rate policy. Nevertheless, the SBP took a number of steps for stabilizing the Rupee-Dollar parity; ranging from monetary policy tools to limited capital controls. Although there remained periods of volatility for the exchange rate, the exchange rate policies broadly witnessed successes in achieving stability. Exchange rate trends saw two distinct phases that almost overlap with the phases of monetary policy discussed earlier and shown in **Figure 1.2**. First phase of exchange rate movements comprised a period of depreciation accompanied by monetary tightening, while the second period witnessed appreciation as well as monetary easing in the wake of foreign exchange inflows.

SBP also made an effective use of a few capital outflow restrictions in the first phase. These restrictions were mainly used during pre-September 11 period to bring the demand and supply for foreign exchange, in the market, in order. During this period, there were limits attached to some transactions, particularly to those related with outflow of the foreign exchange, e.g., traveling quota, export proceed realization duration, repatriation of foreign exchange etc. (see **Exchange and Payment Reforms** in **Annexure 2.1**). These steps were also reinforced through the imposition of margin requirements on import LCs by the commercial banks. In conjunction with initial monetary tightening, as discussed earlier, these measures proved very effective in decelerating the initial spurt of depreciation.

In addition to the capital controls, the SBP intervened extensively in the inter-bank market to stabilize the exchange rate. Up till September 2001, the SBP had been a net seller of the US Dollar in the inter-bank market as it supported the market by selling Dollars for hefty oil or debt payments. Although the market support by the SBP resisted the depreciation of the Rupee, it forced the SBP to resort to the expensive kerb market foreign exchange purchases. Essentially, the limited foreign exchange reserves inhibited the extensive use of this tool and, therefore, required additional measures.

The instability in the exchange rate, soon after the free float, forced the SBP, as described earlier, to adopt a tight monetary stance raising the interest rates and, therefore, indirectly affecting the exchange rate. During September to October 2000, when the Rupee started losing its value against the dollar, the SBP increased the discount rate twice to raise the cost of borrowing in the inter-bank; this, however, proved insufficient in impeding the Rupee’s downward slide. The SBP then squeezed the Rupee liquidity in the market through an increase in cash reserve requirement. These steps were also reinforced by the imposition of margin requirement on import LCs by the commercial banks. As a result, the Rupee-Dollar parity witnessed a sharp fall initially and then a deceleration in its upward climb latter on.

It is important to note here that the successful combination of monetary and exchange tools resulted in halting the depreciation much earlier than the incidents of September 11, 2001. In fact, this is also reflected in the several forex liberalization measures taken by the SBP from August 2001 that included abolishment of nostro limits and allowing residents to make equity investments abroad.

The second phase of exchange rate movements began with the appreciation of Rupee in October 2001 and since then, the Rupee has appreciated from Rs 63.69 (on October 1, 2001) to Rs 57.71 (on June 30, 2003). During this phase, the SBP adopted the policy of a gradual appreciation of the exchange rate. While pursuing this policy, however, the SBP not only safeguarded the interest of exporters but also helped in reducing inflation through cheaper imports. Through massive inter-bank purchases, the SBP not only resisted the sharp decline in Rupee Dollar parity but also accumulated foreign exchange reserves thereby strengthening the ability to intervene and improving public confidence. The level of total liquid foreign exchange reserves rose from US$ 3.3 billion (on October 1, 2001) to US$ 10.7 billion (on June 30, 2003). The SBP, which had been filling its foreign exchange kitty through kerb market purchases, was also successful in gradually shifting its purchases to the inter-bank. During FY03, the kerb purchases completely evaporated and the SBP relied entirely on the inter-bank for reserves accumulation.

The market intervention policy of the SBP proved more effective during the post-September 11 period as the SBP only used this tool to combat the sharp Rupee appreciation. This is in contrast with the pre-September 11 period during which the SBP's US Dollar injections were more to support the market's payment requirements than simply to halt the Rupee depreciation. The stability in the Rupee-Dollar parity, however, had its own repercussions. The inter-bank purchases by the SBP injected massive Rupee liquidity in the market increasing the sterilization requirements.