2 Deepening of Financial System and Services

Despite the rigorous reforms of the financial sector during the 1990s, there was a dearth of financial services offered by the financial institutions in the country. Banks and the non-bank financial institutions were largely involved only in the provision of traditional services like deposit mobilization and credit extension mainly for working capital or project financing needs of industry. Services like personal financing, credit cards or ATM facility were negligible and there was no concept of online banking, phone banking or even housing finance by the banks. The situation, however, started turning around in the 2000s when significant progress was made in improving the health and soundness of the financial sector.

The privatization of public sector financial institutions, relaxation in the licensing and regulatory environment for micro and rural credit institutions, mandatory requirements for banks to get themselves evaluated by credit rating agencies, measures to improve corporate governance, removal of restrictions on consumer financing by nationalized banks, incentives to provide mortgage finance, improvement in the legal framework for defaulted loans recovery, changes in the prudential regulations enabling banks to expand their scope of lending and customer network, reduction in the corporate tax rates on banks, mandating the banks to join ATM networks and the initiation of the development of Real Time Gross Settlement (RTGS) system all helped in bringing about a sea change in the financial services offered by various financial institutions.

Significant progress was made during 2001 and 2002 in terms of expansion of microfinance activities, emergence of new financial products and services, automation of retail banking transactions, modernization of payment system and Islamization of financial services. Financial services commitments under General Agreement on Trade and Services (GATS) under WTO have also impacted the financial sector in recent past. Financial services landscape of future will also be influenced by GATS.

2.1 Role of Microfinance Institutions

Given the fact that our formal financial institutions were unable to cater to the credit needs of micro and small enterprises, the role of Microfinance Institutions (MFIs) could hardly be over emphasized in overall development of our economy. These institutions are more important in our country, where around 70 percent of population is still living in the rural areas and the agriculture sector constitutes approximately 25 percent of GDP. Moreover, considerable rise in poverty incidence during 1990s also called for a greater role of these institutions.

The establishment of Pakistan Poverty Alleviation Fund (PPAF) in 1999 as an autonomous private company is one of the significant developments in microfinance sector. The fund operates with a promise to alleviate poverty, improve access of communities to financial services and enhance investments in infrastructure projects. With these clear commitments, the PPAF aims at the strengthening of microfinance sector through: (1) providing a reliable source of funds to well functioning NGOs; (2) creating public awareness, particularly on the issues related to the outreach of financial services to the poor and its links to the poverty alleviation; (3) encouraging innovative products and improving the quality of existing services offered to MF sector; and (4) acting as bridge between the government and the NGOs. Moreover, the fund may ultimately act as a regulator of MFIs in the Pakistan.

2.1.1 Microfinance Sector Development Program (MSDP)

The government has worked out a comprehensive Microfinance Sector Development Program (MSDP) during 2001 with the help of Asian Development Bank (ADB) to enhance the outreach of microfinance on sustainable basis. Keeping worldwide recognition of social capital as a necessary

safety net for the poor, the MSDP recognizes the vital role of private sector, especially of NGOs, in poverty alleviation efforts. Moreover, the program also encourages banking with the poor. It aims to outreach the poor masses with financial as well as counseling services to improve their social condition through community mobilization, skills development, risk mitigation and infrastructure development.

The government has promulgated Khushhali Bank Ordinance, 2000 to establish a microfinance bank named Khushhali Bank (KB). Keeping the experience of DFIs in view, this bank has been established under the joint ownership of 16 commercial banks (3 public sector, 11 private sector, and 2 foreign banks). Its organization and operations are specifically designed to support a sustainable community-based service delivery system by utilizing the services of NGOs besides using its own branch network. Specifically, the bank has structural integration and partnership with the National Rural Support Program (NRSP).

In addition to this, the government promulgated the Microfinance Institutions Ordinance, 2001, to specify the functions, capital requirements, ownership structure, terms and conditions for the establishment, disclosure requirements and winding up procedure of MFIs. Furthermore, it allows for establishment of three types of MFIs according to their operation limits: nation wide, provincial level and district level. Minimum paid up capital for these three types of institutions is Rs 500 million, Rs 250 million and Rs 100 million respectively. Considering very special nature of MFIs, the SBP has also issued a separate set of prudential regulations for MFIs.

Following the enactment of MFIs Ordinance, 2001, SBP issued a license to the First Microfinance Bank Limited (FMB) to operate at country level.[1] The bank operates with a paid-up capital of Rs 660 million and its major sponsors are the Agha Khan Rural Support Program, Pakistan (AKRSP), Agha Khan Fund for Economic Development, Geneva (AKFED) and International Finance Corporation (IFC). In other words, it is the first conversion of an NGO to a microfiance institution.

The government has established four important funds during 2001 valuing more than US$ 70 million for sustainable microfinance services. The most important one is the Microfinance Social Development Fund (MSDF) amounting to US$ 40 million. The prime objective of this fund is to finance social mobilization and communities' capacity-building expenses of licensed MFIs. Another important fund is the Community Investment Fund (CIF) totalling US$ 20 million. This fund is created to help community-based organizations to develop projects of mutual interest by providing matching grants.

The government has established two more funds, Risk Mitigation Fund (RMF) and Deposit Protection Fund (DPF) to mitigate the risk of indebtedness and loss of deposited money of the poor. The RMF helps in reducing the fear of indebtedness, as it protects poor borrowers in case of failed enterprises or loss of income generating assets due to any unforeseen events that are beyond the control of the borrowers. Similarly, the DPF mitigates the risk of depositors of regulated MFIs, as they will be paid from this fund in case of the liquidation of any MFI.

2.1.2 Outreach of Microfinance Institutions (MFIs)

The Khushhali Bank (KB) began its operations from a remote village in Dera Ghazi Khan and expanded its services to 30 districts and 20,000 households by the end of December 2001 (see **Table 2.1**). As on 31st December 2002, the

Table 2.1: Khushhali Bank Outreach

	Dec-00	Dec-01	Jun-03
District	4	30	-
Households	1,000	20,000	-
Clients	-	-	83,109
Branches	-	-	32
Service centers	-	-	63

Source: www.khushhalibank.com.pk

[1] FMB emerged as the second microfinance bank after Khushhali Bank.

Khushali Bank has extended small loans of Rs 475.5 million to agriculture, livestock, enterprise and small individual enterprises. These loans are disbursed on 20 percent annual service charges and are in the range of Rs 3,000–30,000 with repayment period of 3-12 months. The First Microfinance Bank (FMB) that started its business activities from February 2002 has disbursed loans totaling to Rs 17.6 million by end-December 2002.

The combined assets of these two microfinance institutions i.e., KB and FMB, became Rs 3.1 billion by end December 2002. A quick glance at **Table 2.2** shows that these assets are largely financed through strong equity base, which stood at Rs 2.4 billion over the same period. Within assets, while the investments account for more than 60 percent of overall assets, advances are mere 16 percent. This asset composition typically reflects the phase of fresh entry of these institutions. The composition is very likely to change with the passage of time, as these institutions will extend more loans to the small borrowers. However, the pace of change may remain slow due to very special nature of micro credit. Moreover, utmost care must be taken for the development of business models, as there are very few good domestic examples to follow.

Table 2.2: Microfinance Institutions

million Rupees

	CY01	CY02
Paid up capital	1,705.0	2,365.0
Equity	1,756.9	2,489.9
Borrowing	77.4	401.6
Deposits	0.0	64.4
Liabilities	110.6	587.1
Investments	1,500.0	1,959.5
Advances	110.4	493.1
Total assets	1,767.6	3,077.0

2.2 Emergence of New Financial Products and Services

The financial sector witnessed significant changes in terms of introduction of new services, expansion in existing services and changes in the regulatory framework. During the last few years, the banking sector expanded its menu of services aggressively by introducing new products. In the area of consumer financing, the banks are now competing with each other aggressively in contrast with an almost absence of these activities in the past. Banks have also been revamping their existing services of deposit taking and lending by introducing new instruments/schemes tailored according to the business needs of customers. Encouragingly, these changes are being made to specifically target the small and the medium size savers or borrowers. Consequently, lending to the small and medium enterprises, which had been a neglected area in the past, has now re-emerged as a strong potential investment avenue.

2.2.1 Consumer, Auto and Housing Finance

Consumer Financing

Consumer financing means any financing allowed to individuals for meeting their personal, family or household needs. Unlike in the past, when banks only used to cater to the credit needs for production purposes, the idea of extending consumer finance is getting popular among banks. Although consumer financing was not a new idea, this avenue of lending was almost entirely ignored by the banks and only the non-bank financial institutions had been active in extending such credits. This was due to the fact that banks were reluctant to embark on such activities owing to the longer tenures involved. It was only after 2001, when banks were flushed with liquidity that the interest in such lending arose among banks.

At the moment consumer financing is being provided by banks through credit cards, auto loans, housing finance and personal loans for the payment of goods, services and expenses. Banks are required to extend such loans within the broad parameters set by the SBP (see **Table 2.3**).

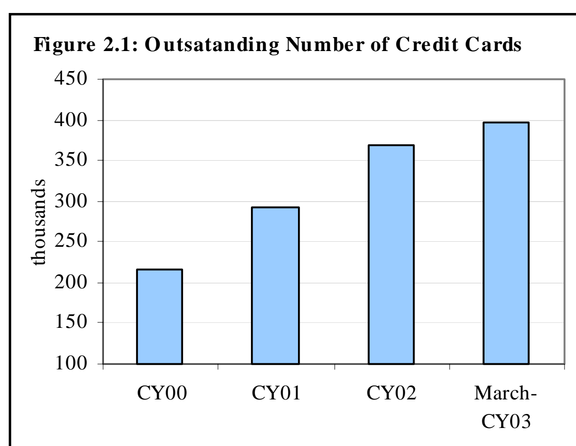
Table 2.3: Some Prudential Requirements for Consumer Financing

	Credit Cards	Auto Loans	Housing Finance	Personal Finance
Maximum limit (million Rs)	0.5*	2	7.5	0.3*
Maximum maturity (years)	Nil	5	20	5
Minimum down payment/debt equity ratio	Nil	10	80:20	Nil
Financing to be commensurate with income	Yes	Yes	Yes	Yes

* Subject to certain conditions these limits could be set higher.

Credit Cards

Financing through credit cards is one of the oldest consumer financing activities in the banking industry. However, the facility had been limited to certain income groups and banks were not very keen to extend the outreach of such services. It was only in the mid 1990s when some foreign banks re-introduced the product to the general public and since then the product has grown tremendously (see **Figure 2.1**). Not only that the number of credit card holders has increased, the volume of transactions using credit cards has also increased significantly (see **Table 2.4**).



Until recently, credit card market had largely been a domain of the foreign banks and only a few domestic banks were competing with them. The situation, however, is now changing significantly; private domestic banks are emerging as the biggest competitor to the foreign banks in this area. The share in the value of transactions carried through credit cards issued by foreign banks has dropped significantly since CY00 (from 95 percent in CY00 to 82 percent in H1-CY03). The domestic private banks have almost entirely captured this loss in share by the foreign banks. Their share, during the same period, increased from a meager 2 percent to 15 percent. Foreign banks, although have lost some of their market, the major share is still with them (see **Table 2.4**).

Table 2.4: Amount of Credit Card Transactions
billion Rupees

	CY00	CY01	CY02	H1-CY03
Public sector commercial banks	0.1	0.1	0.1	0.0
Domestic private banks	0.3	0.9	1.8	0.6
Foreign banks	8.1	9.9	12.3	3.1
Total	8.5	10.8	14.2	3.8
Shares in percent				
Public sector commercial banks	1.2	1.1	1.0	0.9
Domestic private banks	3.8	8.0	12.5	17.0
Foreign banks	94.9	90.9	86.6	82.1
Total	100	100	100	100

Major reasons in grabbing the significant share by the new entrants of the market are relatively lower interest rate charges, annual fee waiver and the relatively easier eligibility criteria. These conditions ignited a fresh interest in credit cards among public and invoked strong competition among banks. The sharp competition could be witnessed in strong advertising campaigns and the incentives given on using credit cards by different banks.

Despite a sharp fall in the overall interest rates charged by domestic banks, financing through credit cards remained extremely expensive compared with weighted average lending rates (see **Table 2.5**). High interest rates set by the commercial banks are, perhaps, due to very high risks of default. Despite the beginning of competition from domestic banks, the rates are still very high. However, the

incentive schemes offered by the new competitors along with annual fee waiver have reduced the cost of credit card transactions.

Despite the fact that risk exposure of banks in credit cards is significant, credit card business is quite attractive for the banks due to substantially higher return that seem to outweigh the risk of delinquency on the part of credit card holders.

Table 2.5: Interest Rates on Credit Cards

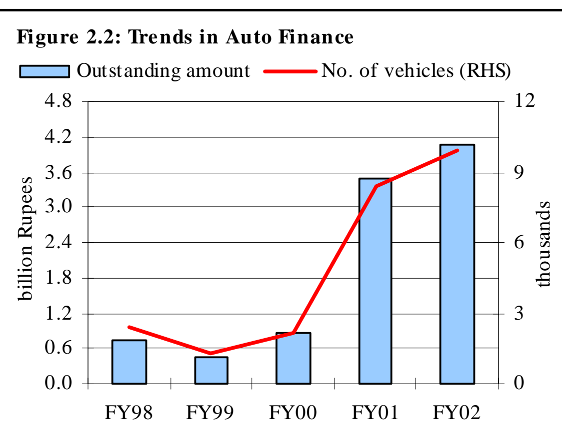
percent per annum

Banks	FY00	FY03
Citi bank	36.0	36.0
Standard Chartered	33.0	33.0
Askari	28.0	28.0
Union Bank	NA	27.0
Bank Alfalah	NA	27.0
MCB	48.0	48.0

Auto Loans

Auto loans had been in vogue in the financial sector since the early 1990s. These were, however, largely in the domain of leasing companies and banks, especially the foreign banks that entered this market in the late 1990s. These loans, however, gained substantial popularity during the last three fiscal years and have been a major driving force behind the thriving auto production in the country. Auto loans and the number of vehicles financed both have more than quadrupled in FY02 since FY99 (see **Figure 2.2**). Askari Bank, Union Bank, Bank Alfalah, Meezan Bank, CitiBank and more recently, Habib Bank, have introduced their car financing schemes. Scheme offered by Meezan Bank is fully Shariah compliant.

Figure 2.2: Trends in Auto Finance



Housing Finance

Mortgage financing is considered a key indicator for gauging economic activity especially in the developed countries. This is so because the construction industry has strong forward as well as backward linkages in the economy. It not only boosts private consumption but also leads to forced savings by the households.

Although housing finance, like financing through credit cards, is not a new concept for the financial sector, the use of this lending instrument had been limited to the housing finance companies and banks were allowed to enter this market only in 1998. In fact only a single company–the House Buidling Finance Corporation (HBFC) had monopolized the housing finance market till the early 1990s. Though the banks were allowed to extend housing finance but they took little interest in this area of investment as it involved longer maturity periods and required special expertise. Since the banks had other easier options of investment such as T-bills and long-term bonds, they found little incentive to enter this market. As these avenues had limited appetite, banks found it profitable to switch to housing finance.

The re-emergence of the mortgage financing, however, is not owed to the market fundamentals only. A concerted effort has been made by the federal and provincial governments and the SBP in the form of fiscal incentives, liberalization of credit regime, changes in the regulatory framework,

rationalization of stamp duties, registration fee and property taxes and ascertaining enforcement of recovery procedure in case of default by mortgagors.[2]

2.2.2 Credit Rating and Other Financial Services

Credit Rating

Credit rating agencies play a vital role in the financial sector by providing an unbiased assessment of various institutions or instruments used by prospective borrowers or investors. It helps the borrowers by encapsulating the independent evaluation of their financial health in an easier to understand symbol. On the other hand, it helps the investor by eliminating the need to evaluate complex financial information of the borrowers. The credibility of the rating agency plays a crucial role in establishing a trust on the credit ratings.

In Pakistan there are only two rating agencies established in the 1990s. Pakistan Credit Rating Agency (PACRA) was the first to be established in 1994. Later on, JCR-VIS came in as the second agency in 1997. These two agencies are also on the approved panel of rating agencies of the SBP for NBFIs and banks. Since 1995, NBFIs are required to have themselves rated by the approved rating agencies. In 2000, the SBP made it mandatory for all financial institutions to have credit ratings and make it public.[3] This decision was taken to safeguard the interest of the prospective depositors, creditors and investors.

Some general services provided by the credit rating agencies in Pakistan are:

- Entity Ratings of Banks, NBFIs and Corporates,
- Individual Rating,
- Instrument Rating,
- Bank Finance, Structured Finance, Project Finance, Mutual Fund, and Receivables, Securitization Rating,
- Lease, Housing Finance, Credit Card and other Corporate/ Consumer Finance,
- Equity Ratings including Initial Public Offerings and Right Offerings Rating,
- Financial Strength Rating,
- Musharaka/Modaraba issues Ratings,
- Grading of Construction Projects.

Asset Management Services

Besides credit rating services, Asset Management services are of prime importance in the financial industry especially where the investors have little know-how of the available instruments and the risks and profitability associated with them. In Pakistan, as per prudential regulations, banks are allowed to undertake such business that include cash or portfolio management and financial advisory services through a subsidiary company to be formed for the exclusive purpose of undertaking such activities. Up till FY03, among banks, only UBL has established its subsidiary by the name of United Asset Management Company (given license by SECP during FY02). Rest of the three companies (2 in private sector and one in public sector) under SECP, were formed well before 2000 (see **Table 2.6**).

Table 2.6: Asset Management Companies in Pakistan

	Year	Services
NIT	1962	Open-end Mutual Fund
ICP	1966	Closed-end Mutual Funds
ABAMCO	1995	Managing open-ended funds
Arif Habib	2000	Mutual Fund & Investment Plans
UAMCL	2002	Financial Advisory & Mutual Fund

[2] SBP also organized a conference on housing finance on December 2002. Purpose of the conference was to bring all stakeholders together, identify the hurdles to housing fiancé and suggest solutions thereby promoting activities in housing finance and construction.

[3] For details, see BPRD Circular No. 15 dated June 6, 2000.

2.2.3 Automation of Retail Banking Transactions

Three developments are worth noting in automation of retail banking transactions that have boosted electronic transactions, along with expansion in enabling infrastructure in the financial sector of Pakistan. Firstly, on the recommendation of task force on Electronic Clearing House (ECH), the SBP made it mandatory for all scheduled banks to connect to presently available (two) ATM network switches by the end of June 2003.[4] Secondly, in order to strengthen communication infrastructure and ensure its availability at lower cost, the government reduced duty on the import of ATM machines by 50 percent and significantly cut down communication charges over the last three years. Thirdly, the government has also provided legal framework to e-banking transactions through promulgation of Electronic Transaction Ordinance 2002.

On the back of these developments, not only the infrastructure supporting electronic payments, i.e., online branches and ATMs expanded, they also resulted in creating people's confidence in electronic transactions. This is clearly reflected in a phenomenal increase in the use of ATM and credit cards over the last couple of years (see **Table 2.7**). Till March 2003, five banks have issued debit cards; six banks have enabled their customers to manage their accounts electronically; and eleven banks have started phone-banking services.

Table 2.7: Some Facts about ATMs

	CY00	CY01	CY02	H1-CY03
No. of on-line branches	322	450	777	994
No. of ATMs	206	259	399	445
No. of transactions (000)	3,624	5,924	9,319	6,450
Value of transactions (million Rs)	12,507	22,108	37,786	28,052

ATMs

ATMs gained high popularity during the last couple of years. Banks have been expanding this facility by increasing the number of their online branches and installing more and more ATMs. During CY02 alone, the number of branches becoming online increased by 72 percent compared to the 40 percent growth in CY01. The number of ATMs grew by 55 percent in CY02 against an increase of 25 percent witnessed in CY01. Almost similar growths in the number of transactions, through ATMs, as well as the value of transactions show a compatible usage of the facility.

Since CY00, the domestic private banks, largely the MCB, have been the major supplier of ATM facility. Though their share in the total number of ATMs provided has, increased from 54.6 percent in CY00 to 62.4 percent in H1-CY03 (see **Table 2.8**), this is largely due to the increase in ATMs of banks other than the MCB. Foreign banks, which had a share of 22 percent in CY00, almost equivalent to that of nationalized banks, lost their share to 15 percent in H1-CY03. The loss in share by both the privatized banks and the foreign banks has been captured by the domestic private banks, which have been adopting electronic banking very aggressively. A loss in share by the foreign banks, which are largely operating in big cities only, and an expansion in

Table 2.8: Distribution of ATMs

	CY00	CY01	CY02	Jun-03
Public sector commercial banks	48	66	89	100
Domestic private banks	113	146	245	278
MCB	*75*	*103*	*151*	*155*
Others	*38*	*43*	*94*	*123*
Foreign Banks	45	47	65	67
Total	206	259	399	445
Shares in percent				
Public sector commercial banks	23.3	25.5	22.3	22.5
Domestic private banks	54.9	56.4	61.4	62.5
MCB	36.4	39.8	37.8	34.8
Others	18.4	16.6	23.6	27.6
Foreign Banks	21.8	18.1	16.3	15.1
Total	100	100	100	100

[4] BPD Circular No. 20, dated 5th August 2002 for mandatory connectivity to two ATM switches by all banks. At present, two ATM Switch Networks are in operation, managed by MCB (M-net) and ABN AMRO Bank (Shared ATM Switch Network).

domestic private banks suggest an increased network in the country and greater access available to the masses. The stagnant share of nationalized banks (though still sizable), however, is a bit disappointing as these banks have the largest network and an increase in their number of ATMs would have meant far reaching access to e-banking.

An analysis of the volume of transactions using ATMs, however, reveals some interesting developments. Although apparently the increase in transactions using ATMs is in line with the increasing number of ATMs, for the domestic private banks, the within group analysis suggests that the transactions and the number of ATMs is not in line with each other for banks other than the MCB (see **Table 2.9**). Most significant rise, however, is in the share of foreign banks only, which presumably suggests that the large city-based clientele of the foreign banks is more aware and inclined towards the usage of modern technology.

Table 2.9: Growth in ATMs Transactions

billion Rupees

	CY00	CY01	CY02	H1-CY03
Public sector commercial bank	1.1	2.2	3.7	1.8
Domestic private banks	9.1	14.0	25.2	10.2
MCB	7.3	11.1	19.6	7.1
Others	1.8	2.9	5.6	3.1
Foreign banks	2.3	5.9	8.9	3.3
Total	12.5	22.1	37.8	15.3

Presently, ATMs in Pakistan generally offer a limited number of automated services that include cash withdrawals, balance enquiries and statements. However, in most of the countries, ATMs allow many other services that include deposits, transfer between accounts and ordering of chequebooks. There is a clear need for expanding existing services provided by ATMs in Pakistan.

Electronic Banking

With a phenomenal growth of electronic transactions internationally, it is crucial for Pakistan to develop its e-commerce infrastructure to be the part of global economy. But due to the capital-intensive nature of such operations, Pakistani banks have been lagging behind in offering e-commerce services in the past. It is only during last couple of years, when the e-banking witnessed some growth in the country. Banks are now investing heavily to bring their operations on modern technological grounds. To facilitate their customers, each bank is now maintaining its website to provide a comprehensive information regarding the services that they offer. Wide-ranging services like Automated Teller Machines, credit cards, debit cards and phone banking are now common among most of the banks.

2.2.4 Modernization of Payment System

The Payment and Settlement System has become an essential element of the financial system of a growing economy. It comprises a set of instruments, entities, procedures, and inter-bank fund transfer systems that ensure exchange of value from one party to another. During 1990s, development and integration of the financial infrastructure and reforms in the payment and settlement systems have received substantial attention both from the governments and central banks around the world.

Considerable developments have taken place to ensure speedy payments and settlement of financial transactions with safety and stability. In this regard, the rapid progress in Information Technology (IT) and financial services industry has provided enabling infrastructure through imaging system, Automated Teller Machines (ATMs), credit & debit cards, and safe financial messaging services. The growing concerns regarding minimizing the systemic risk involved in the large (amount) inter-bank transactions have also resulted in the development of Real Time Gross Settlement (RTGS) System.[5]

[5] In the RTGS system, final settlement of inter bank financial transactions is carried out on a continuous, transaction- by-transaction basis throughout the processing day, thereby, minimizing the systemic risk.

In Pakistan too, the payment system has changed significantly over the last five years. In part, this has come about in response to technological changes that have taken place, but it has mainly evolved as a result of financial sector reforms during 1990s. In this regard, the State Bank of Pakistan, Securities and Exchange Commission of Pakistan (SECP, the government and the private sector have taken several steps to facilitate automation and modernization of payment system in Pakistan. Consequently, significant progress has been made with regard to institutional strengthening, automated cheque clearing, government securities and corporate securities settlement systems.

Institutional strengthening

As a core function of the central bank, the role of the SBP extends to operating, monitoring and ensuring sound payment systems. For this purpose, the SBP has established a separate department (Payment System Department). Moreover, in order to minimize the risks inherent in e-banking and IT-based payment systems, the SBP has also constituted a Payment System Policy Group that will monitor risk related issues and accordingly formulate policies.

In order to provide enabling infrastructure in the financial sector of Pakistan with the objective of promoting e-commerce in the country, the State Bank of Pakistan (SBP) has also constituted a task force on Electronic Clearing House (ECH) to develop strategies to automate the payment system.[6]

The reforms introduced in stock exchanges have also resulted in significant improvement in corporate securities settlement. The establishment of Central Depository System (CDS) and National Clearing and Settlement System (NCSS) has automated the settlement of stocks' transactions.

Automation of Cheque Clearing System

The automation of cheque clearing operations was the first major step towards modernization of payment system in Pakistan. The use of cheques has traditionally dominated non-cash payments in Pakistan. Despite recent developments in other payments instruments, cheques remain a common form of non-cash payment (see **Table 2.10**). The manual cheque clearing used to take a long time due to differences and errors in manual balancing.

Table 2.10: Indicators of Turnover in Clearing House

end-June

Year	Cheques cleared	Total deposits	Cheque able deposits	Turnover in payment system	Cheques cleared to cheque-able deposits ratio	Currency to deposit ratio	Ratio of turnover to GDP
	million No.			(billion Rupees)	percent		
1996	22.2	31.7	29.6	2,824.7	74.9	26.4	1.3
1997	22.9	32.3	31.4	2,832.6	72.9	24.5	1.2
1998	24.7	29.8	28.4	3,508.8	87.1	25.5	1.3
1999	29.1	29.7	28.7	4,467.8	101.7	26.4	1.5
2000	29.6	28.8	27.0	5,357.6	109.5	31.2	1.7
2001	31.5	27.8	26.6	5,772.9	118.4	29.4	1.7
2002	36.6	28.3	27.4	6,711.8	133.7	30.5	1.8

In order to automate the cheque clearing system, National Institutional Facilitation Technology (NIFT) Pvt. Ltd. was established in collaboration with the private sector initiative. The NIFT relies on an image-based system that processes cheques and provides net position of the financial institutions by the end of the working day, which is finally settled (credited or debited) in the banks' account maintained with SBP. With its establishment in 1997, the NIFT has been clearing cheques in

[6] This task force is a part of the E-commerce Working Group developed by the Ministry of Science & Technology, to establish guidelines, policies and implementation of the projects for the promotion of E-commerce in Pakistan.

four major cities.[7] However, in all other centers managed by the SBP, the (SBP) clearinghouses have been performing settlement manually. Nevertheless, the four cities where NIFT has been operating constitute more than 75 percent of the total cheques cleared at various SBP clearing houses.

Inter-bank Transactions

Presently, the inter-bank payments such as bank lending, net settlement of retail cheques and payment leg of government securities transactions are settled through a book-based manual entry system. In this system, the banks holding accounts with SBP are issued chequebooks, which they use to withdraw/transfer funds from their accounts. The banks present cheques at SBP counter by 1:30 pm each day, then these cheques are processed and balances are debited in the remitting and credited to the beneficiary banks' accounts.

This paper-based manual system entails a time lag between the execution of a transaction and its final settlement at SBP. Due to the settlement lag in the current manual process, an individual bank is exposed to a number of risks such as settlement risk (credit risk, and liquidity risk) and systemic risk. The systemic risk is introduced when failure of a bank to meet its obligations causes other banks to also fail on their obligations causing system-wide disruption.

Bank for International Settlement (BIS) has published core principles for systemically important payment system. In order to meet the accepted standards, the SBP has started to implement RTGS. The RTGS systems offer a powerful mechanism for minimizing settlement and systemic risks in the inter-bank settlement process, because they can effect final settlement of individual funds transfers on a continuous basis during the processing day.

Government Securities Settlement

In contrast to cheque clearing system, the government securities are settled through book-based clearing system operated by the SBP. Presently, the government securities settlement is being affected through the Subsidiary General Ledger Account (SGLA). In SGLA, two separate accounts are maintained for each bank: One for banks' own while other for its clients (IPS-Investor's Portfolio of Security). Since the introduction of SGLA in 1991, the movement of ownership through debit and credit in these accounts has mostly replaced physical transfer of securities. All the transactions between SBP and primary dealers and secondary market transactions are reflected in these two SGLAs.[8] However, after implementation of the RTGS, it will link with the government securities settlement system on a delivery-versus-payment (DVP) basis.

It may be noted that transactions of only some kinds of government securities are presently effected through SGLAs. These securities include Market Treasury Bills, Federal Investment Bonds and Pakistan Investment Bonds. **Table 2.11** shows the volume of transactions of MTBs, FIBs and PIBs through SGLAs over last two years.

Table 2.11: Face Value of T-bills and Bonds Moved from one GLA to Other

billion Rupees

Year	3-Months	6-Months	12-Months	FIB	PIB
FY02	594	2,300	1,411	1,986	759
FY03	13	2,481	2,705	702	2,848

Note: These figures refer to sum of numbers of credit and debit

Corporate Securities Settlement

In order to ensure smooth and risk free settlement and transfer of corporate securities (stocks) being traded at the stock exchanges through a computerized book entry system, the Central Depository Company (CDC) was incorporated in 1993 to operate and manage the Central Depository System (CDS). The electronic book entry means that the securities do not physically change hands and the

[7] Recently, on June 7, 2003, the NIFT has also started operations in Faisalabad.
[8] The cash leg of these transactions is finally settled in the banks' current accounts maintained with SBP.

transfer from one client account to another takes place electronically. Since it started operations in 1997, the CDS has been ensuring smooth and efficient settlements of approximately 97 percent of the stock transactions.

National Clearing Company of Pakistan Limited (NCCPL) operationalized a National Clearing and Settlement System (NCSS) on December 24, 2001. In the NCSS, an individual investor or corporate posts his sale position and press "up date" key and his position is automatically settled in CDS.

The SECP has also asked the listed companies to join CDC by July 31, 2003. In order to encourage the issuers to join CDC, the SECP has reduced the security deposit levied on the issuers of CDS eligible securities by 50 percent in the end of January 2003. However, out of 819 declared eligible securities, 406 (around 50 percent) were active on CDC by end December 2002.

2.3 Islamization of Financial Services

The Non Interest Based Banking (NIB) system adopted by banks in 1985 was declared un-Islamic by the Council of Islamic Ideology in the very beginning and by the Federal Shariat Court in November, 1991. The process of reforms in the NIB system and efforts towards Islamization of financial system gathered momentum after establishment of a Commission for Transformation of Financial System (CTFS)[9] in the State Bank of Pakistan and two Task Forces [10] to plan and implement the process of transformation of the financial system to make it Shariah compliant.[11] Major recommendations of CTFS included establishment of Islamic Funds in banks, setting up an implementation cell in SBP, training of banks officials and public education, enactment of an omnibus law on prohibition of interest and setting up a Fund against which Shariah compliant government securities could be issued. CTFS also identified major Shariah compliant modes of financing, model agreements for major modes and guidelines for conversion of the products and services of banks and financial institutions.

Task Force of the Ministry of Law proposed separate draft ordinances namely 'Prohibition of Riba Ordinance' and the 'Financial Transactions Ordinance'. This corresponded to the proposal by the CTFS that in case of two separate laws, the same may be promulgated simultaneously to avoid any gap or dislocation. Task Force of Ministry of Finance came to the conclusion that the outstanding government debt could not be securitized against the pool of the existing government assets and a Mutual Fund based thereon.

In view of the major challenge identified by the Task Force of Ministry of Finance, Government decided that the shift to interest free economy would be made in a gradual and phased manner and without causing any disruptions. This required that Islamic banking institutions and financial products be allowed to progress steadily and firmly in parallel with the conventional banking practices. Consequently, a three-pronged strategy was adopted by SBP that included:

1. Setting up a new full-fledged commercial bank to carry out exclusively banking business based on proposed Islamic products.
2. Setting up subsidiaries by the commercial banks for the purpose of conducting Shariah compliant transactions; and
3. Specifying branches by the commercial banks exclusively dealing in Islamic products.

[9] CTFS, headed by Mr. I. A. Hanfi, former Governor, SBP, was set up by the Federal Government pursuant to the direction given by the Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan in its judgment of December 23, 1999.
[10] The two Task Forces were also set up by the Government in pursuance of the SAB Judgment, first at the Ministry of Law headed by Dr. Mahmood Ahmad Ghazi and second, headed by Mr. Javed Ahmed Noel at Ministry of Finance.
[11] For details, see **SBP Annual Report 2001-2002**, pp 189-198.

2.3.1 Full-fledged Islamic Banks

State Bank issued detailed criteria in December 2001 for establishment of full-fledged Islamic commercial banks in the private sector. The main features of the detailed criteria for setting up scheduled Islamic commercial bank based on principles of Shariah in the private sector are as follows:

- The proposed bank would be a Public Limited Company and would be listed on the Stock Exchange. A minimum of 50 percent of shares shall be offered to the general public.
- All financial transactions will be in accordance with the injunctions of Shariah.
- The application shall indicate the modes of finance to be used for raising resources and extending financial assistance.
- The bank shall have a minimum paid up capital of Rs 1,000 million and also shall at all times maintain a minimum capital adequacy ratio of 8 percent based on risk weighted assets.
- At least 15 percent of total paid-up capital shall be subscribed personally by sponsor directors.
- Application shall stand disqualified if any of the sponsors and/or directors, their spouses or firms are proved to be indulged in unlawful and criminal activities and they are defaulters and tax usurpers.

Al Meezan Investment Bank received the first Islamic commercial banking license from SBP in January 2002. The Meezan Bank Limited (MBL) commenced full-fledged commercial banking operation from March 20, 2002. It also acquired the Societe Generale, Pakistan. Now MBL has a small net-work of 8 branches located in Karachi, Lahore, Faisalabad, and Islamabad.

2.3.2 Islamic Banking Through Subsidiaries and Stand-alone Branches

In January, 2003 the State Bank delineated the instructions on the remaining two parts of the above referred three-pronged strategy,[12] viz. setting up of subsidiaries and Stand-alone branches for Islamic Banking by existing commercial banks. The Banking Companies Ordinance, 1962 was suitably amended to enable banks to form subsidiaries for "carrying on of banking business strictly in conformity with the Injunctions of Islam as laid down in the Holy Quran and Sunnah."[13] The criteria for creating Islamic banking subsidiaries by existing commercial banks are almost similar to the criteria for setting up scheduled Islamic commercial bank with emphasis on complete segregation of accounts of Islamic banking subsidiaries and the parent banks doing conventional banking. The subsidiaries shall have minimum paid up capital of Rs 1,000 million that is equal to the capital requirement for full-fledged commercial banks.

For Part-III of the strategy, guidelines for opening of stand-alone branches for Islamic banking by existing commercial banks, enlisting eligibility criteria, licensing requirements and other operational details on the subject have been issued. Eligibility criteria pertain to financial strength of the applicant bank as evident from its capital base (net capital free of actual and potential losses), adequacy of its capital structure, record of earning capabilities, future earning prospects of the bank, managerial capabilities, bank's liquidity position, track record of the bank's adherence to prudential regulations, credit discipline, quality of customer services and the convenience and the needs of the population of the area to be served by the proposed branches. There are three more considerations: (i) banks seeking permission should have CAMELS rating of 1, 2 and 3 in the last on-site inspection; (ii) there should not be major adverse inspection findings against the bank; and (iii) the bank shall identify experienced and trained key staff to handle the Islamic banking branch operations.

The applying bank is required to submit a proposal to the State Bank, outlining the following details:

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[12] For details, see BPD Circular No. 1 January 1, 2003.

[13] A new clause (aa) has been inserted in sub-section (1) of Section 23 of the Banking Companies Ordinance 1962 by an amendment notified in the Gazette of Pakistan on November 4, 2002.

- Number of branches along with name of city where the Islamic Banking Branch (IBB) is to be offered within the next financial year.
- Products and services to be offered by the IBB including deposits, financing, investment, etc.
- Method of segregating the funds of IBB from the funds of commercial banking of the applying bank.
- Infrastructure and logistic requirements, including manpower and training programs.
- The name, qualification and experience of Shariah Adviser (s), and
- Accounting aspects, such as accounting policies to be followed, profit and loss sharing mechanism, manuals, etc.

The bank will also be required to set up Islamic Banking Division (IBD) at the Head Office/Country Office in Pakistan. The responsibilities of this Division have been depicted in detail. The bank would also appoint a Shariah adviser/Shariah Supervisory Committee consisting of Shariah scholar(s) of repute to advise the IBD on matters pertaining to Shariah. Moreover, the bank shall ensure that proper systems and controls are in place in order to ensure segregation of funds and protect the interest of depositors. The banks shall keep separate books of accounts in respect of Islamic banking operations and ensure proper maintenance of records for all transactions for disclosure of assets, liabilities, expenses and income of IBD/IBB(s). The IBD will comply with statutory liquidity and cash reserve requirements determined by SBP.[14]

2.3.3 Islamic Financial Products for Capital Market

Some developments have also been witnessed in the capital market with regard to Islamization. A number of companies have issued Term Finance Certificates (TFC) to raise redeemable capital on the basis of Musharaka. The payment of profit to or sharing of loss with the TFC holders are linked to the operating profit or loss of the TFC issuing companies. Therefore, the investors assume the risk of sustaining losses proportionate to their principal amount in case of operating losses incurred by the company. In September 2002, SECP also allowed the Mudaraba companies to float Musharaka-based TFCs. The Modarabas have been required to seek permission from SECP to issue TFCs under section 120 of the Companies Ordinance, 1984.

Another significant development during the year in respect of Modarabas is permission to set up 'SME Modaraba' with the participation of about 20 Modarabas to undertake SME business in the smaller towns and distant areas. With an initial paid-up capital of Rs 200 million, the SME Modaraba will resolve the problem of the individual Modarabas which do not have a big branch network to reach out to the prospective clientele.

2.3.4 Regulation of Islamic Banking

With regard to regulatory measures, the State Bank of Pakistan is trying to evolve an environment conducive for working of Islamic banks according to true spirit of the Shariah. The Central Board of Directors of the State Bank has recently approved establishment of Shariah Board in the State Bank. A new department, Islamic Banking Department, has recently been created by merging the separate divisions working under Banking Policy and Research Departments. A number of factors relating to institutional arrangements and supervisory/regulatory and legal framework need to be taken care of. It would require an innovative approach keeping in view the Shariah essentials of Islamic modes, standards recommended by Bahrain based Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and the international best practices and standards adapted by Malaysia based Islamic Financial Services Board (IFSB). In this context recourse is being made to the experience of Bahrain Monetary Agency (BMA) that in addition to the application of rigorous regulatory and transparency standards, has pioneered a range of innovations designed to broaden the

[14] For details, see BPD Circular No. 1 January 1, 2003.

depth of Islamic financial markets and to provide Islamic institutions with wider opportunities to manage their liquidity and risk spectrum.

Efforts are underway to develop instruments for SLR and liquidity management by Islamic commercial banks. For the time being, Meezan Bank has been allowed to maintain Statutory Liquidity in the form of current account with SBP to the extent of 40 percent of SLR for commercial banks (which works out to 6 percent of Time and Demand Liabilities) till the issuance of Islamic Bonds by the Government or other similar non-interest bearing GOP securities.

Similarly Meezan Bank has also been allowed to maintain Special Cash Reserve (SCR) on FE-25 deposits in current account with State Bank in local currency to the extent of 40 percent of SCR for other banks in order to avoid interest payments on SCR. A Musharaka-based Export Refinance Scheme has been designed by SBP in order to provide export finance under both Parts of the Scheme to eligible exporters on the basis of Islamic modes of financing.

To ensure Shariah compliance in operation of Islamic banks their Shariah audit is an important aspect. The State Bank is in the process of finalizing an agreement with Ford Rhodes Sidat Hyder & Co. for Shariah compliance audit of Meezan Bank. The company will conduct Shariah audit of Meezan Bank, prepare a Shariah Compliance Inspection Manual for future use of SBP and provide training to SBP inspection staff.

2.4 Financial Services commitments under GATS

General Agreement on Trade in Services (GATS) is a part of WTO agreement, covering international trade in financial services. It represents the first multilateral effort with an aim to improve investment conditions and create a flexible framework of liberalization of trade in services. The most recent negotiations took place in the beginning of 1998 and the next round of revision is expected by 1st January 2005.

Obligations under GATS are classified into two broader categories: (i) general obligations, which are directly applicable to all members and (ii) specific obligations under which member countries identify their commitments in specific sectors for *market access*[15]*, national treatment*[16] and *modes of supply*[17]. Being a member of WTO, Pakistan has made several commitments under GATS. The following sections present a brief account and a summary of the main commitments on trade in financial services. Pakistan's commitments for financial services are broadly classified as (1) financial services (excluding insurance), and (2) insurance & insurance related services. The financial services are further categorized as (a) banking, (b) asset management, (c) leasing and (e) financial advisory services. Insurance & insurance related services cover both life and non-life insurance.

General obligations are those that apply to all service sectors. In GATS, these include obligations relating to transparency and granting exemption of Most Favored Nations (MFN) treatments to any other member. Similarly, provision of all banking and financial services are subject to the injunctions of Islam. Some of the specific obligations for financial services are as follows.

Banking services

The terms and conditions that accord in banking services promise some liberalization by granting relaxation, which were formerly affected by several barriers. Under the framework of banking sector

[15] Under market access commitment individual countries define the extent of openness of their markets in specific sectors.
[16] National treatment means that without making any discrimination treating both foreigners and nationals equally.
[17] There are four modes of supply: (1) Cross-border supply, in which the service is supplied from the territory of one member into the territory of another member; (2) Consumption abroad, or cross-border consumption of services in which the service is supplied in the territory of one member to a service consumer coming from another member; (3) Commercial presence, the opportunities for foreign service suppliers to establish the business in the member's territory, such as branch, subsidiary corporation or representative office; and (4) Presence of natural persons, the entry and temporary stay in the member territory of foreign individuals in order to supply a service.

Pakistan's commitment brings reform through diversification and liberalization in services related to banking which in turn increases the participation of foreign banks in domestic market.

Under GATS, commitments related to banking services include all the traditional services provided by the bank such as acceptance of deposits and other repayable funds from the public in Pakistan, lending of all types, payments and money transmission services excluding credit, charge and debit cards, guarantees and commitments, trading for own account only of money market instruments, foreign exchange, transferable securities, and other negotiable instruments, all kinds of securities including only public underwriting and placement as agent and provision of services related to such issues, settlement and clearing services for negotiable instruments like cheques, bills and promissory notes only. Some of these commitments related to market access limitation are given below.

- Previously, foreign banks were allowed to open 3 branches only. Now the limit has been raised to a maximum of 25 branches. With regard to branch licensing policy, foreign banks now have the same eligibility criteria as applicable to domestic commercial banks.
- In the old branch licensing policy, foreign banks were required to have only branch licence to operate their businesses. Operational business of foreign banks through establishing branches in Pakistan is no longer allowed. New foreign banks (except those which are already operating their branches as on 12th December, 1997) desiring to undertake the business are now required to set up publicly incorporated limited companies with foreign equity contributing up to 49 percent in the total equity.
- The minimum paid-up capital requirement for foreign banks shall not be more than what is required by the domestic commercial banks i.e. US$ 11.5 million[18].

Asset management and financial advisory services.

- Banks licensed by SBP can undertake portfolio management services through their locally incorporated subsidiaries set up for the purpose with share holding in such public limited companies up to 51 percent.
- Banks are also allowed to undertake financial advisory services through their subsidiaries with shareholding up to 100 percent.

Services related to leasing

Prior to this commitment domestic as well as foreign financial institutions are allowed to undertake the leasing business. Now permission will be granted to the foreign leasing companies to establish subsidiary in order to undertake operational leasing including cross-broader leasing with maximum limit on shareholding up to 51 percent of the total capital.

[18] This limit is changeable from time to time.