BANKING SECTOR REFORMS IN PAKISTAN: AN ANALYSIS OF THE UNFINISHED AGENDA

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CERTIFICATE

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ABSTRACT

In an extension of the study on banking sector reforms in Pakistan, this secondary data-based research describes and analyzes the unfinished agenda and the future prospects of commercial banks in Pakistan.

Pakistan has made significant progress in implementing these reforms. It has achieved a more competitive market structure with the privatization of nationalized commercials banks and significant gains in the form of better supervision and regulation of banking institutions. Performance indicators have shown remarkable improvement. Further reforms in areas such as deposit insurance, e-banking, risk management techniques, derivatives etc. are still being pursued by the SBP to achieve a more efficient and sound banking system. However, issues regarding supervision, compliance with policies and special treatment of politically backed individuals are still present. Trends of consumer, SME and agricultural financing, consolidation of small banks, supporting fiscal reforms and universal banking are expected to continue in the future.

Today, the reforms remain a work in progress despite being singularly revolutionary in their magnitude, truly home grown and world class in their substance. Stress should be given on good governance, communication of the action plan, diversification of sources of income of banks, foreign training of staff and a more integrated banking sector.

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Hassan Barlas.

DEDICATION

To my beloved parents who mean the world to me and to whom I owe more than words can say…..

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LIST OF SYMBOLS

ABL	Allied Bank of Pakistan
ADB	Asian Development Bank
BCO	Banking Companies Ordinance
BID	Banking Inspection Department
BPRD	Banking Policy & Regulation Department
BSD	Banking Supervision Department
CAELS	Capital Adequacy, Asset Quality, Earnings & Profitability, Liquidity and Sensitivity to Market Risk
CAMEL	Capital Adequacy, Asset Quality, Management Soundness, Earnings & Profitability, Liquidity and Sensitivity to Market Risk
CIB	Credit Information Bureau
CIRC	Corporate & Industrial Restructuring Corporation
CRR	Cash Reserve Requirement
DFI	Development Finance Institution
GDP	Gross Domestic Product
HBL	Habib Bank Limited
IAS	International Accounting Standards
IMF	International Monetary Fund
IT	Information Technology
KIBOR	Karachi Inter-Bank Offered Rate
MCB	Muslim Commercial Bank
NBFC	Non- Bank Finance Company
NBP	National Bank of Pakistan
NCBs	Nationalized Commercial Banks
NIT	National Investment Trust Limited
NPLs	Non-performing Loans
PBA	Pakistan Banks Association
PBC	Pakistan Banking Council
ROA	Return on Assets
ROE	Return on Equity
RTGS	Real Time Gross settlement System
SBP	State Bank of Pakistan
SECP	Securities Exchange Commission of Pakistan
SLR	Statutory Liquidity Requirement
SME	Small & Medium Enterprises
TFC	Term Finance Certificate
UBL	United Bank Limited

INTRODUCTION

Broad Problem Area

The last three decades have witnessed several economic policy changes in Pakistan with far reaching consequences: 1970s faced a large-scale nationalization process encompassing trade, industry and financial sectors; 1980s witnessed a beginning of its reversal in non-financial sector; and last part of 1980s and early 1990s saw a surge in the economic measures including trade, fiscal and financial reforms. Since then, a number of measures have been implemented, and would continue to be initiated in the future.

Weak financial systems leave a country's economy prone and susceptible to financial crisis, but this vulnerability decreases with financial depth and diversity in a country's financial sectors. And to a well functioning financial system, it is absolutely essential to have a sound and efficient banking sector (Bokhari, 2001).

Before the onset of the banking reforms in 1990, the financial system consisted of Commercial Banks and Non-Bank Financial Institutions (including Development Finance Institutions). A total of 24 commercial banks (7 domestic and 17 foreign) were doing business in Pakistan as on 30th June 1990. Domestic banks, with absolute public sector ownership and a broad branch network, were catering to major commercial banking needs of the economy and owned around 90 percent in total assets and total deposits of the banking sector. Due to this, entry of foreign banks did not result in any significant structural change, which was very

close to the one that emerged following nationalization in 1974 (State Bank, 2000).

Table 1.1: Structure of Banks in 1990

	Number of Banks	Number of Branches	Assets (%)	Advances (%)	Investment (%)
State-owned	7	7,043	92.2	92.1	93.5
Private	0	0	-	-	-
Foreign	17	45	7.8	7.9	6.5
Total	**24**	**7,088**	**100.0**	**100.0**	**100.0**

Source: State Bank of Pakistan

At the apex, State Bank of Pakistan (SBP) was responsible for guiding and regulating the banking system of the country. However, there was substantial overlapping of regulatory functions, especially with Pakistan Banking Council (PBC) in matters relating to public sector banks.

The effectiveness of SBP supervision (both on-site and off-site) had gradually deteriorated over the years, largely due to the presence of PBC, empowered by the government, which resulted in lack of empowerment and clear demarcation of roles in supervision of nationalized commercial banks.

Pre-Reform Problems

Despite the expectations of economic development and growth that accompanied nationalization, it had its own repercussions and resulted in financial repression.

High Government Borrowing: The Government indulged in high domestic borrowings and commercial banks were required to hold as statutory liquidity reserves (SLR), 30 percent of their deposits in the form of government securities, in addition to a 5 percent cash reserve requirement (CRR). The government also borrowed from SBP by selling ad hoc treasury bills at 0.5 percent per annum, which was the most

inflationary financing and termed as the monetization of government debt. This resulted in low returns on bank’s portfolio, dis-intermediation in the banking system because of the growth of a parallel economy, market segmentation (banks vis-à-vis non-bank), and dispersion in interest rate structure.

Credit Controls: The system of credit ceiling was reperessive, as the magnitude of credit flows to the private sector was determined only after accommodating public sector credit requirements. In addition, it also tended to accommodate established borrowers even if they were simply meant to rollover their loans, as banks were generally not willing to incur the cost of screening and evaluating new projects. With these ceilings in place, the practice of accruing interest on infected loans by banks was very damaging. Since the unrealized income was liable to taxation, it reduced banks’ ability to augment their capital base and to extend new loans. At the same time, these ceilings also had an in-built incentive to evade ceilings imposed by SBP.

Credit Allocation: Most of the directed credit programs resulted in low rates of returns and large non-performing loans (over 30 percent of advances). It was also difficult to ensure that actual intended beneficiaries were using the credit. Mandatory credit targets at concessional rates also reduced the profitability of the banks.

Interest Rates: Floors on deposit rates and ceilings on lending rates of commercial banks discouraged savings and the real interest rate on deposits remained virtually negative for most of the time. This led to financial dis-intermediation.

Limited Competition: The limited competition due to entry restrictions on new institutions and restrained activities of foreign banks hampered the development of the financial system. Furthermore, NCBs accounted for over 60 percent of the assets.

Inefficient Operations: Due to excess staff, the banking operations were highly inefficient.

The World Bank has been an active monitor and proponent of Pakistan's banking sector reforms. The first among its outlined projects was the Financial Sector Adjustment Loan (FSAL), a loan of $150 million, for the liberalization of the financial sector. This was succeeded by a more comprehensive reforms package, the Financial Sector Deepening and Intermediation Project, in 1994. It was a loan package of $216 million and encompassed reforms for the regulating body, the SBP, as well.

In the face of a difficult external situation, and recognizing the institutional and governance problems being faced, the authorities, in particular, the SBP and the Ministry of Finance in early 1997 embarked on a "home-grown" banking reform program (Shah, 2003).

The government of Pakistan requested a number of World Bank missions to help revive the financial sector reform process in Pakistan. In the same year, the World Bank financed a loan of $250 million (co-financed with another $250 million by Japan) under the Banking Sector Adjustment Loan (BSAL), which supported the initial stages of Pakistan's national banking reform program. To assist and ensure the sustainability of the banking sector reform process, the World Bank approved the Banking Sector Restructuring and Privatization Project Loan (BSRP) for $300 million in 2001 The Banking Sector Technical

Assistance Project (BSTAP) in 2002 for $26.5 million aimed to complete the reforms initiated previously and restructuring of the SBP (World Bank Report, 2003).

Reforms in the commercial banks were introduced with the vision of a market oriented, predominantly private system that operates under a strong regulatory framework, is supported by an effective legal and judicial system and intermediates resources in response to price signals.

Under the long-term tentative thinking of the SBP, the reforms aim at creating self-sustained commercially viable institutions with no government support either in respect of resource mobilization or pricing of product. And the financial sector would be predominantly owned by the private sector (Bokhari, 2002).

With this backdrop, there is a need to assess the usefulness of these reforms in terms of future development of the banking sector, analyze the expected impact on growth and welfare of the economy and outline the future direction of reforms. Even though the reform plans have been finalized, the main challenge is to enforce them in a country where many impressive reform plans in other sectors of the economy have failed at the implementation stage.

Rational Of The Study

A research on the unfinished agenda of the commercial banking reforms introduced in Pakistan is significant in understanding the various aspects of the Pakistani commercial banking sector and how the successful adoption of new concepts and models can go a long way in bringing the local sector up to the international standards. It helps in ensuring compliance with consumer provisions and educating the novices how these provisions can best benefit them.

A healthier and more efficient banking system in Pakistan would improve the country's prospects for growth, and enhance its capacity to deal with volatile markets, reduce the risk of financial crisis and improve credit allocation and efficiency (World Bank Report, 2001).

The undertaken research has analyzed the future of Pakistani banking sector in light of these reforms. Many studies have been carried out about the implementation and criticism of the restructuring plan by the World Bank, however not many of these have focused on the unfinished agenda and its implications in a society like Pakistan which is trying to adopt the best of both, the traditional and the modern, world.

Furthermore, in completing this study, the researcher suggests a direction for future reforms in the country. This study serves as the basis for charting the nature and content of future reforms in the banking sector. In addition, it promotes further research not only in the area of banking sector reforms but also the reforms in other areas of the financial, economic and social sectors.

Research Questions

This study aims to answer the following questions:

- Which reforms in the banking sector have been implemented by the SBP as part of the improvements in the financial sector?
- Have the aims behind these reforms been realized?
- What part of the reform agenda is still unfinished?
- How can the banking sector be further modernized to enhance the efficiency and effectiveness of the financial sector in Pakistan?
- What are the future prospects of commercial banking in Pakistan in terms of technology and innovation?

Objectives Of The Study

This research is being conducted keeping in mind the following objectives:

- To understand the role of a modern and efficient banking sector in the financial sector of a country.
- To comprehend the need for such a system for Pakistan's economic growth.
- To find out how the reforms in the pipeline can be implemented for the best interest of the country.
- To provide a future direction for the reforms.
- To provide a certain direction for future research.

Definition Of Terms

Asset Quality: Determines the robustness of financial institutions against loss of value in the assets. It is gauged in relation to the level and severity of non-performing assets, adequacy of provisions, recoveries, distribution of assets etc.

Banking Spread: Difference between weighted average lending and weighted average deposit rates.

Banking System: Consisting of commercial banks, investment banks, savings banks, trade financing banks that are licensed and chartered under banking law.

Banking Risks: Risks associated with the lending functions of a bank (e.g. credit risk, borrower's risk, loan portfolio risks and foreign exchange risks), risks inherent in funding activities concerning deposits, borrowings and cost of borrowings and operational risks (e.g. liquidity risks, fraud risks) and containment of these risks.

Capital Adequacy: Capital base of financial institutions facilitates depositors in forming their risk perception about the institutions. Also, it is the key parameter for financial managers to maintain adequate levels of capitalization.

Efficient Economic System: An economic system where the allocation and use of all resources (human, financial, technical, natural) to various sectors is based on their economic value relative to the opportunity costs and returns to optimize output and income.

Financial System: Comprises of those institutions involve din financial intermediation activities, mobilization of resources (mainly savings and deposits); channeling

resources to users like borrowers and investors via a credit system, financial contracts and financial markets. Comprises the Central Bank, the banking system, quasi-banking institutions, specialized finance institutions, development finance institutions and non-bank financial institutions.

Financial Depth: The state in which a financial system has the ability to trade with ease, financial intermediation is straightforward and marketable securities have ready markets.

Globalization of Financial Markets: A comparatively recent trend in which access to market makers, savers, investors, financiers, brokers is simplified and made easier across the globe. This makes it easier for operations to expand, financing source's variety to increase and portfolios can be diversified.

Interest Rate Spread: The ratio obtained by subtracting the cost factor for interest-bearing liabilities from the percentage yield on earning assets (Interest income/earning assets)–(interest expense/interest paying liabilities).

Intermediary: One who acts as a go-between, middleman or broker, agent.

Legal and Regulatory Environment: the regulations governing the functioning of banking operations in a country, the rules, procedures, orders, directives, circulars and interpretation of laws, acts and ordinances that concern banking operations usually regarding deposits, lending, foreign exchange issued by the Central Bank of a country.

Non-Performing Loan: A loan on which interest is not being accrued, one that has not been paid back to the institution it was taken from.

Operating Expenses: Refers to expenses other than interest expense for e.g. salaries, administrative expenses, etc.

Privatization: To sell/ return to the private sector public companies, which had been owned by the State.

Payment System: The institutions and facilities concerned with the clearing and settlement of receipts and payments arising from banking transactions.

Portfolio: A collection of investments.

Sick Project: A project that is undertaken with too much of a leverage burden (this financing usually being obtained under false pretexts concerning the valuation of the project) thus decreasing the project's chance of success.

LITERATURE REVIEW

A vibrant and dynamic banking sector is vital for a strong and prosperous economy. Apart from being the repository of a nation's savings, banks are a vital source of capital for industry, commerce and agriculture. A strong banking sector is therefore vital for growth, the creation of jobs, the generation of wealth, eradicating poverty, entrepreneurial activity, and for the economy to achieve double digit GDP growth to enable the country to emerge as a developed country by 2020 (The Financial Express, 2003).

It would not be an exaggeration that today weak banking sectors have hampered the development of most of the currently underdeveloped countries in the world. From Chile to the Caribbean, from Morocco to Mexico, from Poland to Pakistan, the effect of a weak and ineffective banking sector can be seen in the economies of these countries.

Today, international capital movements have ensured that there is no dearth of funds for good proposals. Around the world the emphasis is on the restructuring and improvement of the financial markets. In many developing countries, banking sector reforms have been pursued over the past two decades as part of structural reform programs aimed at promoting growth and financial stability (Abdelalijbili, Klausenders and Volkertreichel, 1997).

Many reforms are underway in countries like Brazil, Hungary, Morocco, Tunisia, India, and Bangladesh etc. The central objective is to support the development of institutional capacity to assist the implementation of financial sector reforms. These programs include: (i) actions to raise efficiency in financial intermediation and

broaden access to financial services; (ii) reforms to enhance financial system transparency and the effectiveness of regulation and supervision for both the banking system and securities markets; and (iii) steps to bolster defenses against financial crisis (World Bank Report, 2001).

The financial sector reforms were introduced in India with a view to preventing excessive regulation of the financial structure and to provide an impetus towards the development of infrastructure and productive assets in the country (Bhattacharyya, 2004). To induce dynamism and vibrancy to the banking sector, the government has strived to introduce competition. India's experience with competition has been that it has resulted in lowering costs, improving service, expansion of the sector, etc. (The Financial Express, 2003).

The similar reforms implemented over the past decade in Pakistan have had a substantive impact on financial intermediation and the structure of the financial sector. The country has witnessed a maturing of the financial markets. Many major commercial banking, asset management business and specialized investment institutions are growing rapidly in private sector institutions (The Dawn, 2002).

According to the World Bank Lead Financial Sector Specialist for the South Asia Region, Joe Pernia *"All Pakistan's citizens, from important business interests to the smallest personal account holder, deserve to have access to secure banking and credit. Achievement of the country's vision for a healthy and efficient banking system will give them that while eliminating abuses in the system"* (World Bank Report, 2001).

Pakistan is not isolated with regard to its financial sector dilemmas. On the contrary, the contagion has reared its head in almost every country of the world. And nor is it that developing countries are subject to tribulations caused by such issues. The fact that they are more pronounced and severe in these countries however is true. Not that long ago, it took a lot of hardship and a lot of money to resolve the savings and loan crisis in the United States and Japan has only recently begun to take determined steps to restore its banking system to health after almost a decade of economic stagnation and at great cost (Nishimizu, 2003).

The government and the regulatory authorities in Pakistan have followed a step-by-step approach, not a big bang one. The entry of foreign players has assisted in the introduction of international practices and systems. Technology developments have improved customer service. Some gaps however remain.

Banking Sector Reforms In Pakistan

Realizing the inherent weaknesses of the financial structure that emerged after nationalization, government initiated a broad based program of reforms in the financial sector. At the end of 1989, a reform program was initiated to reduce the market segmentation, instill competition, and switch over to market-based and relatively more efficient monetary and credit mechanism. However, this reform process gathered momentum in 1997, when a crucial set of reforms aiming at institutional strengthening, restructuring of banks and DFIs, and improvement in regulatory framework was introduced by the World Bank (State Bank Report, 2000).

Ishrat Hussain, the governor of SBP, claimed that the planned reforms would change the character of the country's banking. "*Such a drastic reform agenda has seldom been undertaken in a developing country. Once new management takes charge, a larger portion of our banks would be run by the private sector, hoping that more banks in the private sector would help to improve efficiency*" (The Banker, 2000).

Reforms were introduced at the institutional level for financial liberation. These included amendment of the Banks Nationalization Act, 1974 which led to the privatization of major NCBs such as MCB, Allied Bank (1991-1993), UBL (2002) and Habib Bank (2003). NCB's domination of the banking sector was reduced from almost 100 percent in 1991 to around 20 percent by 2003. Private sector was encouraged. In order to avoid the mushroom growth of banks a moratorium was imposed in 1995 and no new bank was allowed to open thereafter. However, the branch policy for both the domestic private and foreign banks was eased to provide the opportunity for existing banks to grow. On the contrary, nationalized banks were prevented to open new branches in December 1996 and asked to close unprofitable ones in 1997. These reforms were aimed at reducing segmentation of financial markets, introducing competition in the financial sector, strengthening capital base of financial institutions and switching over to indirect, market-based and relatively more efficient monetary and credit policy. Many of the results of liberalization so far have been impressive (State Bank Report, 2000).

Pricing and remuneration for most of the financial services are now determined by banks on competitive basis. There are no directions from the SBP. Government has to pay

market based interest rates on debt raised through the banking system.

To reduce the systematic risk to the financial system, banks were asked to restructure and rationalize their work strength and size. Golden handshake and several other schemes for employees and bank closure programs were carried out during 1997 and 1998.

The prudential regulations in force were mainly aimed at corporate and business financing. The SBP in consultation with the Pakistan Banking Association and other stakeholders developed a new set of regulations which cater to the specific separate needs of corporate, consumer and SME financing. The new prudential regulations, 28 in number, enable the banks to expand their scope of lending and customer outreach. The SBP also took a major leap forward shifting from a one-size-fits-all approach of regulation to more risk-focused supervision by categorizing and instituting separate sets of prudential regulations for corporate/commercial banking (Hussain, 2003).

To strengthen the capital base of banks and achieve international consistency, the SBP enforced the Basel system of defining minimum capital requirements for banks in 1997. To further strengthen their competitive ability, both domestically and internationally and to encourage the economies of scale, the minimum paid-up capital requirement of the banks was raised to Rs. 1 billion in year 2000. This has resulted in mergers and consolidation of many financial institutions and weeding out of several weaker banks from the financial system. CRR, SLR, risk weighted capital, fund management and investment advisory services by forming subsidiary companies were also contemplated (State Bank Report, 2003).

Guidelines were put forward by the SBP to classify loans and advances. Banks were asked to set quarterly recovery targets, submit progress reports, and form strategies to improve future recovery process. At the same time, minimum conditions for borrowers were also established to ensure that defaulters were not provided fresh loans. Strict monitoring and reduction of NPLs was carried out by active involvement of the Corporate Industrial Restructuring Corporation (CIRC) and Committee of Revival of Sick Units (CRSU) established in year 2000. This has reduced the volume of NPLs and allowed the sick industrial units to revive while at the same time enabled the banks to clean up their balance sheets. The positive development is that the quality of new loans disbursed since 1997 has improved and recovery rate is 95 percent (The Dawn, 2002).

To achieve the desired objectives, the regulator SBP was given autonomy in 1997 through amendment in the SBP Act of 1956. PBC was also dissolved providing a much needed unity of command. Other steps taken include internal restructuring, computerization and networking, hiring of staff training of staff in banking supervision, adoption of international accounting standards, delegation of authority to BOD of banks and setting up of CAMELS and CAELS system for risk-based inspection and off-site surveillance of banks. Capacity of SBP is likely to further improve in near future with regard to its core functions (Hussain, 2004).

Laws were amended and strengthened. These included the Banking Ordinance 1962, unified system of banking courts and The Financial institutions Ordinance 2001 replaced the Loan Recovery Act 1997. On the request of the SBP, the Federal Government constituted Banking Laws Review

Commission in April 2000 to review the legal problems and legislative needs of the financial sector, modify the existing legislation regarding the financial sector where required and to propose drafting of new laws. SBP trained judicial officers were assigned as heads of banking courts and infrastructure and logistic support to the banking court was also strengthened (Ford Rhodes Sidat Hyder, 2004).

Corporate governance was incorporated in the banking sector through SBP's enforcement of Banking license regulations, transparent financial transactions, fit and proper tests for independent appointment to Board and Chief Executive positions, new professional management from private sector, insider trading, regulations of external auditors' profession, and prudential guidelines for Board of Directors. The SBP also issued a "Handbook of Corporate Governance" for banks to provide guidance. "Code of Corporate Governance" issued by SECP has been implemented for the banking sector as well (IMF Report, 2002).

All banks were required to get themselves evaluated by credit rating agencies in 2000 to facilitate depositors to make informed judgments about placing their savings with the banks.

The high corporate tax rates on banks adversely affected profitability and attractiveness as an avenue for investment and new equity injection. The Government reduced the tax rate from 58 percent to 44 percent during the last three years and it is envisaged that the rate will be reduced gradually and brought at par with the corporate tax rate of 35 percent by 2007. This will in turn help in reducing the spread between the deposit rates and lending rate and benefit financial savers (Economic Survey, 2003).

SBP removed restrictions imposed on banks for consumer financing in 2002. Auto financing has made consumer durables more accessible for the middle class through banks. This has also boosted the manufacturing of TVs, air-conditioners, DVD players, washing and drying machines, deep freezers etc. in the country. Credit and Debit Cards are also gaining popularity and the numbers of cardholders have doubled during the last two years (Hussain, 2003).

Banks were encouraged to move towards Electronic banking. There is a big surge among the banks including NCBs to upgrade their technology and on-line banking services. ATMs have expanded to about 500 ATMs throughout the country. The decision mandating the banks to join one of either two ATM switches available in the country has provided a further boost. Progress in creating automated or on-line branches of banks has been quite significant so far and it is expected that by 2005 a majority of the bank branches will be on-line or automated. Investment in information technology is being undertaken by the banks to enhance efficiency, reduce transaction costs and promote E-Commerce (State Bank Report, 2003).

In its endeavor to further strengthen its core supervisory functions, the SBP is automating the payment settlement system. The objective of moving towards a robust payment system is to promote and maintain financial stability within the economy. This will provide convenience in transfer of payments to the customers. The Real-Time Gross Settlement (RTGS) system processes large value and critical transactions on real time while electronic clearing systems are being established in all cities (Ford Rhodes Sidat Hyder, 2004).

A greater number of emerging economies are moving towards the universal banking paradigm. Pakistan too is falling in line with this trend and the SBP in 2002 allowed banks to form subsidiaries to conduct functions of asset management, venture capital, exchange companies, mutual funds etc. The move though makes the case for economies of scale more compelling and could expedite the process (Nishimizu, 2003).

Banks are being encouraged towards mortgage financing. The upper limit has been raised from Rs 5 million to Rs 10 million. Tax deduction on interest payments on mortgage have been allowed up to a ceiling of Rs.500,000. The new recovery law is also aimed at expediting repossession of property by the banks. The banks have been allowed to raise long-term funds through rated and listed debt instruments like TFCs to match their long term mortgage assets with their liabilities (Hussain, 2003).

SBP has broadened the scope of Agriculture Credit Scheme and removed other restrictions to enable the commercial banks to increase their lending for agriculture, thus mainstreaming agriculture lending as part of their corporate business (Economic Survey, 2004).

Banking sector reforms can be very painful and risky. They involve the closing down of problem banks. The closure of problem banks does not only lead to a cessation in the delivery of essential banking services but may also lead to massive job losses. Banking sector reforms also carry with them the enormous risk being stalled by powerful interest groups that had previously benefited from indiscreet lending policies of banks. There is also the risk that the reforms may not be successful. But these reforms were necessitated by the fact that the banking sector in many

countries had ceased to perform its key function of safekeeping of depositor’s monies and extending credit to worthy borrowers (Kato, 2004).

Developing countries have made important progress over the last decade toward establishing sound and efficient bank intermediation. In many respects, however, their banking sectors still fall short of achieving the dynamism, efficiency, and depth of full-fledged market-based financial systems in industrial countries or in the most advanced developing countries (Abdelalijbili, Klausenders and Volkertreichel, 1997).

METHOD

Data

All the data required for this research was gathered from secondary sources. No primary research was carried out. Therefore, it was a secondary data-based research.

Sources Of Data

The required information was gathered through secondary sources such as Economic Surveys of the Government of Pakistan, other publications, journals (virtual and real), books, annual reports and numerous websites. Data was collected from two major sources:

- **Donors:** Reports published by international agencies (like World Bank and IMF) that are not only the donors but also monitoring the reform process.
- **Executors:** Numerous reports by the SBP and Ministry of Finance were also consulted, which were the implementers of the banking sector reforms.

Procedure

Since familiarity with the reforms and its elements was already present, the areas to be covered were identified first. Sufficient background literature was collected to adequately support the study. Then, based on the future intentions of the related working bodies and the unimplemented agenda, secondary data was sought. The information gathered, was used to evaluate how the intended future steps will affect the banking sector and its stakeholders. In the end recommendations were given based on the above results.

RESULTS & DISCUSSION

Reform Outcomes

The banking sector reforms introduced in Pakistan, in the period 1990 to 2003 have paid off. They have helped the country achieve a more competitive, liberal and efficient banking sector, which was a far-fetched reality less than 8 years ago.

Pakistan has made significant progress in implementing banking sector reforms and has achieved a more competitive market structure with the expanding market share of private and foreign banks and the privatization of nationalized commercials banks. There are also significant gains in the form of better supervision and regulation of financial market and institutions.

It’s progress in reforming its commercial banking sector has been appreciated by John Wall, the World Bank Country Director for Pakistan, in such words *"We are immensely encouraged by Pakistan's commitment to reform the institutional workings that underpin a healthy economy. The government has demonstrated that it understands the essential links between putting in place all the fundamentals, a safe and sound banking system in this case, and its ability to create the conditions for sustainable growth in Pakistan and thus a better life for its 138 million people”*.

The results of the above mentioned reforms have been analyzed and evaluated through a set of banking soundness indicators. These indicators show that over the past decade, consolidation, liquidation and merger of banks, particularly with investment banks and DFIs, have resulted

in reduction in the number of financially-weak institutions. The new entities have strong capital base. This fostered financial stability within the financial sector for having fewer but stronger banks capable of utilizing the economies of scale and withstanding economic downturns. The average capital base of commercial banks has risen to Rs3.7 billion in 2003 from Rs1.8 billion in 2000, when the consolidation process was initiated. As a result private sector banks have now increased to about 80 percent of the banking sector. Privatization has helped correct the incentive structure, bring in efficiency and market based discipline and thus has a direct bearing on financial stability.

Capital adequacy ratios (CAR) look much stronger than the past. By the end of 2003, the overall CAR stood at 8.7 percent, which is above the internationally accepted benchmark of 8 percent. Thus, commercial banks now have a stronger capital base.

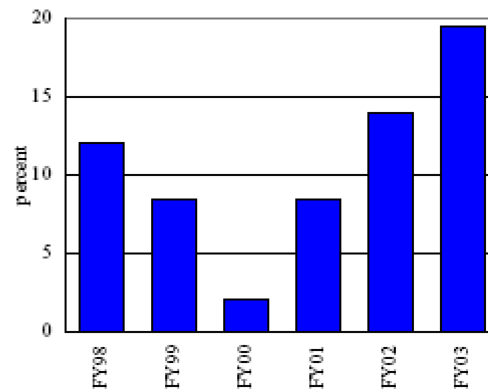
The banking sector has been making exceptional profits over the past few years. After-tax profits increased to Rs 28.4 billion in 2003. Profitability indicators accordingly registered a significant improvement. The return on assets (ROA) increased to 1.24 percent, almost equal to the internationally accepted benchmark of 1.25 percent. Similarly, the return on equity (ROE) increased to 20.5 percent. The profitability of banks, amidst squeezing margins, was accomplished on the back of huge gains on the sale of securities together with an increased volume of business. The improved performance of the corporate sector in general and the positive outlook of the capital market coupled with the improved performance of National Investment Trust in particular, yielded handsome dividend

incomes for the banks contributing 15.5 percent to their pre-tax profits. Decline in the banks administrative expenses and lower borrowing requirements due to ease of liquidity have also resulted in higher profits.

The asset quality of the banking sector has been showing signs of consistent improvement over the last few years. NPLs for commercial banks were down to Rs156.02 billion in December 2003. Significant decline in NPLs has been witnessed along with a substantial recovery of NPLs and new guidelines for write-off of irrecoverable loans.

Total assets of the banking system have registered growth since the reforms started. Deposits expansion was the main stimulant along with a substantially increased focus on loans.

Figure 4.1: Deposit Growth Rate



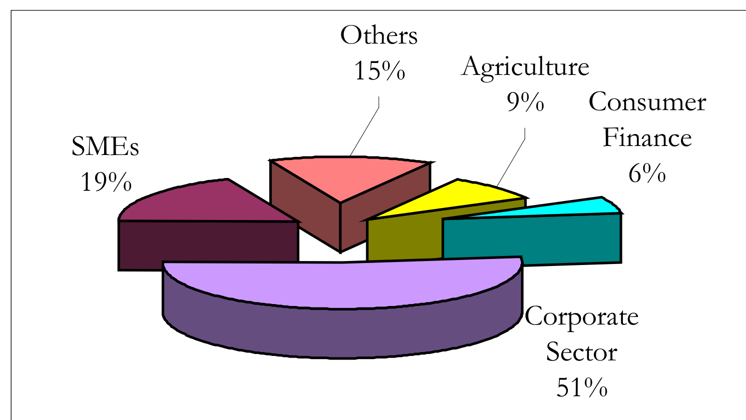
Source: State Bank of Pakistan, 2003

As a result of strong deposit growth and heavy investment in government securities, banks are having system-wide abundant liquidity and with robust indicators. While investments have shown subdued growth, a considerably large portion of funds has flowed towards loans. This happened not only because opportunities to make capital gains diminished as interest rates touched rock bottom, but also because of an increased credit demand from corporate and consumer sectors as economic activities started to pick

up momentum. Credit to private sector has touched the historic peak of Rs.244.6 billion, in 2003-04. Heavy credit demand on the back of improving economic prospects, low returns on investments and uncertainty governing the future behavior of interest rates as well as the steep fall in weighted average lending rates by all the groups etc. are some of the factors which contributed largely towards this phenomenal growth. This upward growth reflects a renewed public sector confidence in the basic macroeconomic fundamentals and thereby a source of accelerating economic growth in the country. Growth and diversification of assets portfolio has helped the banks to substantially increase their profitability.

Agricultural credit also shows an increasing trend in the post reform period. Commercial banks are actively disbursing credit to this vital sector of the economy. The disbursement of credit to this sector amounted to Rs47.9 billion and has already exceeded the lending by ZTBL in the first half of FY 2004. The loan portfolio of commercial banks in year 2003 is depicted in the following figure:

Figure 4.2: Loan Portfolio of Commercial Banks Year 2003



As a corollary of reforms in the banking sector, the number of loss making domestic as well as foreign bank

branches are also declining. The information flows to the banks based on the assistance of CIB have improved their credit risk appraisal capacity and ultimately reduced the NPLs in their portfolio.

The most widely used indicator of financial depth is the ratio of M2 to GDP, which indicates the importance of banks in an economy. This ratio has increased significantly over the past 14 years, from 39.2 percent in 1990-91 to 42.8 percent in March 2004. This clearly shows that the banking sector is more important today than a decade ago. Other indicators such as, the ratio of Total Deposits to M2 and Time Deposits to M2, have also improved over time.

There are still few weak and vulnerable institutions but overall the banking sector in Pakistan is much stronger today compared to seven years ago or in comparison to other countries in the region. Performance indicators are specified in the following table:

Table 4.1: Performance Indicators of the Banking Industry

	1997	1998	1999	2000	2001	2002	2003
Capital Adequacy	Percent						
Risk Weighted CAR	6.0	12.5	12.2	11.4	11.3	12.6	11.1
Capital/Total Assets	3.1	5.6	5.0	4.9	4.6	6.1	6.0
Asset Quality							
NPLs / Total loans	22.1	19.5	22.0	19.5	19.6	17.7	13.7
Provision to NPLs	54.2	56.2	46.6	53.9	53.2	58.2	64.7
Net NPLs/Capital	143.6	72.1	117.4	96.7	100.7	54.2	37.5
Earnings & Profitability							
ROA (After Tax)	(1.30)	0.50	(0.30)	(0.01)	(0.01)	0.80	1.20
ROE (After Tax)	(36.20)	12.00	(6.20)	(0.30)	(0.30)	14.30	20.50
Net Interest Income/Gross Income	46.50	55.60	54.30	61.20	68.90	66.10	59.40
Liquidity							
Liquid Assets/ Total Assets	41.4	41.3	38.7	37.5	39.9	48.1	46.0
Liquid Assets/ Total Deposits	49.4	50.3	48.2	48.0	50.3	61.5	57.9
Advances / Deposits	51.8	51.2	55.9	60.5	56.9	51.0	53.6

The Unfinished Agenda

The government's commitment to banking reforms has made Pakistan's financial sector stronger in the last three years with the result today that it is in the top tier of the Asian countries in terms of quality of management, quality of balance sheet and quality of regulation.

Nevertheless, there are still some major weaknesses with respect to efficiency of the banking sector. Thus, further reforms in main areas are still being pursued by the SBP to achieve an efficient, sound and competitive banking system. These are still under development and thus form the unfinished agenda:

Efficiency of Banking Sector: Soundness of banking system requires its constituent institutions to be efficient, having an optimal size and relatively healthy portfolio and the banking system itself of being the optimal size. Although the country has achieved a more competitive market structure, the efficiency of the banking sector in their core process of intermediation has not yet improved. One of such measures of efficiency is the spread (in weighted average term) between the lending rates and deposit rates. Real deposit rates have been negative for quite some time while real lending rates do not move with the movement in inflation rate. This phenomenon is blamed on the improper sequencing of reforms. In Pakistan, financial reforms preceded fiscal reforms whereas it ought to have been the other way round. Thus efforts are being made for devising a superior indicator of efficiency, for reducing the spread between the lending and deposit rates as well as implementation of the fiscal and debt management reforms.

Legal Framework: A well-functioning legal framework without any loopholes is part of the long-term reform strategy. Despite legal and judicial reforms that have worked to resolve financial contract resolution, implementation of court judgments is still ineffective partly due to remaining weaknesses in the law and its enforcement. The implementation of new foreclosure law is still beset with some teething problems, which need to be tackled. Simultaneously, the implementation of court judgment could be facilitated by providing courts with adequate resources to affect loan recovery. A Bankruptcy law is under formulation and needs to be put in place. So is the need to approve the Anti-money laundering law, since rapidly changing global banking scenario and recent technological developments have made the banking system more vulnerable to money laundering. Compliance with the recommendations prescribed by the Asia Pacific Group on Money Laundering (APGML) needs more work.

Basel II Accord: Implementing change in business processes propagated by Basel II has become a challenging task since the allied markets of money and capital lack depth and breadth and is caught up in the secondary stage of development. Market discipline is still evolving, as are transparency requirements. Even for standardized and basic indicator approaches, credit rating agencies in Pakistan need to increase in number as well as catch up on the sophistication of the trade, data should be accurate, timely and reliable, credit exposures over a certain limit have to be rated for accurate credit risk measurement, securitization process needs to be in place, capacity building for expertise in risk management is vital and up gradation of human skills at banks and SBP is required.

Deposit Insurance Framework: The SBP has been considering the institution of a Deposit Insurance Scheme (DIS) that pacifies the potentiality of system-wide depositor runs that are triggered on the basis of adverse information that causes even sound banks to fail. It also protects the small depositors (up to Rs 100,000) and builds confidence in the banking system. While providing a stabilizing impact to the banking system, a DIS spurs excessive risk taking by the banks under the comfort of insurance cover. This also absolves the depositors and borrowers of their responsibility to monitor banks, thus weakening the market discipline. Weak legal infrastructure with respect to contract enforcement and bankruptcy laws are major concerns before launching DIS.

Islamic Banking: Pakistan decided upon a parallel banking system allowing Islamic banks to operate along with the conventional banks. Though Islamic banking operations are expanding rapidly, their share in the overall banking system is miniscule. The sector is facing teething problems in the preliminary stage of its establishment. The Pakistani Islamic financial market is required to initiate the process of reforms that could be enhanced over time in order to fortify the emerging sector. There is need for development of new products for efficient deployment of funds (deposits). The target market of the Islamic financial products in the country is huge, provided practical and acceptable solutions to all financial problems of the end users are worked out. Shariah compliance will draw all those prospective customers into the ambit of banking. Development of regulatory and supervisory framework, adoption of pre-emptive strategies to address any adverse trends and enhancing corporate

governance structures and risk management systems need to be beefed up in comparison to what they were in the past.

Technological Developments (E-Banking): Changes in business practice, business models and customer service are becoming a necessity and not an after thought. Although electronic transactions have grown significantly in recent years, still a major chunk of banking transactions in Pakistan is being done through cash and checks. Though E-banking has opened up a whole new array of opportunities and prospects both for the financial institutions and consumers, it has its own unique risks and threats to deal with. It warrants an enabling legal infrastructure, strong supervisory oversight and most of all, banks' own set of proper risk management practices. The government has facilitated adoption of technology in Pakistan by strengthening the communication infrastructure and by making it available at lower prices. However, only widespread use of electronic and mobile banking channels can reduce the transaction costs while extending the outreach to a large segment of the population.

Reference Lending Rate: Karachi Inter-Bank Offered Rate (KIBOR) was launched earlier in the year 2004 as the reference rate for loans (Rupee denominated floating and fixed rate term loans) to the corporate sector. The KIBOR is put into effect as benchmark with multiple objectives: to encourage transparency, promote consistency in market based pricing, pass on the benefit of change in the monetary policy to customers and improve management of market risk. The results may not be visible in the very short run since immediate impact of any quote by a bank on the customer is unrealistic and in the long run banks will be competing on the basis of spreads. It can only be

implemented fully in the coming years when all the banks abide by this.

Derivatives Market: The Pakistani market appetite for formal derivatives, pulled out from the need for risk management strategies, prevailing low interest rates and a comparatively stable exchange rate, has started to come forward in the recent past. At present, the nascent derivative market has started to emerge with few contracts of forward rate agreements (FRAs), swaps and currency options but its volume lies around Rs.5 billion, which is quite small. In the absence of imaginative products and a less developed debt market, the customers are left with very few options. Since derivatives facilitate the specific identification and management of various risks, they have the potential to enhance the safety and soundness of financial institutions and to produce more efficient allocation of financial risks. However, as derivatives also repackage these basic risks in combinations that can be quite intricate, they can also threaten the safety and soundness of institutions if not clearly understood or properly managed. As our market is not fully developed to take large exposures, the SBP has been actively intervening in the riskier initiatives of the banks. It requires formal approval of derivative agreements. Presently, approvals have been given on a case-to-case basis considering the bank's potential of risk management. Down the road, the approvals may become institution specific and only sound banks may be allowed to play within the defined parameters. Moreover, the SBP is also preparing the risk management guidelines for derivatives. These derivatives, if used cautiously, are expected to be a positive step towards gaining economic efficiency.

Improvements in Banking Supervision: Supervision techniques need to be constantly evaluated and upgraded in view of the rapidly changing financial scenario. To ensure financial stability through proactive monitoring of risks faced by the banks, the SBP has developed an Institutional Risk Assessment Framework (IRAF), which is currently in the implementation stage. It is based on four inputs including compliance with standards, codes and guidelines, supervisory and regulatory information, financial performance and condition and market information and intelligence. Technologically driven swift information flow ensures more effective and efficient supervision and thus fosters a greater degree of transparency and discipline in banks with an automatic check on management. Risk management guidelines (Know Your Customer), consolidated supervision, stress testing (identifying the risk factors, which have a bearing on the financial health and performance of institutions, and determining the degree by which these factors affect the vital financials), coordination with ICAP, streamlining of data collection and CIB online are some of the initiatives being taken by the SBP to improve supervision.

Analysis

Despite the guidelines provided by World Bank and efforts to comply with them by the SBP, the commercial banking sector of Pakistan is still under par. Both the internal and external environment influences the reforming process in any area. The Internal factors include the prevalent official infrastructure, work ethics and attitudes of the professionals, level of skills and basically the nature of the building blocks of that particular sector. The external environment or the macro-economic environment is permanently surrounding and influencing the development process and also plays a pivotal role in determining the outcome. Before embarking upon any project, it is necessary to understand these environments and visualize how to take advantage of the positive aspects and minimize the affects of the negative ones. Unless these pre-requisites are in place it is hard to imagine that any meaningful progress could be possible. Even in case of Pakistan, only when the macroeconomic situation took a turn for better, the banking sector reforms were vigorously pursued and the SBP achieved autonomy and competence that the public sector banks began to show some demonstrable results.

The reform process has considerably changed the structure and the face of the Pakistani banking sector. It has reduced the concentration and role of the public sector and enhanced symmetry, not only in the size of banks but also in their pricing behavior. These are now more influenced by market dictates. While the fall in lending rates has substantially helped economic recovery of the country, the increasing pressure of competition has pushed

banks into sectors, which have so far remained largely under-served. All this would lead to realization of allocative efficiency and balanced growth in the industry.

Evaluating the health of the banking sector since 1990 reveals that the progress being achieved now is a result of more transparent and efficient operations rather than manipulation of reports and figures, as was the case in the past. Reform is not simply a new course of action ordained by the authorities and then expected to be followed. It is a revolutionary process that takes a lot of time and involves not only a change in practice but change in attitudes as well.

Over these many years, SBP has come under censure from all including the Asian Development Bank (ADB), journalists, professionals, researchers and laymen. They complain that SBP is too preoccupied with its own restructuring and reforms, to play a pro-active catalyst to support other industries and sectors of the economy. Pakistan's banking sector is said to be faced with a crisis, though such statements are not supported by any facts. These negative attitudes mostly take root from people and institution's own insecurities and less than honorable intentions rather than concern for the country. These sentiments can no more be pacified by words alone. The actual track record of reform and improving quality of service are the key milestones for restoring confidence.

The facts about Pakistan's banking sector speak volumes about its excellent performance that has been achieved after introducing these reforms. Recent financial sector assessment program mission jointly organized by the IMF and the WB have concluded: *"Pakistan has one of the soundest and healthiest banking sector in the region."*

Stress tests exposing the banking sector to various unanticipated shocks have also revealed that the Pakistani banking system is strong enough to withstand any shocks in the future.

Many professionals related to the banking field were questioned for the purpose of this research and their viewpoints are unanimous. They sincerely believe that the reform process initiated by the SBP has worked wonders in restoring public confidence in the banking sector of the economy after the cooperative societies' disaster. A proper system of check and balance has been created that is now ensuring safeguard of public interest. All banking companies come under the 28 prudential regulations enforced by the SBP. All the developments are for furtherance of the banking business in Pakistan and have no hidden political or personal agenda as such. Guarantees, licenses and checks on all financial transactions, to control financial indiscipline, benefit the customers and banks. Banks are penalized if they fail to comply with the regulations. The fines are too large to be borne by them and so they usually refrain from such practices. Implementation of these reforms has resulted in self-sustained and commercially viable banking institutions.

The concept of universal banking being encouraged by the SBP has enabled subsidiaries to take advantage of commercial banks' superior management and expertise. This has benefited the public as well as the economy and will continue to do so in the future. People have a sense of security that a solid bank backs their investments.

The increasing competition among the banks to capture the retail market has ensured that the banking sector is continuously progressing with each bank coming up with

innovative products and consumer friendly packages that indicate a healthy economy.

The trend of forwarding advances is also on the rise and raises risk management issues in the eyes of the analysts. According to the experts, such concerns are baseless since every loan has specific criteria that need to be fulfilled. Not every request is satisfied and only parties with the repaying capacity are given loans. Since check bouncing has become a criminal offence, even the borrowers are more conscious of repaying dues in time.

Another concern in the market is the continuous drain on depositors' wealth; they are at present in a disadvantageous position, as they have to settle at a negative real rate of return. The argument for this is that lending rates have also declined over the past few years and since banks are earning less, they are giving out less as well. The cut in lending rates has been made possible by lowering of deposit rates on the back of falling inflation rate. These declining rates are also breeding the investment trend that has helped in the development of the private sector, increased competition and growth of the economy.

Other than the depressing yields, the specter of massive liquidity has not had any adverse impact on the system. Banks' adventures in the booming stock market have been capped at twenty percent of their equity. Along with upcoming margin rules for stock trading (as against a highly leveraged badla trade, in which the banking system is an important player) are likely to further solidify the banking system's inherent strength.

No process is infallible and despite such enormous success, there are a few weak links in the Pakistani

banking sector. Banks are faced with maturity mismatches, as so far they have not been able to tap the longer-term funds (insurance, pension and mutual funds etc.) to their liability side of the balance sheet, highlighting failure at development of appropriate product class to fend off the ensuing yield risk. The banks have to strike a balance between prudent lending and a rapid build up of risky portfolio. Furthermore, persistent fall in NPLs may allow banks to become complacent as reckless and imprudent lending may easily translate into bad loans.

So far the reform process has been strictly according to guidelines and policies that the SBP announces to the banks and then expects them to follow. To check if the banks are performing according to the policies, SBP used to send its teams to commercial banks at different intervals. The team went to a bank and took over the cash and other departments. No cash transactions could take place while the team was performing its duty. The team counted the cash and matched it with the bank statements and the statements submitted to the SBP. Fines were charged according to the discrepancy, if any.

In the past, sudden checks on banks were in practice. Now, according to the advice of the Americans, SBP has to inform the banks and give them a period of 15 to 20 days so that they can recover their inconsistency. So now the banks work hard during the 15 to 20 days period, in order to maintain their credibility and the teams too enjoy special treatment.

Compliance is checked in a number of banks and branches, but not in all. As a result not all the branches spread all over Pakistan conform. This is a major discrepancy, which SBP is aware of, but is still unable to

rectify. If it sends some team, which reports this, then that branch has to pay a large fine. But it is extremely difficult to monitor every branch, as SBP does not have sufficient teams to send and investigate.

One of the major problems that is hindering banks from functioning according to SBP regulations is the VIP culture and VIP treatment prevalent in Pakistan. A VIP's demands for a loan are immediately fulfilled without completing the formalities such as filling the necessary forms, guarantees and other details. In such cases, usually the amount is not recovered that promptly, so banks suffer. In other cases, some people are awarded loans on special basis meaning special terms and conditions are applied over them. The result of this malpractice is that the bank's statements are affected. So they usually keep 2 statements. One is their internal that shows the true picture and the other is the one, which they submit to the SBP. The bank is caught when the SBP inspection team takes over the bank and exposes the disparity in the balances and SBP records. Then either the team leader fines them or some high bank official is called before the Governor SBP, who charges the fine accordingly. In some cases the bank officials do not provide the necessary documents to the team and then they are directly reported to Governor.

This situation is considered out of the hands of SBP since an official in the higher echelons of our political system or one with good references is considered above the law. Despite evidence, SBP cannot incriminate such a person and so implementation of the reform process is less than perfect. The discrepancies are there and can only be corrected when corrupt people are removed, which is next to impossible in our society.

SBP may be committed to excellence but this behavior is still not mainstreamed and spread unevenly and sporadically. The problem solving approach is not yet rooted in our culture and we are still looking to our superiors for solutions.

Future Prospects

Currently the SBP has been working on a ten-year vision that sets the strategic direction. The short-term strategy is to complete the set of reforms initiated in 1991. In the near future, an action plan for yet another crucial phase of banking reforms in Pakistan is expected to be initiated, which will be integrated into the business plan of the SBP. A Champions of Change Group would be responsible for preparation of this action plan. A forecasting group has also been constituted to prepare different types of forecasts of various segments of the national economy. The SBP is also expected to keep abreast with the current international best practices and deal with the banking sector in Pakistan on different issues.

The performance of the banking sector in the coming years depends on the general economic conditions and monetary regime. An optimistic future economic outlook bodes well for the banking sector. Market intelligence suggests that the appetite for consumer loans will remain high as they come with relatively less hassle and are not tied to any particular purpose. The charm for the banks is the high rates on such loans.

Though recent stabilization in returns on government papers entails a slack down in trading gains, the expected growth in the scale of business along with allied growth in fee-based incomes would, at least, make good the likely

reduction in trading gains, if not elevate the level of earnings. This upturn in demand for bank credit, in the wake of improving returns, is likely to boost the profitability of the banking sector more substantially in the following quarters. However, the banks will have to take extra care of their expanding exposures, for a rapid growth in lending if accompanied by lax controls may take its toll on the earnings through deterioration in asset quality. Also, the increasing return makes these loans most susceptible to interest rate swings and could prompt serious difficulties for banks if rates were to change rapidly.

The trend of active participation of commercial banks in disbursement of credit to the agriculture and SME sectors is expected to continue in the future. The SBP has also been considering different measures to accelerate credit to the small and subsistence farmers and enterprises. Agriculture credit cards and utilizing post offices as an outpost for mobilization of savings and disbursement of credit to the rural areas can become realities in the near future.

Small private banks have been improving their market share in recent years. They are involved in community and niche banking and have been successful in acquiring market share of large commercial banks. However, they are aware that in the near future, size will become increasingly important. Absence of economies of scale and scope, failure to upgrade technology, and lack of quality human resource base do not allow these institutions to compete effectively with large banks. They would have to perforce amalgamate and reach a critical mass and size to compete more effectively with the greater capital base institutions.

As foreign exchange regime is being gradually liberalized, further measures would be undertaken to open up the market for cross-boarder risk products to private wealth managers and well-established corporate houses. Likewise, Pakistani banks like HBL and National Bank are expected to open branches in India to allow access to the Indian financial markets.

In Pakistan, the economic growth rate has suffered due to stabilization program because of the lack of fiscal discipline that ensures sustainable development and growth. The fiscal reforms should have preceded the financial reforms, however the opposite sequencing was followed. Fiscal reforms are expected to be implemented in full force with the help of the World Bank in the coming years to enhance the efficiency of the banking sector.

The risk management techniques in the banking field are still evolving. Simultaneous development of internal administrative and management controls to keep up with the expanding loan portfolio for effective and profitable operations is in the pipeline. Building in-house risk management capacity, creating awareness, educating the counter parties, building up local expertise, introducing proper controls and disclosures standards are some of the pre-requisites that are expected to be put in place.

If all goes according to plan, in the long-term the banking system would consist of a two-tier structure. Top tier would consist of strong private sector owned universal banks providing credit and financial services to large-scale industries and other corporate clients, consumer and SME financing, in addition to operating internationally. Second tier would consist of specialized and other private sector banks. The focus of this tier will be to provide

credit and financial services to micro, small and medium enterprises, in addition to meeting specialized credit requirements for exports, agriculture and rural sectors.

It is to be hoped that the direction set by the current reforms will continue and enable commercial banks in Pakistan to be on the same level as international ones.

CONCLUSION & RECOMMENDATIONS

Conclusion

The banking system of Pakistan has made long-strides in recent years towards its goal of becoming a financially viable and firm arm of the economy, which in turn would help promote growth and prosperity. Its remarkable performance in terms of establishing sound and efficient bank intermediation; deepening the financial markets, increasing managerial latitude, assets growth, particularly unprecedented loans expansion, appearance of a vast array of new financial instruments, professionalism rather than connections taking hold in management and significant rise in profits, has further strengthened the process. These advancements have blurred traditional distinction between institutions and resulted in the financial markets becoming increasingly globalized. It speaks not only of the success of monetary and credit policies pursued under the reform program but also signifies potential influence on aggregate demand which would further stimulate economic activity and induce supply and production response in the country.

However the banking sector still falls short of achieving the dynamism, efficiency, and depth of full-fledged market-based banking systems in industrial countries or in the most advanced developing countries. The reforms still have a long way to go. Mortgage and consumer financing to middle income classes, assistance to SMEs and agriculture are at very low levels and have to be stepped up. If these reforms are no longer pursued the benefits will remain confined to a small class of corporate and trade businesses and thus opportunities for expansion of

economic activity, credit to middle class and new job creation will be missed.

If the existing policies continue, standards of good governance are not weakened, institutional reforms and restructuring are implemented and the country does not face any setbacks in the future, Pakistan would be able to attain a 6 percent growth path and thus reduce poverty and unemployment. This is a realistic goal to achieve, but requires hard work, dedication and honest dealings by every Pakistani whether in the private or public sector.

While the debt-burdened economy is not yet out of the woods, macro stability was won, and growth is returning with more jobs and investments. The people of Pakistan are the first to point out that the reforms remain a work in progress. However, it is important to note that the reforms implemented to date have been singularly revolutionary in their magnitude, truly home grown and world class in their substance, and will place in Pakistan's hands an additional 3 percent of GDP for poverty reduction. And, the elected Federal and Provincial Governments have set their own bar high for the work that still needs to be done.

The current phase (2003-2005), whereby the real economy is beginning to pick up, does not require that the same set of reforms, which were pursued in the past three years, have to be continued. This phase requires a completely different set of structural, sectoral and micro reforms rather than the price reforms, fiscal squeezing and monetary tightening observed during first phase.

Despite all the above precautions and pursuing sensible and prudent economic policies it is hard to predict when a country is likely to be the target of speculative attack. Even when the economic fundamentals are

strong, the markets have witnessed serious disruptions. But it is better to have good policies and bad luck rather than bad policies and bad luck. Policies based on proven international best experiences rather than ideological rhetoric are the best guide for building up support and implementing reforms.

Recommendations

The banking sector's persistent robust operating performance over these past years is a healthy sign. But, it may not be sustainable on a long-run basis. To bring it up to the standards of the developed countries, a lot still remains to be accomplished. In the future, SBP needs to continue its efforts towards new and broader horizons.

The growth of electronic commerce requires transparent, market favorable regulation and legislation in certain areas. This presents challenges to the government, who must adapt national and international policies to the new digital economy. We must ensure that our laws, which were designed for an earlier business environment, do not unnecessarily impede the development of new and innovative services. Regulations are necessary to the extent that they do not hamper growth of new or existing markets. New regulations should also be flexible enough to cater for technology changes and new global environment. In other areas, the government should encourage industry self-regulation where industry practices are aligned with international practices.

Reforms are a long-term process. However, the market expects short-term solutions. Reform requires a shared vision, carefully designed sequencing, and effective management. Change of ownership and mindset are going to be

critical for successful bank restructuring, and improvements in corporate governance and credit culture. Therefore clear communication of a convincing long-term restructuring plan and feedback from the banking professionals is important.

Good governance is good politics. To sustain the process of structural reforms in Pakistan, its political culture must change, away from the politics of patronage to politics of good governance. Legislation should be free from political interference and no one should be above the law. Transparency and communication are important to turn around market perceptions at the height of a crisis.

The current trade gains and upturn credit demand are not viable in the long run. Since the competition in domestic banking system has become fierce and the profit margins on traditional modes of corporate and trade financing are under pressure, the banks are moving into new business areas such as consumer, mortgage, SME and agriculture financing. This trend should continue along with more product diversification. In Pakistan, 75 per cent of the earnings of all banks come from interest and the rest flows from fees and commissions. In India, the ratio is stated to be around 60-40. The banks here are slow to design products and broaden service base to diversify their sources of incomes.

Product diversification may enhance the risk profile and thus require expertise, systems and procedures, controls, technology and risk management technique, as banks are still going through an evolutionary phase in developing risk appraisals and mitigating techniques in these areas. Banks can control the credit risks of lending by making loan sales, not only of the NPLs to CIRC but also

of healthy loans to other banks and institutions (NBFCs, Mutual Funds etc). Modern methods of measuring interest rate risk should be adopted such as duration models rather than repricing and maturity gap models.

Bankers should be sent abroad, through an agreement with World Bank, to bring the skills and techniques of modern banking systems, innovative products and services and networking into global chain to the Pakistani banking sector. With an understanding of the local economy, they will be able to modify and implant these changes in the banking system better than foreign professionals working in Pakistan.

Securitization (selling of loans and other assets backed by securities) can help banks asset portfolios to become more liquid, provide an important source of fee income, act as a mechanism for hedging interest rate exposure gaps and help reduce the effects of regulatory taxes such as capital and reserve requirements and deposit insurance premiums. With house and consumer financing on the rise, securitization can originate in mortgage loans, credit cards, student and other commercial and industrial loans. For this purpose, government agencies or government-sponsored enterprises need to be involved for either sponsoring such programs, acting as guarantors to the investor or becoming involved in buying and holding such securities. Strengthening and widening the scope of CIRC can carry out these functions.

After 1-link ATM services, banks should also cooperate and introduce 1-link operations system in Pakistan similar to the European practices. A major server can be installed in Karachi through which all banks can be linked. This will

facilitate the customers as checks of one bank can be cashed at another.

There is still a long way to go before the intended results can truly be realized. SBP has to prove by deeds, not just words that it is implementing policies that will help its people escape from poverty and help the country move toward debt sustainability and economic stability. Unless the reforms extend to every sphere of the financial sector, they cannot mean anything for the average Pakistani and reforms without social and economic benefits to a wider segment of the population are useless.

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