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EXECUTIVE SUMMARY

Banks plays an important role in the proper functioning of a country's economy. It plays a supporting hand in overall growth by providing funding to the private sector, facilitating the development of industries, which starts a chain reaction that results in increase in employment, higher productivity, increase in standard of life of people and higher GDP. Banking is a high risk business that utilizes the capital of lenders to meet the requirements of the borrowers, acting as an intermediary between the two.

In today's world, where uncertainty and instability are dominant market factors, to safeguard the interests of government, lenders and borrowers a sound and transparent banking system is needed. Disclosure practices play an important role in providing a complete mechanism, to ensure the soundness and stability of the financial system. Basel Committee on Banking Supervision was established by the Central Bank Governors of ten countries, including US, UK and Canada in 1974. They meet regularly, four times a year. Their objective is to formulate broad supervisory standards, guidelines and recommended statements of best practices. This financial body not only states what disclosures are to be made by banks, they also provide risk management frameworks to deal with various kinds of risks that banks face everyday, including credit, operational and interest rate risks.

This thesis project focuses on studying the level of disclosures prevalent in Pakistan's banking industry. For this purpose, a detailed survey has been conducted to verify how many Pakistani banks comply with International Disclosure Requirements. This data was then compared with the disclosure results of the survey conducted by the Basel Committee on Banking Supervision in 2001.

It is concluded from this thesis that Pakistani Banks are far behind their International counterparts in compliance with the disclosure requirements. However, now State Bank has developed a road map by which Pakistani Banks will be in line with International Banks in meeting International Requirements for disclosures.

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CHAPTER 1:

INTRODUCTION

CHAPTER 1: INTRODUCTION

1.1 INTRODUCTION

Banking is one of the most sensitive businesses all over the world. Banks play very important role in the economy of a country and Pakistan is no exemption. Banks are custodian to the assets of the general masses. The banking sector plays a significant role in a contemporary world of money and economy. It influences and facilitates many different but integrated economic activities like resources mobilization, poverty elimination, production and distribution of public finance. It is purchase of car or building of a home banks are always there to serve you better. It is play ground or any educational or healthy societal activity the money of banks nurture them. It is an industrial project or agricultural development of the country the sponsor-ship of banks is very much involved. Banks play very positive and important role in the overall economic development of the country.

Over the past several years, we have seen an increased incidence of financial crises, both in industrialized countries and in emerging market economies. These crises have not only disrupted the financial systems in affected countries but also have had severe effects on economic activity. In an environment of heightened uncertainty and increased volatility, this needs to be reinforced with the development of a more robust and resilient banking system. Hence the importance of highly developed Disclosure practices lies in not only providing the much needed transparency in the banking system but it also ensures the soundness and stability of the financial system. The rapid developments in the financial such as asset securitization have rendered the previous disclosure practices be less effective.

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1.2 OBJECTIVE OF THE STUDY

Objective of this study/thesis is to conduct a survey of Public disclosures made by the banks. For this survey a sample of nine Pakistani has been chosen (list of selected banks had been shown later). In this survey; methodology and variables that are followed

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will be on the pattern of Survey conducted by Basel Committee on Banking Supervision in year 2001 for Public Disclosure by Banks. This survey was conducted by Basel Committee was to promote discipline in banking and capital market. A sample of internationally active banks in 13 countries was taken.

The disclosure survey that we will conduct is planned to identify the trends in disclosure made by the banks; that is to what extent Pakistani banks are following international requirement for the disclosures.

1.3 SCOPE AND LIMITATION OF THE STUDY

1) The scope of the project will only be limited to public limited banks.
2) Foreign Banks will not be included in the study mainly due to non-availability of audited financial statements.
3) Another constraint is the insufficient information enclosed in the financial statements.
4) List of banks chosen for survey are as follows

I.	Askari Commercial Bank Limited	(ACBL)
II.	Bank of Punjab	(BOP)
III.	Bank Alfalah Limited	(BALF)
IV.	Faysal Bank Limited	(FBL)
V.	Muslim Commercial Bank	(M.C.B)
VI.	Meezan Bank	(MB)
VII.	National Bank of Pakistan	(NBP)
VIII.	Pakistan Industrial Credit and Investment Corporation Limited	(PICIC)
IX.	Union Bank	(UB)

1.4 RESEARCH QUESTIONS

The research questions relevant to our scope are

a) What are the current trends in the Disclosure practices of Pakistan
b) What are the gaps between the prevalent practices and the internationally recognized Disclosure Practices required under Basel Capital Accord

c) Identification of the weakness inherent in the Disclosure practices of our banks and how to remove those

d) Examining the supervisory and regulatory role of state bank of Pakistan and reviewing its efforts in enhancing the Disclosure practices of Pakistani Banks

1.5 METHODOLOGY

The methodology that I have chosen for the completion of this research is through the following tasks and activities:

1) International Financial Reporting Standards (Guiding disclosure through IFRS)
2) Public disclosure by banks: result of the 2000 disclosure survey
3) Various Banks websites
4) Financial statements
5) Newspapers
6) Search for the information on the internet
7) Articles from books and journals
8) Interview with industry people
9) Information from other research papers

CHAPTER 2:

LITERATURE REVIEW

CHAPTER 2: LITERATURE REVIEW

The purpose of the literature review is to provide through understanding of the terminologies, concepts are used in the research.

2.1 INTERNATIONAL ACCOUNTING STANDARD BOARD (IASB)

The International Accounting Standards Board is an independent, privately-funded accounting standard-setter based in London, UK. It started its operations in 2001 and its main objectives are as follows:

- Develop, in the public interest, a single set of high quality understandable and enforceable global accounting standards that require high quality transparent and capable information in financial statements and other financial reporting to help the participants in the various capital markets of the world and other users of the information to make economic decisions.
- Promote the use and rigorous application of those standards.
- Work actively with national standards-setters to bring convergence of national accounting standards and International Financial Reporting Standards (IFRS) to high quality solution.

IASB replaced the old regime of International Accounting Standards Committee (IASC) in standard setting. The IASC was issuing International Accounting Standards (IAS). So far there were forty one IAS which had been issue before IASB replaced IASC in 2001. As one of the major weaknesses of IASC was that the standards it was issuing contained many objectives thereby defeating the purpose of consistency in recognition, measurement and presentation of transactions. IASB intends to limit such choice of accounting treatments. Structure of IASB consists of Trustees, The IASB, Standards

Advisory Council (SAC), and International Financial Reporting Interpretations Committee (IFRIC).[2]

2.2 INTERNATIONAL FINANCIAL REPORTING STANDARDS

International Financial Reporting Standard (IFRS), often known by the older name of International Accounting Standards (IAS) are a set of accounting standards. They are issued by the International Accounting Standards Board (IASB).

2.3 BASEL COMMITTEE ON BANKING SUPERVISION

The Basel Committee, established by the central-bank Governors of the Group of Ten countries at the end of 1974, meets regularly four times a year. It has about twenty-five technical working groups and task forces which also meet regularly.

The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. Countries are represented by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. The present Chairman of the Committee is Mr Jaime Caruana, Governor of the Bank of Spain, who succeeded Mr William J McDonough on 1 May 2003.

It formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems. In this way, the Committee encourages convergence towards common approaches and common standards

[2] *(Source: http://cbdd.wsu.edu/kewlcontent/cdoutput/TOM505/page9.htm Date: July 4th, 2005)*

without attempting detailed harmonisation of member countries' supervisory techniques.

The Committee reports to the central bank Governors of the Group of Ten countries and seeks the Governors' endorsement for its major initiatives. In addition, however, since the Committee contains representatives from institutions which are not central banks, the decisions it takes carry the commitment of many national authorities outside the central banking fraternity. These decisions cover a very wide range of financial issues. One important objective of the Committee's work has been to close gaps in international supervisory coverage in pursuit of two basic principles: that no foreign banking establishment should escape supervision; and that supervision should be adequate. To achieve this, the Committee has issued a long series of documents since 1975.[3]

2.4 BASEL CAPITAL ACCORD II

Basel Committee on Banking Supervision (BCBS) finalized the New Capital Adequacy framework commonly known as Basel II in June 2004. The new capital framework envisages safety and soundness of the financial system through its three pillars. Firstly, more risk sensitive calculation of capital charge for individual banks based on their risk management policies and practices. Secondly, Supervisory Review Process to ensure sufficient supervisory oversight for adequacy of banks' capital. Thirdly, enforcement of Market Discipline by requiring banks to make extensive disclosures. Though implementation of Basel II is not mandatory even for member countries, yet its implementation has a host of inherent benefits justifying its implementation in Pakistan. Foremost is the fact that the new framework will pave way for more robust and stronger banks. Besides, it will also enable the domestic banking sector to prepare for stiff competition in the rapidly changing sophistications and boundaries of the financial world. Nevertheless, implementation of Basel II is, by no means, an easy

[3] *(Source: www.bis.org/indes.htm)*

task especially in countries like Pakistan where risk management is still in its infancy stage. Based on in-house discussions, review of implementation of Basel II in other economies and consultations with all the stakeholders, SBP has issued a road map for Basel II implementation on 31st March 2005. The transition to Basel II would be as follows;

Banks would be required to adopt Basel II as follows:

1) Standardized Approach for credit risk and Basic Indicator /Standardized Approach for operational risk from 1st January 2008.

2) Internal Ratings Based (IRB) Approaches from 1st January 2010. (Banks interested in adopting IRB Approaches for capital requirement against credit risk before 1st January 2010 may approach SBP for the purpose. Their request will be considered on case-to-case basis).

To ensure smooth transition to Basel II, there would be a parallel run of one and half year for Standardized Approach and two years for IRB Approaches starting from 1st July 2006 and 1st January 2008 respectively.

Banks' internal plans for Basel II implementation shall be reviewed and continuously monitored by SBP during the pre- implementation period as well as during parallel run.

2.5 CAPITAL STRUCTURE

A firm can finance operations through common and preferred stock, with retained earnings, or with debt. Usually a firm will use a combination of these financing instruments.

The proportion of short and long-term debt is considered when analyzing [4]capital structure. And, when people refer to capital structure they are most likely referring to a firm's debt-to-equity ratio, which provides insight into how risky a company is. Usually a company more heavily financed by debt poses greater risk.

[4] http://www.investopedia.com

2.6 CAPITAL ADEQUACY

A measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures. This ratio is used to protect depositors and promote the stability and efficiency of financial systems around the world. Two types of capital are measured: tier one capital, which can absorb losses without a bank being required to cease trading, and tier two capital, which can absorb losses in the event of a winding-up and so provides a lesser degree of protection to depositors.

The efficient functioning of markets requires participants to have confidence in each other's stability and ability to transact business. Capital rules help foster this confidence because they require each member of the financial community to have, among other things, adequate capital. This capital must be sufficient to protect a financial organisation's depositors and counterparties from the risks of the institution's on- and off-balance sheet risks. Top of the list are credit and market risks; not surprisingly, banks are required to set aside capital to cover these two main risks. Capital standards should be designed to allow a firm to absorb its losses, and in the worst case, to allow a firm to wind down its business without loss to customers, counterparties and without disrupting the orderly functioning of financial markets.

Minimum capital standards are thus a vital tool to reducing systemic risk. They also play a central role in how regulators supervise financial institutions. But capital requirements have so far tended to be simple mechanical rules rather than applications of sophisticated risk-adjusted models, although moves are afoot to change this by 2002. Further, there is a difference in the capital requirements of banks and securities houses, which could lead to competitive distortion in the lon[5]g-run between these two main types of financial institutions.

2.7 FINANCIAL RISK

Financial risk in banking organization is possibility that the outcome of an action or event could bring up adverse impacts. Such outcomes could either result in a direct loss of earnings / capital or may result in imposition of constraints on bank's ability to meet its business objectives. Such constraints pose a risk as these could hinder a bank's ability to conduct its ongoing business or to take benefit of opportunities to enhance its business. Regardless of the sophistication of the measures, banks often distinguish between expected and unexpected losses. **Expected losses** are those that the bank knows with reasonable certainty will occur (***e.g***., the expected default rate of corporate loan portfolio or credit card portfolio) and are typically reserved for in some manner. **Unexpected losses** are those associated with unforeseen events (e.g. losses experienced by banks in the aftermath of nuclear tests, Losses due to a sudden down turn in economy or falling interest rates). Banks rely on their capital as a buffer to absorb such losses. Risks are usually defined by the adverse impact on profitability of several distinct sources of uncertainty. While the types and degree of risks an organization may be exposed to depend upon a number of factors such as its size, complexity business activities, volume etc, it is believed that generally the banks face Credit, Market, Liquidity, Operational, Compliance / legal / regulatory and reputation risks.

2.8 CREDIT RISK

Credit risk arises from the potential that an obligor is either unwilling to perform on an obligation or its ability to perform such obligation is impaired [6]resulting in economic loss to the bank.

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[5] http://www.investopedia.com/
www.sbp.gov.pk

In a bank's portfolio, losses stem from outright default due to inability or unwillingness of a customer or counter party to meet commitments in relation to lending, trading, settlement and other financial transactions. Alternatively losses may result from reduction in portfolio value due to actual or perceived deterioration in credit quality. Credit risk emanates from a bank's dealing with individuals, corporate, financial institutions or a sovereign. For most banks, loans are the largest and most obvious source of credit risk; however, credit risk could stem from activities both on and off balance sheet.

In addition to direct accounting loss, credit risk should be viewed in the context of economic exposures. This encompasses opportunity costs, transaction costs and expenses associated with a non-performing asset over and above the accounting loss.

Credit risk can be further sub-categorized on the basis of reasons of default. For instance the default could be due to country in which there is exposure or problems in settlement of a transaction.

Credit risk not necessarily occurs in isolation. The same source that endangers credit risk for the institution may also expose it to other risk. For instance a bad portfolio may attract liquidity problem.

2.9 INTERNAL RISK RATING

Credit risk rating is summary indicator of a bank's individual credit exposure. An internal rating system categorizes all credits into various classes on the basis of underlying credit quality. A well-structured credit rating framework is an [7]important tool for monitoring and controlling risk inherent in individual credits as well as in credit portfolios of a bank or a business line. The importance of internal credit rating framework becomes more eminent due to the fact that historically major losses to banks stemmed from default in loan portfolios. While a number of banks already have a system for rating individual credits in addition to the risk categories prescribed by SBP, all banks are encouraged to devise an

[6] www.sbp.gov.pk
[7] www.sbp.gov.pk

internal rating framework. An internal rating framework would facilitate banks in a number of ways such as Credit selection, Amount of exposure, Tenure and price of facility, Frequency or intensity of monitoring, Analysis of migration of deteriorating credits and more accurate computation of future loan loss provision, Deciding the level of Approving authority of loan.

[8]

2.10 MARKET RISK

It is the risk that the value of on and off-balance sheet positions of a financial institution will be adversely affected by movements in market rates or prices such as interest rates, foreign exchange rates, equity prices, credit spreads and/or commodity prices resulting in a loss to earnings and capital.

Financial institutions may be exposed to Market Risk in variety of ways. Market risk exposure may be explicit in portfolios of securities / equities and instruments that are actively traded. Conversely it may be implicit such as interest rate risk due to mismatch of loans and deposits. Besides, market risk may also arise from activities categorized as off-balance sheet item. Therefore market risk is potential for loss resulting from adverse movement in market risk factors such as interest rates, forex rates, equity and commodity prices. The risk arising from these factors have been discussed on following pages.

2.11 INTEREST RATE RISK

Interest rate risk arises when there is a mismatch between positions, which are subject to interest rate adjustment within a specified period. The bank's lending, funding and investment activities give rise to interest rate risk. The immediate impact of variation in interest rate is on bank's net interest income, while a long term impact is on bank's net worth since the economic value of bank's assets, liabilities and off-balance sheet exposures are affected. Consequently there are two common perspectives for the assessment of interest rate risk. Interest rate risk

[8] www.sbp.gov.pk

occurs due to (1) differences between the timing of rate changes and the timing of cash flows (**re-pricing risk**); (2) changing rate relationships among different yield curves effecting bank activities (**basis risk**); (3) changing rate relationships across the range of maturities (**yield curve risk**); and (4) interest-related options embedded in bank products (**options risk**).

2.12 LIQUIDITY RISK

Liquidity risk is the potential for loss to an institution arising from either its inability to meet its obligations or to fund increases in assets as they fall due without incurring unacceptable cost or losses.

Liquidity risk is considered a major risk for banks. It arises when the cushion provided by the liquid assets are not sufficient enough to meet its obligation. In such a situation banks often meet their liquidity requirements from market. However conditions of funding through market depend upon liquidity in the market and borrowing institution’s liquidity. Accordingly an institution short of liquidity may have to undertake transaction at heavy cost resulting in a loss of earning or in worst case scenario the liquidity risk could result in bankruptcy of the institution if it is unable to undertake transaction even at current market prices.

Banks with large off-balance sheet exposures or the banks, which rely heavily on large corporate deposit, have relatively high level of liquidity risk. Further the banks experiencing a rapid growth in assets should have major concern for liquidity.

Liquidity risk may not be seen in isolation, because financial risk are not [9]mutually exclusive and liquidity risk often triggered by consequence of these other financial risks such as credit risk, market risk etc. For instance, a bank increasing its credit risk through asset concentration etc may be increasing its liquidity risk as well. Similarly a large loan default or changes in interest rate can adversely impact a bank’s liquidity position. Further if management misjudges the

[9] www.sbp.gov.pk

impact on liquidity of entering into a new business or product line, the bank's strategic risk would increase.

2.13 OPERATIONAL RISK

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and system or from external events.

Operational risk is associated with human error, system failures and i[10]nadequate procedures and controls. It is the risk of loss arising from the potential that ina[11]dequate information system; technology failures, breaches in internal controls, fraud, unforeseen catastrophes, or other operational problems may result in unexpected losses or reputation problems. Operational risk exists in all products and business activities.

Operational risk event types that have the potential to result in substantial losses includes Internal fraud, External fraud, employment practices and workplace safety, clients, products and business practices, business disruption and system failures, damage to physical assets, and finally execution, delivery and process management.

The objective of operational risk management is the same as for credit, market and liquidity risks that is to find out the extent of the financial institution's operational risk exposure; to understand what drives it, to allocate capital against it and identify trends internally and externally that would help predicting it. The management of specific operational risks is not a new practice; it has always been important for banks to try to prevent fraud, maintain the integrity of internal controls, and reduce errors in transactions processing, and so on. However, what is relatively new is the view of operational risk management as a comprehensive practice comparable to the management of credit and market risks in principles. Failure to understand and manage operational risk, which is present in virtually all banking transactions and activities, may greatly increase the likelihood that some risks will go unrecognized and uncontrolled.

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[10]

[11] www.sbp.gov.pk

2.14 CURRENCY RISK

It is the current or prospective risk to earnings and capital arising from adverse movements in currency exchange rates. It refers to the impact of adverse movement in currency exchange rates on the value of open foreign currency position. The banks are also exposed to interest rate risk, which arises from the maturity mismatching of foreign currency positions. Even in cases where spot and forward positions in individual currencies are balanced, the maturity pattern of forward transactions may produce mismatches. As a result, banks may suffer losses due to changes in discounts of the currencies concerned. In the foreign exchange business, banks also face the risk of default of the counter parties or settlement risk. While such type of risk crystallization does not cause principal loss, banks may have to undertake fresh transactions in the cash/spot market for replacing the failed transactions. Thus, banks may incur replacement cost, which depends upon the currency rate movements. Banks also face another risk called time-zone risk, which arises out of time lags in settlement of one currency in one center and the settlement of another currency in another time zone. The forex transactions with counter parties situated outside Pakistan also involve sovereign or country risk.

2.15 DERIVATIVES

A security, such as an option or futures contract, whose value depends on the performance of an underlying security or asset. Futures contracts, forward contracts, options, and swaps are the most common types of derivatives. Derivatives are generally used by institutional investors to increase overall portfolio return or to hedge portfolio risk.

2.16 CREDIT DERIVATIVES

Credit derivatives are privately held negotiable bilateral contracts that allow users to manage their exposure to credit risk. Credit derivatives are financial assets like forward contracts, swaps, and options for which the price is driven by the credit risk of economic agents (private investors or government). For example, a bank concerned that one of its customers may not be able to repay a loan can protect itself against loss by transferring the credit risk to another party while keeping the loan on its books.

2.17 CREDIT ENHANCEMENT

Credit enhancement is method whereby a company attempts to improve its d[12]ebt or credit worthiness. Credit enhancements take many different forms. An Example of a credit enhancement would be conversion rights added on to a debt instrument in order to lower the issuing interest rate. [13]

2.18 FAIR VALUE HEDGES

The group hedges a proportion of its existing foreign exchange risk in available for-sale equity securities by fair value hedges in the form of currency futures. The group also hedges part of its existing interest rate risk resulting from any potential decrease in the fair value of fixed rate assets or increase in fair value of term deposits from customers denominated both in local and foreign currencies using interest rate and cross currency interest rate swaps.

2.19 CASH FLOW HEDGES

The group hedges a portion of foreign exchange risks it expects to assume as a result of certain foreign acquisitions and cash flows from floating rate customer deposits and held-to-maturity debt securities using currency options and currency swaps.

2.19 BANKS CAPITAL

For regulatory purposes international regulators have divided a bank's capital into three tiers, reflecting the extent to which instruments meet the key underlying principles of capital, loss absorbency and permanence. Tier 1 is the highest

[12] http://www.investopedia.com/

quality form of capital and so can be included without limit in a bank's capital for regulatory purposes. Tier 2 and Tier 3 capital include features that conform less closely with the underlying principles and are therefore limited to a proportion of the Tier 1 held.

2.20 TIER 1 CAPITAL[14]

The risk based capital system divides capital into two tiers- core capital (Tier I) and supplementary capital (Tier II and Tier III). Tier 1 capital includes fully paid up capital, balance in share premium account, reserve for issue of bonus shares, general reserves as disclosed on the balance-sheet and un-appropriated /unremitted profit (net of accumulated losses, if any).

2.21 TIER II CAPITAL

Supplementary Capital (Tier II) is limited to 100 percent of core capital (Tier I). It includes; general provisions or general reserves for loan losses, revaluation reserves, exchange translation reserves, undisclosed reserves and subordinated debt.

2.22 TIER III CAPITAL

The tier III capital consisting of short-term subordinated debt would be solely for the purpose of meeting a proportion of the capital requirements for market risks.

2.23 SECURITIZATION

The process of creating a financial instrument by combining other financial assets and then marketing them to investors. Mortgage backed securities are perfect example of securitization.

[14] (Source: www.sbp.gov.pk, BDP Circular no 31)

2.24 RISK WEIGHTED ASSETS

Total risk weighted assets of a bank would comprise two broad categories: credit risk weighted assets and market risk-weighted assets. Credit risk weighted assets are calculated from the adjusted value of funded risk assets i.e. on balance sheet assets and non-funded risk exposures i.e. off-balance sheet item. On the other hand for market risk-weighted[15] assets, first the capital charge for market risk is calculated and then on the basis of this charge amount the value of Market Risk Weigh[16]ted Assets is derived.

2.25 ACCOUNTING POLICIES

25.1 BASIS OF PRESENTATION

Consolidated financial statements are prepared in accordance with International Financial Reporting Standards. The consolidated financial statements are prepared under the historical cost convention as modified by the revaluation of available-for-sale investment securities, financial assets, and financial liabilities held for trading and all derivative contracts.

The preparation of financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the reporting period. Although these estimates are based on management's best knowledge of current events and actions, actual results ultimately may differ from those estimates.

24.2 DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING

Derivative financial instruments including foreign exchange contracts, interest rate futures, forward rate agreements, currency and interest rate swaps, currency and interest rate options (both written and purchased) and

[15] http://www.investopedia.com/

other derivative financial instruments are initially recognized in the balance sheet at cost (including transaction costs) and subsequently are remeasured at their fair value. Fair values are obtained from quoted market prices, discounted cash flow models and options pricing models as appropriate. All derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

Certain derivatives embedded in other financial instruments, such as the conversion option in a convertible bond, are treated as separate derivatives when their risks and characteristics are not closely related to those of the host contract and the host contract is not carried at fair value with unrealized gain and losses reported in income.

Changes in the fair value of derivatives held for trading are included in net trading income.

On the date a derivative contract is entered into, the group designates certain derivatives as either (1) a hedge of the fair value of a recognized asset or liability (fair value hedge); or, (2) a or a firm commitment (cash flow hedge). Hedge accounting is used for derivatives designated in this way provided certain criteria are met

The group's criteria for a derivative instrument to be accounted for as a hedge include:

a) Formal documentation of the hedging instrument, hedged item, hedging objective, strategy and relationship is prepared before hedge accounting is applied;
b) The hedge is documented showing that it is expected to be highly effective in offsetting the risk in the hedged item throughout the reporting period; and
c) The hedge is highly effective on an ongoing basis.

CHAPTER 3:

BANKING SECTOR OF PAKISTAN

CHAPTER 3: BANKING SECTOR OF PAKISTAN

3.1 EARLY HISTORY

At the time of independence the areas, which now constitute Pakistan were producing only food grains and agriculture raw material for indo-Pakistan subcontinent. There were practically no industries, and what ever raw material was produced was being exported from Pakistan. However, commercial banking [17]facilities were provided fairly well here. There were 487 offices of scheduled banks in the territories now constituting Pakistan.

As a new country without resources it was very difficult for Pakistan to run it's own baning system immediately. Therefore in accordance with the provision of Indian Independence Act of 1947, an Expert Committee was appointed to study the issue. The committee recommended that the Reserve Bank of India should continue to function in Pakistan until 30th September 1948, so that the problems of time and demand liablility, coinage, currencies, Exchange etc. be settled between India and Pakistan. It was also stipulated that Pakistan would take over the management of public debt and exchange control from Reserve Bank of India on 1st April, 1948.

There were 19 non-Indian foreign banks with the status of small branch offices which were engaged solely in export of crops from Pakistan, while there were only 2 Pakistani institutions i.e. Habib Bank and Australasia Bank. The panic of uncertain future shook the confidence of the people- the government, therefore, promulgated the banking companies Ordinance, 1947, to safeguard the interests of both the banks and the customers.

[17] Practice and law of Banking In Pakistan by Dr. Ashrar H. Siddiqi

In order to make necessary arrangements for the assumption of control, an Expert committee was appointed to recommend necessary steps, including the required legislation to establish a Central Bank of Pakistan.

[18]

The foreign expert advised that due ot acute shortage of qualified staff the establishment of a Central Bank was not practicable; but he recommended a currency Board until such timeas the conditions become favorable. However, contrary to the recommendations, the government of Pakistan decided to establish a full-fledge Central Bank. Consequently the Governor-General of Pakistan and the Father of Nation, Quaid-i-Azam Mohammad Ali Jinnah, inaugurated the state Bank of Pakistan on July 1st, 1948, after the state bank of Pakistan order was promulgated on may 12, 1948. thus a landmark was made in the history of banking when the state bank of Pakistan assumed full control of banking and currency in Pakistan.

The first important task, which the state bank of Pakistan had to attend to, was the issue of currency notes and withdrawal of Reserve Bank of India notes with over-printing of Government of Pakistan, which had been in circulation in Pakistan so far.

As the central bank of country, the state bank addressed itself with the equally urgent task of creating national banking system. Inorder to attain this goal it provided every help and encouragement to Habib Bank to expand its network of branches, and also recommended to Government the establishment of a new bank which could serve as an agent of state bank. As a result, The National Bank of Pakistan came into being in 1949 and by 1952 it became strong enough to take over the agency function from Imperial Bank of India. In order to develop sound banking and weeding out weak institutions, the banking companies (control) Act was promulgated in 1949, thus empowering the state bank to control the operations of banking companies in Pakistan including preparation of the required trained man-power. Further, the state bank restricted the opening of new branches by foreign banks in port towns or in big cities from where trade was being carried out with

[18] Practice and law of Banking In Pakistan by Dr. Ashrar H. Siddiqi

foreign countries, while Pakistani banks were allowed to opern as many branches as possible within the country.

Pakistan entered into a phase of planned economic development in 1956; and naturally, further expansion in the banking and credit facilities was essential. Though there had been a remarkeable expansion in the number of offices of Pakistani banks since independence, it has remained heavily concentrated in large cities. Therefore, the state bank had to accord priority to the establishment of branches in the interior of the country.

Another very significant event in the development of banking in Pakistan was the appointment of the Credit Enquiry Commission in 1956 to examine the scope and working of the institutions providing credit facilities to agriculture, trade, commerce and industry, and recommend measures for further improvement.

More Pakistani scheduled banks continued to be established, which included the commerce bank limited and the standard Bank limited. By June 1965, the number of scheduled banks stood at 36; the deposits increased to Rs. 688.28 crores, while credit expansion by the banks to the private sector rose to Rs. 575.87 crores due to keen demand under the impact of economic growth and better scope for private enterprises. The separation of East Pakistan and its repercussions in the form of economic depression, demonetizations of currency in 1972; and the rampant worldwide inflation caused a lot of difficulties to the banking system in [19]Pakistan. Yet the growth of banking in Pakistan since 1948 has indeed been phenomenal. The network of not only Pakistani but the foreign banks cover a very large segment of population in every nook and corner of the country. They mobilize the saving and other funds from public in general and finance various sectors of economy from this pool more than 7000 branches of these banks have mobilized more than Rs. 887 billion in deposits and provided finance to various sectors amounting to more than Rs. 548 billion by june 1997.

Besides this growth, specialized credit and financial institutions have also developed over the years, and cater to the needs of specific sectors, National

[19] Practice and law of Banking In Pakistan by Dr. Ashrar H. Siddiqi

Investment Trust; Peoples Finance Corporation; Equity Participation Fund; national Development Finance Corporation, Banker's Equity Ltd; Small Business Finance Corporation etc. are contributing their due share in the country's economic life.

In the hope that banking would enter a new era of further development oand progress, Pakistani commercial banks were nationalized in Pakistan since January 01 1947, but it has now been realized that this step proved to be counter productive , hence reversal has been initiated since January 1991. Besides disinvestments and privatization of nationalized commercial banks, establishment of commercial and other banks in private sector is being encouraged. Consequently a large number of commercial and other banks have come into operation since 1991.

A new concept of interest free banking was introduced in 1981 and by now it has been established on sound footing, and new trends and techniques are being implemented to make this system result oriented. New products and their systematic consumption is making Pakistani Banking comparable to their several modern counterparts anywhere in developed world.

3.2 OVERVIEW

With increasing profits, improving asset quality and solvency, the year 2004 proved to be a milestone for the banking system. The favorable macroeconomic environment coupled with the institutionalization of reforms, introduced over the last five years, continued to provide the vital support. The banking system, by capitalizing on the opportunities created by the sharp upswing in the business cycle, expanded its balance sheet at an exceptional pace. This not only produced substantial profits for banks with the increasing high-earning assets but also conferred benefits to the growing number of customers in the form of improved and diversified financial services. The significant achievements can be highlighted by some of the financial soundness indicators of banking system such as [20]

- Five largest banks holding more than 50% of the assets of the banking system.

[20] Banking System Review 2004
www.sbp.gov.pk

- The loan portfolio of the banking system grew strongly
- Return on Assets (ROA) this year was the heist ever 1.2 %.
- Asset quality improved further.
- Solvency of the banking system improved.
- Liquidity conditions was good, deposit base expand rapidly also because of remittances.
- The Islamic banking operation continued to expand as many banks have started shariah based modes of financial activities.
- Double digit growth in large scale manufacturing (LSM) is thus a product of higher borrowing form banking system.

3.3 FUTURE OUTLOOK

Future outlook of banking industry appears to be positive. As the banking system is helped by the resolute and concerted efforts of the policy-makers over the last couple of years, seems to have developed inherent strength to endure the unexpected shocks.

The growth momentum of the economy and continuation of the business friendly policies, the demand for credit by the private sector is likely to remain intact, leading to further increase in the loan portfolio of banks. However, the [21]pace of growth might slow-down with the increasing interest rates. Particularly, consumer financing might be considered the high risk factor and loss of purchasing power in the face of high inflation. The manufacturing sector, especially the automobile industry, which benefited immensely from the strong growth in consumer finance, might also feel some pressure. Another major determinant of the future loans growth will be the trends in banks' financing to the SMEs and agriculture sectors. These sectors have been traditionally under-served compared to their potential and contribution in the economy, there is still considerable scope for banks to make further inroads.

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[21] Banking System Review
www.sbp.gov.pk

[22]

Given the persistent rise in loans, the earnings prospects for the banking system look even brighter for 2005-06. It, however, hinge a great deal on banks' ability to maintain the high quality of their loans as well as their operating efficiencies.

With the impressive achievements in the last couple of years, the task before the policymakers and managements of banks will be more challenging and daunting; to consolidate the gains as well as to lift the system to the international service quality levels. SBP is making efforts to comply with the majority of the Basel Core Principles for Effective Banking Supervision. The implementation of the Basel II Capital Accord in a phased manner is one of the top policy agenda of its future strategic plan. Another thing on which policy makers are emphasizingis to increase the outreach of the financial services to the underserved segments of the society to mainstream their capabilities for the benefit of the economy.

3.4 STATE BANKS INTSTRUCTIONS ON DISCLOSURE REQUIREMENT

In order to facilitate banks/DFIs to ensure compliance of statutory/regulatory requirements regarding financial disclosure, SBP had issued a Master Circular containing consolidated instructions on financial disclosure. All banks/DFIs, listed or non-listed – including branches of foreign banks and those which have peculiar shareholding structure, have to follow these instructions.

The instructions entail banks to prepare their annual financial statements in the prescribed manner, at the end of each accounting year, on the last working

[22] Banking System Review 2004
www.sbp.gov.pk

day. These financial statements together with the auditor's report, as passed in the Annual General Meeting, should be published and circulated as well as furnished.

All DFIs are also required to prepare their annual financial statements at the end of each accounting year as on the last working day of that year. These financial statements together with the auditor's report, as passed in the Annual General Meeting, should be circulated to the shareholders and furnished as returns to SBP within three months of the close of the period to which they relate. SBP also dictates that an abridged version of the financial statements be published in the newspaper(s) within the prescribed time.

SBP also requires quarterly un-audited financial statements, along with directors' review, to be prepared by all banks / DFIs, including the branches of foreign banks. Half yearly financial statements, including limited scope review by the statutory auditors, should also be prepared by all banks / DFIs.

These financial statements should be circulated by domestic banks / DFIs to their shareholders. Similarly, an abridged version of the financial statements shall be published in the newspaper(s) by all banks / DFIs.

Besides above, other requirements of Code of Corporate Governance regarding financial disclosure remain applicable, provided they are not inconsistent with SBP's instructions.

3.5 CORPORATE GOVERNANCE

The subject of corporate governance is increasingly gaining importance not only in Pakistan but also the world over because the very survival of an entity has become strongly dependent on efficient and self-regulated governance system. In the Pakistani banking scene, a lot of changes have taken place like greater emphasis on financial liberalization, globalization, increase in the pace of privatization, emergence of new private banks and technological advancements offering wide array of products and services, thereby increasing the likelihood of [23]banks being exposed to various types of risks like operational, credit, financial

[23] www.sbp.gov.pk

and market risks. Therefore, the banks as custodians of public money are required to be governed properly; a clear line of demarcation as to responsibilities of the board of directors (BOD), management, shareholders and external stakeholders was necessary.

Therefore, SBP being aware of the real issues has taken very important decisions to inculcate the culture of corporate governance in order to promote safe and sound banking practices, which include;

- Regular, timely, comprehensive, meaningful and reliable financial disclosure of financial affairs has been made compulsory. In this context, in addition to existing disclosure requirements, SBP has recently made compulsory to include a “Statement on Internal Controls” and comprehensive paragraph under the heading “Risk Management Framework” in the Directors’ Report in their Annual Accounts. Besides annual accounts, the Banks and DFIs have also been mandated to publish their Quarterly Accounts and credit rating assigned to them by independent credit rating agency. To further enhance the disclosure requirements in line with best international practices, the format of annual accounts of banks is being reviewed.

- Steps have been taken to make the external audit transparent and impartial. The management letter received from them is required to be acted upon and appropriate measure taken in consultation with audit committee without delay.
- Being the key players in a bank, BOD and senior management are supposed to understand the risk exposure of bank. Therefore, the composition of BOD and senior management in a bank should include individuals who are highly skilled and experienced in determining the risk appetite given the size and nature of bank’s activities. Accordingly, SBP has laid down “Fit and Proper Test” criteria for BOD and senior management/professionals, requiring them to possess certain qualifications and experience.

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3.6 MINIMUM CAPITAL REQUIREMENT FOR BANKS/DFIS

In order to align the regulatory capital requirement with the internationally accepted standards and institute a true risk based capital adequacy framework, SBP has decided to impose capital charge for market risk, in addition to presently applicable capital requirement on credit risk Also, in order to strengthen the capital base of institutions, the minimum paid–up capital requirement (net of losses) of Rs1 billion is being increased to Rs2 billion. The capital position is to be reported to SBP on consolidated as well as on standalone. Any bank/DFI failing to meet the minimum paid-up capital requirement (net of losses) of Rs1.5 billion by 31st December 2004 and Rs2 billion by 31st December, 2005, shall not be allowed to undertake a full range of financial services.

3.7 ON-SITE MONITORING AND INTERNAL CONTROLS

With the advent of increasing emphasis on proper management of various risks facing financial institutions throughout world, the need of an effective internal control system was greatly felt, which is an integral part of an ideal risk management framework. Therefore, State Bank of Pakistan has prepared **Guidelines on Internal Controls**. These guidelines require all banks/DFIs to ensure existence of an effective system of internal controls which is commensurate with the nature, size and complexity of their business; minimizes the risk inherent in their activities; and responds to changes in the business and general economic environment in which the banks/DFIs operate. These guidelines include a brief introduction to the Internal Controls, followed by Objectives of Internal Control System, Control Principles, Components of Internal Control System, Responsibilities of key players, Implementation of Internal Controls, Evaluation of Internal Controls, and finally, Reporting of Internal Controls. All

[24] *(Source: http://www.sbp.gov.pk)*

banks/DFIs are also required to submit a half-yearly progress report, within 30 days of the end of each calendar half-year, regarding the status of the development and implementation of the guidelines. In addition, the internal control systems will be tested/checked by our inspectors and will factor in the CAMELS-S rating system under ‘S’ (Systems & Controls).

3.8 STATE BANKS INTSTRUCTIONS ON ASSETS SECURITIZATION THROUGH SPECIAL PURPOSE VEHICLE (SPV).

State bank of Pakistan has taken many steps to promote Asset securitization through special purpose vehicle (SPV). State bank of Pakistan has provided many guidelines for this purpose including general guideline, guideline [25]for arranger/structuring Agent, for administrator/trustee/Servicing Agent, Investor, Originator, Originator, and Underwriter.

General guideline for Asset securitization includes that banks do not own any share capital in the SPV, the SPV and the ABS (Assets Backed Securities) issued do not carry the same or similar name as that of the bank/DFI. SPV shall not include the name of the bank/DFI in its name or imply any connection with the bank/DFI, for example, by using a symbol closely associated with the bank/DFI. All reasonable steps are taken to ensure that investors are informed in writing that their obligations to the SPV and investors in the ABS of the SPV are limited to the extent expressed in their written agreement with SPV the extent expressed in their written agreement with SPV. All transactions between them and SPV are conducted at arms length and are market based.

[25] (Source: www.sbp.gov.pk, BDP Circular no 31)

[26]The banks/DFIs holding Asset Backed Securities (ABS) have risk exposure to these underlying ABS assets. State bank of Pakistan has asked banks to determine total exposure to any particular obligor; they shall therefore take into consideration the exposure against the ABS assets of that particular obligor. State bank of Pakistan have asked banks/DFIs that they shall invest in only those ABS, which are listed on the Stock

Exchange and have a minimum credit rating of A or equivalent from a Credit Rating Agency approved by SBP or an international credit rating agency viz. Standard & Poor, Moody or Fitch and Total exposure of a bank/DFI towards ABS issued by a SPV shall not exceed 5% of its own paid up capital or 15% of the total value of the ABS issued by a SPV which ever is less. Further, the aggregate exposure on account of ABS shall not exceed 20% of the total paid up capital of the bank/DFI. (This will encourage banks/DFIs to (a) invest in and sell-down these ABS, i.e. to churn their ABS portfolio to stay within the 20% cap and to (b) actively trade in ABS to develop a secondary market, rather than to simply purchase these ABS and hold them till maturity) iv) For Capital Adequacy purposes, the banks holding ABS shall treat them at par with investment in TFCs and accordingly apply the risk weights prescribed by State Bank.

[26] (Source: www.sbp.gov.pk, BDP Circular no 31)

CHAPTER 4:

PUBLIC DISCLOSURES BY BANKS;

Findings and Analysis

CHAPTER 4: PUBLIC DISCLOSURES BY BANKS;

Finding and Analysis

For the analysis of disclosure made by Pakistani banks, Question that has been taken is recommended by Basel Committee on Banking Supervision. On the basis of these question study has been conducted from the Annual accounts of Pakistani Banks.

CAPITAL STRUCTURE

Survey Item	ACB	UNL	BALF	FBL	MCB	MBL	NBL	PICIC
Disclosed the amount of common shareholder's equity	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclosed the amount of tier one capital:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclosed the amount of perpetual non-cumulative preference shares:	No	No	No	No	No	No	No	No
Disclosed Deductions from tier one and tier two capital:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed the amount of tier three capital, where applicable:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed the total base:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclose the amount of minority interests in the equity of subsidiaries:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclosed the amount of innovative or complex capital instruments, including the percentage of total tier one capital:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed the maturity, including call features of complex or hybrid capital instrument:	No	No	No	No	No	No	No	No
Disclosed step-up provision for capital instruments (where applicable)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed key "trigger" events	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed provisions of capital instruments permitting interest of dividend deferrals or any other cumulative characteristics, where applicable	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed the issuance of capital through special purpose vehicles (SPVs)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

CAPITAL STRUCTURE

Survey Item	Basel Disclosure rate (2000)	Survey Response	Comments on Disclosure Trends
Disclosed the amount of common shareholder’s equity	100 %	Yes	
Disclosed the amount of tier one capital:	100 %	Yes	
Disclosed the amount of perpetual non-cumulative preference shares:	97 %	No	
Disclosed Deductions from tier one and tier two capital:	67 %	N/A	
Disclosed the amount of tier three capital, where applicable:	65 %	N/A	
Disclosed the total base:	98 %	Yes	
Disclose the amount of minority interests in the equity of subsidiaries:	94 %	Yes	
Disclosed the amount of innovative or complex capital instruments, including the percentage of total tier one capital:	83 %	N/A	
Disclosed the maturity, including call features of complex or hybrid capital instrument:	77 %	No	
Disclosed step-up provision for capital instruments (where applicable)	67 %	N/A	
Disclosed key “trigger” events	33 %	N/A	
Disclosed provisions of capital instruments permitting interest of dividend deferrals or any other cumulative characteristics, where applicable	68 %	N/A	
Disclosed the issuance of capital through special purpose vehicles (SPVs)	89 %	N/A	

COMMENTS:

All the banks in the survey have disclosed the qualitative term of the capital structure. However disclosures about quantitative terms are not sufficiently covered in the annual account this includes advance information including tier 2 and tier 3 capital, step up provision and hybrid instruments this could be due to the fact that banks in Pakistan do not use such sophisticated capital instrument. In the basel survey it was reveled that banks of other developing countries clearly disclose such capital structure.

CAPITAL STRUCTURE: Disclosure requirements related to capital structure is used to ensure and inform various stakeholders of the banks about banks level and composition of capital, including the use of hybrid capital instruments. Through this disclosure requirement stakeholders can check that how banks capital is financed, what instrument has been used for financing, how much of the capital is through stockholder equity; how much is through debt; how much in capital there is reserve; how much there is general provisions. If the capital structure disclosures are not properly disclosed than it will misguide various stakeholder of the banks. They might wrongly interpret the information and can make incorrect decisions. In the case of Pakistani banks as identified in the survey that Pakistani banks are only disclosing common shareholder's equity, tier one capital, and amount of minority interests in the equity of subsidiaries. Only this information is not sufficient for any stakeholder to make decision. Advance level of requirement that Pakistani banks are not disclosing will not affect stakeholders much because banks in Pakistan do not uses such sophisticated capital instruments.

CAPITAL ADEQUACY

Survey Item	ACB	UNL	BALF	FBL	MCB	MBL	NBL	PICIC
Disclosed the risk-base capital ratio calculated in accordance with the methodology prescribed in the Basel Capital Accord:	none	none	none	None	none	none	none	none
Provided all information relevant to understanding how Basel Capital Accord requirements for market risk under the internal models approach have been calculated:	none	none	none	None	none	none	none	none
Disclosed all information relevant to understanding how Basel Capital Accord requirements for market risk under the standardized approach have been calculated, including disclosure of capital charges for components risk elements, as appropriate:	none	none	none	None	none	none	none	none
Disclosed the risk of balance sheet assets (specifying book value and risk weighted amount for each bucket):	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclosed the risk exposure of each offbalance sheet instrument (specifying nominal amount, credit equivalent amount and risk weighted amount for each risk bucket):	Yes	No	Yes	No	No	No	Yes	No
Provided analysis for changes in the banks capital structure and the impact on key ratios and overall capital position:	No	No	No	No	No	No	No	No
Disclosed whether the bank has an internal process for assessing capital adequacy and for setting appropriate levels of capital:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

CAPITAL ADEQUACY

Survey Item	Basel Disclosure rate (2000)	Survey Response	Comments on Disclosure Trends
Disclosed the risk-base capital ration calculated on accordance with the methodology prescribed in the Basel Capital Accord:	95%	None	
Provided all information relevant to understanding how Basel Capital Accord requirements for market risk under the internal models approach have been calculated:	38%	None	
Disclosed all information relevant to understanding how Basel Capital Accord requirements for market risk under the standardized approach have been calculated, including disclosure of capital charges for components risk elements, as appropriate:	19%	None	
Disclosed the risk of balance sheet assets (specifying book value and risk weighted amount for each bucket):	27%	Yes	
Disclosed the risk exposure of each off-balance sheet instrument (specifying nominal amount, credit equivalent amount and risk weighted amount for each risk bucket):	44%	Some have done it (3 out of 9 bank)	Only NBL, BALF, ACB have shown.
Provided analysis for changes in the banks capital structure and the impact on key ratios and overall capital position:	69%	No	
Disclosed whether the bank has an internal process for assessing capital adequacy and for setting appropriate levels of capital:	45%	Yes	

COMMENTS:

Capital adequacy disclosure of Pakistani banks demand lot of improvement. These banks are not following the international banking practice of disclosing capital adequacy ratio/risk base capital. Only the on-balance sheet ration and off-balance ratios are disclosed in the annual account. Banks do meet the minimum capital requirement stated by SBP but no disclosures are published about the analysis for changes in the banks capital structure and the impact on key ratios and overall capital ratios.

CAPITAL ADEQUACY: Disclosure requirements related to Capital Adequacy is used to ensure and inform various stakeholders of the banks about the bank's assessment of its capital levels relative to its risks and business lines. Not disclosing item required under capital adequacy has very adverse effect on all the stakeholders including banks. Pakistani banks are only disclosing the information regarding the risk of balance sheet assets(specifying book value and risk weighted amount for each bucket), risk exposure of each off-balance sheet instrument, and information whether the bank has an internal process for assessing capital adequacy. The disclosure regarding capital adequacy is not adequate for stakeholders including banks management. By not disclosing advance information regarding capital adequacy can lead to incorrect decision by stakeholders. Advance capital adequacy disclosure requirements such as information regarding risk-base capital ratio, information relevant to Basel Accord requirement for market risk under the internal models approach, information relevant to understanding how Basel Capital Accord requirement for market risk under the standardized approach, and changes in capital structure and its impact on key ratios provide a mechanism through which management of the bank and other stakeholders are remained informed with various kind of risks. Not disclosing such information can lead to danger for the banks management.

INTERNAL & EXTERNAL RATINGS

	ACB	UNL	BALF	FBL	MCB	MBL	NBL	PICIC
Disclosed the process and method used to assess credit exposures on both and individual counter party and portfolio basis, including a description of the internal classification system (e.g., what each rating means in terms of default probability, degree of risk being distinguished, performance over time and ex-post evaluation):	No	No	No	No	No	No	No	No
Provided summary information on the quality of on and off-balance sheet credit exposures, base on the internal rating process or external rating:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Provided summary information about the internal rating process	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Described how internal rating are used in the bank's internal capital allocation process:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

INTERNAL & EXTERNAL RATINGS

Survey Item	Basel Disclosure rate (2000)	Survey Response	Comments on Disclosure Trends
Disclosed the process and method used to assess credit exposures on both and individual counter party and portfolio basis, including a description of the internal classification system (e.g., what each rating means in terms of default probability, degree of risk being distinguished, performance over time and ex-post evaluation):	52%	No	
Provided summary information on the quality of on and off-balance sheet credit exposures, base on the internal rating process or external rating:	17%	Yes	
Provided summary information about the internal rating process	58%	Yes	
Described how internal rating are used in the bank's internal capital allocation process:	14%	Yes	

COMMENTS:

Most of the banks provide standard information about what internal rating are. However disclosures about the processes and the method used to asses credit exposures are missing. Also missing are disclosures about how internal ratings are utilized in the banks internal capital allocation process. It will be interesting to note that other international banks surveyed were also lacking in these disclosures.

INTERNAL AND EXTERNAL RATINGS: Disclosure requirements related to internal and external rating is used to ensure and inform various stakeholders of the banks about the bank's use of internal ratings in its internal capital allocation process or comparison of internal ratings with external rating. Pakistani banks only disclose that they have an internal rating process in compliance with State Bank of Pakistan and some information on quality of on and off-balance sheet credit exposure. This information regarding internal rating is not sufficient to make rational decision by stakeholder of the bank. By not providing advance information regarding internal rating such as process and method used to assess credit exposure on both individual counter party and portfolio basis, including a description of the internal classification system can misguide management and other stakeholders. Not disclosing this information might be because that management do not have plan for incorporating these mechanism in the bank.

CREDIT RISK MODELLING:

Survey Item	ACB	UNL	BALF	FBL	MCB	MBL	NBL	PICIC
Disclosed whether credit risk measurement models are used, and if so, provided descriptive information about the types of models, portfolio covered and size of portfolios:	No	No	No	No	No	No	No	No
Disclosed how the bank has incorporated historical default experience for different asset categories, current conditions, changes in portfolio composition and trends in delinquencies and recoveries:	No	No	No	No	No	No	No	No
If and institution stress tests its counterparty credit exposures, it should disclose its process for stress testing, and how testing is incorporated into its risk management system	No	No	No	No	No	No	No	No
Disclosed quantitative and qualitative information about the credit risk measurement models used, including model parameters (e.g., holding period, observation period , confidence interval, etc.), performance over time, and model validation and stress testing:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclosed whether credit scoring is used when granting credit, and if so, provide descriptive information about the credit scoring model and how it is used:	No	No	No	No	No	No	No	No

CREDIT RISK MODELLING

Survey Item	Basel Disclosure rate (2000)	Survey Response	Comments on Disclosure Trends
Disclosed whether credit risk measurement models are used, and if so, provided descriptive information about the types of models, portfolio covered and size of portfolios:	41%	No	
Disclosed how the bank has incorporated historical default experience for different asset categories, current conditions, changes in portfolio composition and trends in delinquencies and recoveries:	45%	No	
If and institution steess tests its counterparty credit exposures, it should disclose its process for stess testing, and how testing is incorporated into its reks management system	28%	No	
Disclosed quantitative and qualitative information about the credit risk measurement models used, including model parameters (e.g., holding period, observation period , confidence interval, etc.), performance over time, and model validation and stess testing:	11%	Yes	
Disclosed whether credit scoring is used when granting credit, and if so, provide descriptive information about the credit scoring model and how it is used:	42%	No	

COMMENTS:

The only information disclosed in the annual account of banks is the qualitative information on the credit modeling. However banks are seriously lacking in disclosing the information such as credit scoring used, stress test etc

SECURITIZATION ACTIVITIES:

Survey Item	ACB	UNL	BALF	FBL	MCB	MBL	NBL	PICIC
Disclosed the amount and types of assets securitized:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Described the bank's strategy and objective for securitisation:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed the amount of servicing retained on securitized assets:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Described the amount of risk on assets retained when assets are securitized	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed general recourse provision on securitisation:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Described details on subordinated interests retained (first loss protection) when assets are securitized:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed the accounting treatment of securitisation transactions and other credit risk mitigation techniques:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Disclosed the income effect of securitisation:	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

SECURITIZATION ACTIVITIES:

Survey Item	**Basel Disclosure rate (2000)**	**Survey Response**	**Comments on Disclosure Trends**
Disclosed the amount and types of assets securitized:	49	N/A	
Described the bank's strategy and objective for securitisation:	44	N/A	
Disclosed the amount of servicing retained on securitized assets:	32	N/A	
Disclosed the amount of risk on assets retained when assets are securitized:	27	N/A	
Disclosed general recourse provision on securitisation:	23	N/A	
Described details on subordinated interests retained (first loss protection) when assets are securitized:	22	N/A	
Disclosed the accounting treatment of securitisation transactions and other credit risk mitigation techniques:	45	N/A	
Disclosed the income effect of securitisation:	44	N/A	

COMMENTS:

There are no laws regulating securitization processes in Pakistan, which is why no banks are making disclosures on this. However increasing demand of securitizatised assets has prompted SBP to issue circular facilitating investor, middleman, banks and for all the parties involved in the transaction in securitization process.

SECURITISATION ACTIVITIES: Disclosure requirements related to securitization activities is used to ensure and inform various stakeholders of the banks about the type, methodology and validity of credit risk models employed by the bank. Disclosure requirements under securitisation activities are very important while Pakistani banks are disclosing none of the requirements. Which is very alarming situation for the banks and regulatory authority. However State Bank of Pakistan has taken action for this and developed a road map to incorporate securitization activities into to banks operations and annual accounts.

CREDIT RISK:

Survey Item	ACB	UNL	BALF	FBL	MCB	MBL	NBL	PICIC
Provided a reconciliation of activity for any allowances established for credit impairment ("continuity schedule"):	No	No	No	No	No	No	No	No
Disclosed information on the impact of non-accrual ad impaired assets on the financial performance of the bank including information on charges-offs and provision:	No	No	No	No	No	No	No	No
Disclosed the amount of any charge-offs and recoveries and that have been recoded directly in the income statement:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Described how the level of allowances compares with historical net loss experience:	No	No	No	No	No	No	No	No
Provided information on total credit exposures, including exposures arising from lending, trading, investment, liquidity/funding management and off-balance sheet activities:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Described policies and practices for sovereign risk provisioning:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Discussed practices and procedures used for evaluation the adequacy of credit loss provisions and credit loss allowances:	No	No	No	No	No	No	No	No
Discussed the techniques used to monitor and manage past due to impaired assets/credit relationships:	No	No	No	No	No	No	No	No
If the institution uses collateral, covenants, guarantees or credit insurance to reduce risk exposure, the impact on credit exposure should be disclosed:	No	No	No	No	No	No	No	No
Provided information on the amount and nature of derivatives credit risk loss allowances:	No	No	No	No	No	No	No	No
Disclosed the replacement cost of non-performing derivatives:	No	No	No	No	No	No	No	No

CREDIT RISK:

Survey Item	Basel Disclosure rate (2000)	Survey Response	Comments on Disclosure Trends
Provided a reconciliation of activity for any allowances established for credit impairment (“continuity schedule”):	93	No	
Disclosed information on the impact of non-accrual ad impaired assets on the financial performance of the bank including information on charges-offs and provision:	85	No	
Disclosed the amount of any charge-offs and recoveries and that have been recoded directly in the income statement:	88	Yes	
De4scribed how the level of allowances compares with historical net loss experience:	53	No	
Provided information on total credit exposures, including exposures arising from lending, trading, investment, liquidity/funding management and off-balance sheet activities:	56	Yes	
Described policies and practices for sovereign risk provisioning:	73	Yes	
Discussed practices and procedures used for evaluation the adequacy of credit loss provisions and credit loss allowances:	58	No	
Discussed the techniques used to monitor and manage past due to impaired assets/credit relationships:	53	No	
If the institution uses collateral, covenants, guarantees or credit insurance to reduce risk exposure, the impact on credit exposure should be disclosed:	13	No	
Provided information on the amount and nature of derivatives credit risk loss allowances:	10	No	
Disclosed the replacement cost of non-performing derivatives:	7	No	

COMMENTS:

The banks are disclosing amount of any charge-offs and recoveries, total credit exposures, and policies and practices that are very basic requirement for bank according to international standards. Pakistani banks are missing higher levels of disclosure requirement that are very important for banking industry. Without these disclosures there are lot of ambiguity to clearly evaluate the banks risk.

CREDIT RISK: Disclosure requirements related to credit risk is used to ensure and inform various stakeholders of the banks about procedures for evaluating the adequacy of allowances and data on credit losses.

GEOGRAPHIC AND BUSINESS LINE DIVERSIFICATION

Survey Item	ACB	UNL	BALF	FBL	MCB	MBL	NBL	PICIC
Provided information on market activity by broad instrument category (e.g., futures, forwards, swaps and options:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Provided information on market activity by broad risk category (foreign exchange, interest rate, commodity, equity), or by major product (bonds, swaps etc):	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Provided information on trading revenues by major risk category (foreign exchange, interest rate, commodity, equity), or by major product (Bonds, swaps etc.):	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Provided a breakdown of past due assets by asset category:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclosed credit exposure information by business line	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclosed summary information about the geographic distribution of credit exposure, including domestic and international credit:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

GEOGRAPHIC AND BUSINESS LINE DIVERSIFICATION

Survey Item	Basel Disclosure rate (2000)	Survey Response	Comments on Disclosure Trends
Provided information on market activity by broad instrument category (e.g., futures, forwards, swaps and options:	82	Yes	
Provided information on market activity by broad risk category (foreign exchange, interest rate, commodity, equity), or by major product (bonds, swaps etc):	80	Yes	
Provided information on trading revenues by major risk category (foreign exchange, interest rate, commodity, equity), or by major product (Bonds, swaps etc.):	69	Yes	
Provided a breakdown of past due assets by asset category:	33	Yes	
Disclosed credit exposure information by business line	62	Yes	
Disclosed summary information about the geographic distribution of credit exposure, including domestic and international credit:	76	Yes	

COMMENTS:

Pakistani banks are giving detailed disclosures about their geographical and business line diversification.

GEOGRAPHIC AND BUSINESS LINE DIVERSIFICATION: Disclosure requirements related to credit risk is used to ensure and inform various stakeholders of the banks about the nature and extent of any concentration in risk exposure.

ACCOUNTING AND PRESENTATION POLICES:

Survey Item	ACB	UNL	BALF	FBL	MCB	MBL	NBL	PICIC
Disclosed the basis of measurement for assets at initial recognition and subsequent periods at initial recognition and subsequent periods, e.g., fair value or historical cost:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclosed income and expense information grouped by nature or function within the bank:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Provided summary information about how trading activities affect earning, based on internal measurement and accounting systems:	No	No	No	No	No	No	No	No
Disclosed the basis for determining when assets are considered past-due and/or impaired for accounting and disclosure purposed (number of days where appropriated):	No	No	No	No	No	No	No	No
Distinguished between trading assets and trading liabilities:	No	No	No	No	No	No	No	No

ACCOUNTING AND PRESENTATION POLICES

Survey Item	Basel Disclosure rate (2000)	Survey Response	Comments on Disclosure Trends
Disclosed the basis of measurement for assets at initial recognition and subsequent periods at initial recognition and subsequent periods, e.g., fair value or historical cost:	100	Yes	
Disclosed income and expense information grouped by nature or function within the bank:	98	Yes	
Provided summary information about how trading activities affect earning, based on internal measurement and accounting systems:	85	No	
Disclosed the basis for determining when assets are considered past-due and/or impaired for accounting and disclosure purposed (number of days where appropriated):	80	No	
Distinguished between trading assets and trading liabilities:	48	No	

ACCOUNTING AND PRESENTATION POLICIES: Disclosure requirements related to credit risk is used to ensure and inform various stakeholders of the banks about general policies covering various activities.

ALL OTHER RISKS:

Survey Item	ACB	UNL	BALF	FBL	MCB	MBL	NBL	PICIC
Provided qualitative disclosures of interest rate risk in the banking book:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Provided quantitative disclosures of interest rate risk in the bank book:	No	No	No	No	No	No	No	No
Disclosed quantitative and qualivtative information and strategies for managing liquidity risk:	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Disclosed information about the main types of operational risk and identified and discussed any specific issues considered to be significant :	No	No	No	No	No	No	No	No
Disclosed legal contingencies (including pending legal actions) and discussed possible liabilities:	No	No	No	No	No	No	No	No

ALL OTHER RISKS:

Survey Item	Basel Disclosure rate (2000)	Survey Response	Comments on Disclosure Trends
Provided qualitative disclosures of interest rate risk in the banking book:	71	Yes	
Provided quantitative disclosures of interest rate risk in the bank book:	66	No	
Disclosed quantitative and qualivtative information and strategies for managing liquidity risk:	78	Yes	
Disclosed information about the main types of operational risk and identified and discussed any specific issues considered to be significant :	82	No	
Disclosed legal contingencies (including pending legal actions) and discussed possible liabilities:	72	No	

CHAPTER 5:

ANALYSIS

CHAPTER 5: ANALYSIS

5.1 STATE BANKS EFFORTS FOR IMPLEMENTATION OF INTERNATIONAL DISCLOSURE REQUIREMENT

International disclosure requirement provide a framework that pave way for robust and stronger banks. Compliance with international disclosures will enable the domestic banking sector to prepare for stiff competition in the changing sophistications and boundaries of the financial world. Implementation of these requirements by Pakistani banking sector by no means is an easy task where risk management is still in its infancy stage. For the implementation of these requirements by Pakistani banks and to be incompliance with the international requirements State Bank of Pakistan has issued a circular on March 31st, 2005 introducing a road map for the implementation of these requirements.

In this road map; timeframe given by State Bank of Pakistan for the adoption of different disclosure requirement approaches are as follows:

- Standardized Approach for credit risk and Basic indicator / Standardized Approach for operational risk from 1st January 2008.
- Internal Banks/DFIs will be required to adopt a parallel run of one and half year for standardized approache and two years for IRB Approach starting from July 1st, 2006 and January 1st, 2008 respectively.

These above timeframe has been finalized after consultation with and with the agreement of the presidents /CEOs of all banks/DFIs.

State Bank of Pakistan has issued new framework that consists of three mutually reinforcing pillars; the first pillar relates to Minimum Capital Requirement, second pillar describes Supervisory Review Process under the new framework and the third pillar describes the Market Discipline required to be adopted by the banks. Under pillar one, the framework offers three distinct options for assessment of capital requirements for credit risk and three options for operational risk. The approaches available for assessment of capital for credit risk are Standardized Approach, Foundation Internal Rating Based Approach and Advanced Internal Rating Based Approach. The approaches available for computing capital charge for operational risk are Basic Indicator Approach, Standardized Approach and Advance Measurement Approach. Whereas the capital requirement as to the Market Risks remains unchanged and banks will continue to assess the capital charge against the market risk based on the existing instructions under the Basel-I.

For the smooth, realistic and undisrupted transition from present capital adequacy framework towards more risk sensitive new capital adequacy framework – the Basel II, all banks/DFIs are required to designate one senior officer from their institution who will supervise all activities relating to Basel II within the bank and will serve as a point of contact between SBP and that particular bank. To facilitate this State Bank of Pakistan has allowed banks that they may also put in place a support functionary to assist the person in charge as considered appropriate. This responsibility may be assigned to Head of Risk Management or Chief Credit Officer or Chief Financial Officer. Banks/DFIs are required to establish an adequate setup and report to SBP the name and other particulars of the coordinator for Basel II implementation as soon as possible but not later than 31st May 2005.

While the detailed instructions and rules relating to capital adequacy requirements under Basel II will be issued in due course of time, the purpose of this circular is to provide a broad roadmap and outline which is required to start work for the adoption of Basel II.

State Bank of Pakistan have asked Each bank/DFI to formulate their internal plans specifying the approach they are willing to adopt and the plans for moving to the particular approach. The plans should envisage the risk management setup, various risk assessment methodologies being used for assessment of various risk categories and the policy and procedures for the capital allocation. It must highlight what are the gaps for moving to Basel II implementation and what steps are required to overcome those gaps. Banks/DFIs should give a time bound action plan narrating the activities to be done and the time when it will be accomplished within the overall implementation timeframe as mentioned above.

5.2 ANALYSIS OF DATA DISCLOSUED AND WEAKNESS INHERENT IN THE DISCLOSURE PRACTICES IN PAKISTANI BANKS

In an effort to promote effective market discipline in banking and capital markets, the Basel Committee on Banking Supervision has long encouraged banks to publicly disclose quantitative and qualitative information to inform market participants about the banks risk management practices and financial strength. Basel Committee on Banking Supervision has developed several questions on disclosures to check the level of compliance of disclosures with the international requirement. The questions were on the following categories:

- Capital Structure
- Capital Adequacy
- Internal and External Ratings
- Credit Risk Modeling
- Securitisation Activities
- Credit Risk
- Credit Derivatives and other Credit Enhancements
- Derivatives
- Geographic and Business Line Diversification
- Accounting and presentation Policies
- All other Risks

The result of the survey conducted by the Basel Committee on Banking Supervision of internationally active banks in 13 countries concludes that banks disclosed 59% of the survey items.

In the survey of Pakistani Banks conducted in this thesis; Pakistani banks have only disclosed to the only 23 requirement out of 64 items that is not even 50% of the international requirement of disclosure of banks. Under each category of survey questions mentioned above Pakistani banks only disclosed to very basic requirements and unable to disclose higher levels of requirements.

If analyzed turn by turn every category we can infer as follows

- **Capital Structure:** As in the capital structure category Pakistani banks have disclosed very basic requirement such as common shareholder equity, tier one capital, total base, and amount of minority interest in the equity of subsidiaries. But the Pakistani banks were unable to disclose the information about requirements like tier two and tier three capital, innovative or complex capital instruments, maturity including call features of complex or hybrid capital instruments, issuance of capital through special purpose vehicles. The reason for not disclosing higher requirements are many. First reason for not disclosing advance capital structure requirements are that Pakistani banks do not uses hybrid and sophisticated capital instruments. Second reason for not disclosing is that State bank of Pakistan has not yet ordered to banks to do so. It might be because of Pakistani banking industry has not yet reached to a level to disclose these items.

- **Securitisation Activities:** None of the Pakistani bank has disclosed any of the item requirements. Even the results of the survey conducted by Basel Committee of International banks do not show positive outcomes. Even international banks are not properly disclosing the items under Securitisation. Before 2005 securitisation disclosure was unknown to the banking industry and there was no requirement by Sate Bank of Pakistan to Pakistani banks about any disclosure regarding securitisation. However in year 2005 State Bank of Pakistan has taken steps to include securitization activities in the disclosure. State Bank of Pakistan has issued a circular providing guidelines including general guideline, guideline for arranger/structuring agents, guideline administrator/trustee/servicing Agent, guideline for investor, guideline for originator, etc.

- **Geographic and Business Line Diversification:** All the disclosure regarding Geographic and Business Line Diversification has been disclosed by Pakistani banks. This shows that Pakistani banks are in compliance with the international banks. Pakistani banks are disclosing all the items identified by the Basel Committee on Banking Supervision. As information regarding market activity by broad instrument category, market activity by broad risk category or by major product, information on trading revenues by major risk category, and information about the geographic distribution of credit exposure can be found in the annual accounts of the Pakistani banks.

- **Internal & External Ratings:** The adequacy of disclosure related to internal rating based approach to setting capital requirement has been given importance in the new Basel Accord. Pakistani banks have shown lot of improvement in these years by disclosing the requirement like summary information on the quality of on and off-balance sheet credit exposure base on the internal rating process or external rating and summary information about the internal rating process. However banks did not disclosed any information about the process and method used to assess credit exposure on both and individual counter party and portfolio basis, including a description of the internal classification system. The only disclosed information in annual accounts with respect to above mentioned requirement is an article describing that banks have internal rating system in accordance to State bank of Pakistan but unable to disclose how and what impact it will have on the banks.

- **Accounting and Presentation Polices:** The Survey result shows that out of five only two items has been satisfied by the Pakistani banks which are not a good sign. Pakistani banks have disclosed the qualitative information such as basis of presentation and accounting policies such as treatment with investment (held for trading and held for maturity, available for sale), sale and repurchase agreement, advances and depreciation treatment etc. however Pakistani banks are unable to disclose the advance disclosure requirement such as summary information about how trading activities affect earning, based on internal measurement and accounting system, determining when asset are considered past-due and/or impaired for accounting and disclosure purposed, distinguished between trading assets and trading liabilities. This may be because of banks internal inefficiency to meet the international requirement and at the same time State bank of Pakistan did not put any regulation regarding these disclosures on banks.

- **Credit Risk:** Every bank is exposed to credit risk. Disclosures are made by the banks supervisory and regulatory authorities to implement mechanism in banks so that banks should be able to avoid the losses they can face because of these risks. The level of information about credit risk is not at all well disclosed and only basis information like total credit exposure etc is found in annual reports. The policies practices and procedures for determining credit risk, credit risk allowances etc are not disclosed at all. Similarly, information on derivatives and credit derivatives are not very commonly disclosed either even though the banks have ventured into both areas in recent times. In Pakistan banks are disclosing information that has been instructed by State bank of Pakistan. Now a days State bank of Pakistan is formulating new and innovative procedures for credit and other risk after that it might be followed by the banks which could make Pakistani banks able to fulfill the international disclosure requirements.

5.3 CONSEQUENCES OF TRANSPARENT DISCLOSURES AND NON DISCLOSURES

Information in the annual accounts required by the disclosure requirements is important in a variety of ways.

For analysts and investors reviewing annual reports, it is essential that financial risk positions clearly communicated. Risk information in capital markets helps to ensure that the value of quoted securities of listed companies accurately reflects their true intrinsic values.

Another driver is the developing focus on capital adequacy and the measurement of regulatory capital requirements for credit, market, operational and other banking risks. This has put pressure on banks to develop comprehensive methods within their risk management framework to support capital allocation. As there are many changes in the financial markets greater attention to the provision of financial risk information is required.

Banks' disclosures about their risk management and risk exposures is also of increasing interest to the supervisory and regulatory authorities. These stakeholders are interested in the disclosure of information on financial instruments, risk exposure and internal risk management systems. However, from the perspective of the markets, national accounting laws and stock exchange instructions state only the minimum requirements that must be met by an annual report. Convergence between investors, customers and markets in the financial markets increases the need for improving relationships with investors, other banks and customers. The banks should therefore include a clear picture of their actual risk positions to enable correct evaluation of actual risks connected to their business.

As the banking business fundamentally relies on identifying, pricing, managing and controlling risk, the bank has to be able to present not just numbers but real substance and knowledge if it wants to gain credibility for its risk management. Several major unexpected losses, have highlighted the importance of risk management in banking. It is in the bank's own interest that external parties are given as comprehensive a picture of their risk management as possible. Moreover, the management of banking risks is increasingly recognized as a core competence, leading to a strategic advantage over competitors for the banks with an advanced risk management framework.

The rapid changes in the marketplaces and distribution channels of banking services, the developments in e-commerce and Internet, the increasing competition and more demanding requirements from customers, all point towards a need for greater transparency in communication with the stakeholders of the bank. Business strategies towards risk taking and the acceptable level of 'risk appetite' are major subjects of consideration for the management of banks. A clear description of the methodologies and techniques used for risk measurement, the underlying assumptions, confidence levels used and the assessment of risk limits should now be a standard reporting practice.

Through disclosure requirements, regulatory authority insures that specified mechanism has been accomplished by the banks. Each category of disclosure requirements has an impact on Banks management, banks customers, Investors, Lenders, regulatory authorities, and all the parties that has some relation with banking sector. For example

CHAPTER 6:

CONCLUSION

CHAPTER 6: CONCLUSION

The favorable macroeconomic environment coupled with the institutionalization of reforms, introduced over the last five years, continued to provide the vital support. The banking system, by capitalizing on the opportunities created by the sharp upswing in the business cycle, expanded its balance sheet at an exceptional pace. This not only produced substantial profits for banks with the increasing high-earning assets but also conferred benefits to the growing number of customers in the form of improved and diversified financial services. The loan portfolio of the banking system, on the back of strong business confidence, grew strongly. This gave a significant boost to the economic activities as the businesses expanded their capacities to meet strong demand pressures. The loans growth was also broad-based as substantial funds flowed to consumer, Small and Medium Enterprises (SMEs) and agriculture sectors. The share of SME and agriculture sectors in total loans of the banking system in 2004 has risen to 25 percent which is quite impressive, while that of consumer financing was less than 10 percent. Banks' growing interest in these sectors not only helped in increasing their clientele, but also helped in credit risk diversification. The persistent inflow of deposits kept the banking system sufficiently liquid to meet the strong credit demand.

The goal of financially sound and viable banking system would remain elusive without the existence of necessary infrastructure, built in line with international best practices. To achieve this objective, a number of reforms were initiated by State Bank of Pakistan and the process continues unhindered. State Bank of Pakistan initiatives taken towards Financial System Stability includes Minimum Capital Requirement Enhancement and Capital Charge for Market Risk, Resolution of Problem Banks, Payment Systems, Margin Financing, Corporate Governance, and Regulatory Measures to Reduce NPLs.

The Basel Core Principles (CPs) for Effective Banking Supervision have gained great importance for prudent regulation and supervision of financial sector. These principles are considered as benchmark for the banking supervision and their compliance reflect the robustness of the supervisory framework of a country. Cognizant of the importance of these principles, the SBP has been preparing an internal assessment of compliance with these principles since 2001. the assessment methodology is based on criteria prescribed by the Basel Committee Supervision (BCBS). The extent of compliance with each principle is expressed interms of a ranking continuum i.e. compliant, largely compliant, materially non-compliant, and non compliant. In February 2004 a joint mission of the IMF and the World Bank carried out an independent assessment of the SBP's compliance with CPs under Financial Sector Assessment Program (FSAP) of the country. This was the firs such assessment and it provided an independent evaluation of the level of robustness of supervisory framework of the country.

The findings of our disclosure survey indicate that over the years disclosure practices of our banks have improved and are moving tin the right direction. The basic areas of bank's activities and functions are well disclosed, while there is a need to improve disclosure in the areas of advance mechanisms like credit risk modeling, use of credit derivatives and derivatives, securitization etc. though we have a large gap in terms of disclosure practices from the Basel Committee's Surveys findings but still the banking disclosures are generally satisfactory and not a matter of real concern. For this we need to appreciate the role of State bank of Pakistan, which has taken a number of steps to strengthen the banking sector of Pakistan.

CHAPTER 7:

RECOMMENDATION

RECOMMENDATIONS

Banking standards prevalent in the country are one of the many economic indicators that are used to determine the financial viability of investing in that country. The inefficient banking standards leading to poor disclosure requirements said by State Bank Pakistan are not only hearting the banks but are also tarnishing Pakistan image. After the preparation of this report the following recommendation have been charted out to uplift the banking standard of Pakistan.

- Linkage with Basel committee: State Bank should form a formal linkage with Basel committee. With their collaboration SBP can create and implement more stringent and better banking standards that are aligned with the internationally banking standard. This collaboration would also entail

- SBP should also maintain strong relationships with state banks or other countries to remain up to date and alert about the latest polices and measures being followed by its counterparts abroad. Managers from SBP could also get formal training from other State Banks which are renowned to have quality banking standards.

- Commercial banks themselves should implement highest standards of disclosures in their annual accounts even SBP dose not require to do so. Lack of disclosures by commercial banks adversely affects them as key stakeholders are not aware of the Risk management mechanism have been implemented in the banks whether to know if the bank is reliable investment or not.

- Local and foreign banks in Pakistan should make a common banking body, in which one or more member should have representation in that committee. This committee should make an effort to learn new mechanism that has been introduced by the Basel Committee.

- State Bank of Pakistan is making an effort to incorporate international disclosure in Pakistani Banking industry. However the road map developed by State Bank of Pakistan for these disclosures is very long. For example road map developed for incorporating disclosures regarding securitization activates has a time period of five years. State Bank of Pakistan should fasten their efforts regarding disclosures.

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