Shamshad Akhtar: Pakistan – banking sector reforms: performance and challenges

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A. Introduction

In recent years, growth and turnaround in Pakistan's banking sector has been remarkable and unprecedented. Classified as Pakistan's and region's best performing sector, the banking industry's assets have risen to over $60 billion, its profitability is exceptional and at an all-time high, non-performing loans (NPLs) are at an all-time low, credit is fairly diversified and bank-wide system risks are well-contained. Almost 81% of banking assets are in private hands. Likewise, the present foreign stake comes to 47% of total paid-up capital of all the financial institutions regulated by State Bank.

Given its achievements, Pakistan's banking sector reforms offer a useful insight into design-specific lessons for countries venturing to restructure and reform their banking sectors. Dwelling on these lessons, I propose to further outline the significant impact and benefits of banking sector reforms of Pakistan on its population and economy. While a lot has been done and achieved, sustainability of banking system requires the banking industry to position itself to address the emerging challenges and complications, commonly observed in the post-banking liberalization era. Recognizing this, the State Bank of Pakistan (SBP), in partnership with the industry, plans to implement the outstanding reforms agenda, while also taking new initiatives, to broaden and deepen the banking system.

B. Banking sector design-specific lessons

The first lesson learnt from Pakistan's banking sector reforms is that the reform strategy needs to be broad based and well sequenced. The reforms must be all-encompassing; resultantly the process is arduous, complex and continuous.

Pakistan's banking sector reforms have been launched and implemented over 1990s. The pace and sequencing of these reforms were aligned and sharpened to provide a major impetus towards the end of 1990s.

Deregulation and restructuring took a strong foothold in Pakistan as the Government decided to privatize banks and allow liberal entry of new banks. Simultaneously, SBP removed all restrictions and barriers on banks' conduct of business by 1997/98 which included: (i) removal of floor and caps on interest rate structure by 1997-98; (ii) abolishment of concessional lending schemes (except for Locally Manufacturing Machine and Export Finance scheme); and (iii) lifting the cap for project financing. Accordingly, banks and NBFIs were able to set their lending rates in relation to the demand/supply conditions in the market.

While promoting banking sector liberalization, SBP ensured introduction of effective and comprehensive regulation, consistent with international standards and best practices, and implemented institutional restructuring and strengthening.

Carrying forward the bank restructuring process in 2007, the Government is planning to float Global Depository Receipts (GDRS) of few large banks by offering a proportion of their shares in international markets. This should help to further dilute government holdings in large banks. Taking cue from the minimum capital requirements (MCR) imposed by SBP, market led mergers and acquisitions (M&A) are helping consolidate and, as such, develop stronger and robust banking sector.

The second lesson is that effective monetary policy and conducive economic environment facilitate transition and augment impact of reform. The dismantling of credit ceiling, both at sector and bank level, and the switch to market based indirect monetary instruments improved the quality of monetary management. These measures, along with the move of the Government to market based pricing of central bank borrowing, helped reduce fiscal subservience of monetary policy. Macroeconomic stability (following the lowering of fiscal deficit and external current account deficit over FY2002-03) provided an environment for central bank to ease monetary policy, which helped bring down interest rates to historical low of 5.05%[1] by June 2004.

The third lesson that emerges from the banking sector reforms is for the regulator to have effective powers and capacity to lead and implement reforms. Prior to the reforms, SBP's autonomy was limited and its supervisory domain was undermined by the Pakistan Banking Council (PBC), a body formed to oversee the affairs of the nationalized commercial banks (NCBs). Moreover, the supervisory framework lacked proper risk mitigation elements and supervisors lacked requisite supervisory skills in this regard. In addition, the regulatory capacity was inadequate to regulate a market oriented financial system. In 1997, SBP legislation was amended to enhance SBP's independence and to empower its Board more effectively in monetary management matters. Furthermore, PBC was abolished and central bank staff was trained in relevant areas to build capacity at all levels. There has been considerable accomplishment in terms of central bank obtaining the necessary understanding and leadership for steering the process of bank reforms. SBP is now equipped to deal with numerous transition challenges that are commonly observed, given the state of economic development, governance and political economy, in developing countries.

Another lesson learnt from Pakistan's banking sector reforms is that bank privatization succeeds if accompanied with appropriate debt and labor restructuring. In early 1990s, the Banks (Nationalization) Act, 1974 was amended to empower the Government to sell all or any part of the share capital of NCBs and to allow entry of new banks. The Privatization Commission Ordinance laid down the legal framework for privatization and provided for the establishment of Privatization Commission, which facilitated banking sector privatization. The process was led by competent transaction teams who conducted valuation and structured deals in a transparent manner.

Pursuant to nationalization, weaker banks were merged with relatively bigger banks involving re-grouping of 11 banks into five large banks. Of these, four banks were subsequently privatized and strategic shareholding of two large banks is now with foreign parties. In addition, the Government has offloaded 26% stake of the largest bank, National Bank of Pakistan through the stock market. Presently, the top five banks cumulatively account for 52.6% of banking assets. In parallel to privatization of NCBs, SBP over the last 16 years or so licensed 28 new banks, of which six are microfinance banks and five Islamic banks.

Success of Pakistan's privatization program emerged from a well coordinated effort to recognize upfront need for change of management, debt and labour resolution. The Government facilitated bank restructuring process by recapitalization of banks through (i) equity injection of Rs46 billion in some of the public sector banks and write offs equivalent to Rs51 billion, (ii) lay off of close to 35,000 employees in two phases[2] from public sector banks and (iii) closing of over 2000 unbanked branches. To reduce the level of NPLs, the Government and SBP coordinated to establish the *Committee for Revival of Sick Industrial Units (CRSIU)* and the *Corporate and Industrial Restructuring Corporation (CIRC)* which together have enabled debt recovery of Rs15.1 billion, while settling write offs to acquire the NPLs of public sector banks. Creation of a National Accountability Bureau (NAB) Cell at SBP to expeditiously process the cases of wilful defaulters has further facilitated debt resolution. Moreover a special law, *the Financial Institutions (Recovery of Finances) Ordinance, 2001* was enacted with a view to facilitate speedy recovery of loans. SBP also introduced a special scheme to speed up the recovery of NPLs. Under this scheme, borrowers were allowed to settle their obligations on the basis of Forced Sale Value vis-à-vis outstanding amount, whichever is lower. Borrowers were required to deposit 10% down payment at the time of signing of settlement agreement and repay remaining amount in 12 quarterly instalments. The scheme encouraged a lot of defaulters to come forward and settle their long outstanding liabilities.

Finally, it is important to recognise that quality of ownership and professional management are key to success of privatization. While launching privatization of state owned banks, in early 1990s, the Government eased entry requirement and allowed issuance of a number of bank licenses. Under the criteria, *Guidelines for Setting up Commercial Banks,* Pakistan has for long allowed and had foreign banks in the country. Banks are encouraged to be set up as local subsidiary along with strategic holding of up to 49% or they can conduct banking business in branch mode or as a wholly owned, locally incorporated subsidiary provided these are: (i) banks from countries belonging to

[1] Weighted average marginal lending rate

[2] In the first phase (1997) 24,000 employees were laid off and in the second phase around 11,700 employees were relieved.

regional groups and associations of which Pakistan is a member and (ii) foreign banks with global tier-1 paid-up capital of US$5 billion or more. Moreover, on a case to case basis foreign banks may be allowed to open a wholly owned subsidiary. Aside from change of ownership to private sector, central bank through its fit and proper criteria has encouraged appointment of professional management and Boards at the banks so that those charged with the responsibility of management and oversight have due competence, integrity and qualifications.

C. Trends, impact and benefits of reforms

The sustainability of transformation in banking sector, in any environment, is critically dependent on reforms' success in (i) promoting higher degree of depth and efficiency in financial intermediation process by effective resource (deposit) mobilization and channelling these resources to productive sectors at competitive pricing, thus playing a critical role in promoting economic growth; (ii) strengthening the financial performance and soundness of banks; and (iii) extending the outreach of financial services to under-served/un-banked segments of the society.

Depth and efficiency of financial intermediation in Pakistan has improved. This is captured by the rise in: M2/GDP ratio from 36.6% in FY00 to 44.2% in FY06; bank assets to GDP ratio from 49.1% in 1997 to 55.6% in 2005 and deposit to GDP ratio – an indicator of the level of financial savings – from 38.7% in 1997 to 43.1% in 2005. More significantly, equity market capitalization grew from merely 10.3% of GDP in 2000 to 37.1% of GDP in 2006. Equity markets benefited from sizeable growth in banks and their performance. Now banks constitute almost 25% of market cap at Karachi Stock Exchange and valuation of their shares is quite high with commercial banks' P/E ratio of around 10x in December 2006.

Despite significant improvement in financial indicators, relative to its regional comparators, Pakistan's financial market has a relatively lower depth and penetration (see para. 24 below). Moreover, Pakistan's financial system continues to be predominantly bank based with the bond markets barely constituting 5-7% of GDP and the low pension and insurance coverage.

Profitability and financial soundness of banks is impressive and Pakistan's performance indicators in this area are amongst the best in its regional peers. The profits of commercial banks crossed over $1 billion for the first three quarters of calendar year (CY)2006. Over CY2000-September 2006, return on assets of banks rose from negative 0.2 to 2.1 and return on equity from negative 3.5% to 26.1%. Banks' profitability has been driven by a combination of factors. These include (i) a rise in earning assets of commercial banks to 85% in September 2006 which is significantly above the pre-reform period and a rise in advances to total assets from 49.1% (CY2000) to 55.1% (Sep 2006), (ii) a decline in the total and operating expense to income with latter being half the pre-reform period, (iii) a rise in the SME, consumer finance and agriculture sector lending which constitutes over one third of total outstanding advances and typically is priced above the average lending rates and those prevailing for larger corporate clients, (iv) a high share of non interest bearing or low yield deposits, while share of fixed term (above 6 months maturity) deposits declined and (v) a substantial growth in service charges which are emerging as a new source of revenue as electronic banking is taking hold. A SBP study has highlighted that privatization has had distinct impact on profitability of the banking sector, though its impact on efficiency is relatively weak.[3] This is largely as older and larger banks need more lead time to enhance their capacities and develop their internal control systems to improve efficiency. It is expected that over the period there will be more progress in these areas.

Industry wide capital adequacy ratios (CARs) are high while NPLs have scaled down. Risk weighted CAR for banks has increased from 11.3% in December 2005 to 12.7% by 30 September 2006: Tier 1 capital to risk weighted assets rose from 8.3% to 9.8% and capital to total assets from 7.9% to 8.8%. Aside from recapitalization, banks' capital adequacy ratios have benefited from new capital injections and/or re-ploughing of profits as banks are required to raise their capital base. Debt settlement and recovery (see para. 12 above) coupled with introduction of sound prudential regulations, vigilant supervision and stricter enforcement of these regulations have facilitated a sharp fall in NPLs to total loans and net NPLs to net loans ratios to 7.7% and 1.8%, respectively over CY2000-September 2006.

[3] State Bank of Pakistan: *Financial Sector Assessment (FSA)*, 2005: See Annex A.

Growth in private sector credit and underlying sector diversification has improved. Set to expand businesses, in the last three years, banks have recorded a record growth in private sector credit which reached close to Rs402 billion ($6.7 billion) in FY06. This has helped serve the economy well in a number of ways. It has fuelled economic activity, revived and enhanced industrial capacities, met crop and non-crop requirements and has supported steady growth in services sector whose contribution to GDP has grown to 52.3%. Presently, the corporate sector accounts for almost half of the total credit outstanding, credit to agriculture sector now accounts for 6.4%, SME-financing accounts for 16.1%, and consumer financing accounts for 14.3% of the total credit outstanding.

To enhance the reach of the banking system and serve the society's credit requirements, SBP encouraged systematic development of microfinance sector as well as Islamic financial institutions. Primarily in informal sector, the microfinance industry is now being nurtured in formal sector. The Microfinance Ordinance, 2001, supported by SBP's dedicated prudential regulations, provides the legal and regulatory framework for microfinance banks, which is consistent with the best practices. To date, SBP has approved licenses for six microfinance banks[4] but these banks have only recently been operationalized so their impact has yet to emerge. Islamic banking is gaining a foothold in Pakistan as SBP has issued licenses to six Islamic banks and allowed a number of conventional banks to offer Islamic window. SBP is working with the industry to promote Shariah compliance regulatory and supervisory framework. While still at a nascent stage, constituting only about 2.3% of industry assets, the growth in Islamic banks has far exceeded the growth observed in larger Asian markets.

Consolidation of banking sector helps develop a stronger and robust banking system but it requires regulator's determination and industry's dynamism to launch effective mergers. To encourage a consolidated banking sector, SBP called for a phased increase, over a period of five years, in the MCR of commercial banks to eventually reach at least Rs6 billion ($100 million) by the year 2009. Domestic private banks have either injected own capital or sought alliances and partnerships to augment capital; alternatively domestic or foreign banks have stepped in to acquire mid- or small-sized banks to expand their capital and outreach. Excluding specialized financial institutions (such as microfinance and Islamic banks who have been allowed new licenses) SBP has imposed an embargo on new conventional bank licenses. The process of capital enhancement and consolidation has progressed well. Of the total 39 commercial banks (excluding microfinance banks that enjoy lower capital requirements), eight banks have complied with 2009 stipulated capital requirements and 16 banks have raised capital to meet 2006 MCR, while other 11 banks are well on their course to meet the prescribed MCR. There remain four banks that are either in the process of being privatized, such as SME Bank, or those with specific mission/objective, such as the First Women Bank, who remain below the stipulated requirements. While capital injections have been spurred by the possibility of recourse to capital markets or foreign interest in banking system, the impetus to consolidation emerges from the wave of M&A, which in turn is driven by foreign interest in Pakistani banks triggered by their profitability.

There has been a growing foreign interest. Existing foreign banks have by and large enhanced their presence and stake in Pakistan and some new foreign banks have entered for the first time. Since the year 2000, 30 M&A have taken place. At present foreign stake comes to 47% of total paid-up capital of all the financial institutions regulated by State Bank. The most sizeable deal of $513 million was struck by the Standard Chartered Bank which acquired a mid-size strong local bank (Union Bank). This is being followed by others such as ABN-Amro, NIB and Citibank etc. that are contemplating acquisitions. This M&A wave will help further consolidate the banking sector. Principally driven by high investor confidence and economic prospects, the current M&A wave is also triggered by the need for banks to meet higher capital requirements and also growing competition which will make it increasingly difficult for small banks to survive. Together the growing trend of M&A and recent issue of GDR of MCB Bank at the London Stock Exchange have attracted close to $1 billion inflows and another equivalent amount is yet to flow in.

[4] Four microfinance banks (Khushali Microfinance Bank Limited, First Microfinance Bank Limited, Tameer Microfinance Bank Limited and Pak Oman Microfinance Bank Limited) are working at national level while two (Rozgar & Network) are operational at district level.

D. Sustainability of banking sector reforms

Prospects for the continued and sustainable banking sector growth are promising. What lends confidence to bankers that are fast expanding their stakes and interest in Pakistan is the

(i) high and sustainable economic growth that the country is set on; real GDP in the past 2 years grew by 8.6% and 6.6% and is now set to register another 7% growth;

(ii) real consumption expenditure is on the rise and leading the demand growth, boosted by doubling of per capita incomes to $850, a fourfold increase in remittances over few years, rising industrial capacities for consumer durables, automobiles, etc. and growing role of consumer financing and personal loans in meeting the demand for consumer goods;

(iii) in recent years, investment spending has gained substantial momentum and will be rising further as the Government and private sector launch and implement large infrastructure projects. The Government has plans to add 5000 MW new power capacities in private sector along with a number of hydel projects, highways and port infrastructure, while catering for the development of large urban infrastructure to upgrade large cities; and

(iv) foreign direct and portfolio flows is at an all time high and is expected to further grow given the economic potential and high returns on equity in both corporate and banking sectors.

The scope for enhancement of banking business is phenomenal as the level of financial exclusion is exceptionally high despite the growth in banking. Today, penetration ratio of financial services is low judged by any measure. Thus far less than 20% of the population has access to financial services given Pakistan's low depositor base and number of borrowers are under 5 million (3% of population). More graphically, there are only 171 deposit accounts per 1000 people and 30 loan accounts per 1000 people. Like wise, only 30% of the adults have bank accounts. Credit/GDP ratio at 27% is low judged by country and sector financing requirements or judged by levels prevailing in emerging markets. Consumer financing penetration ratio is 3.9%; steps are being taken to relax exposure limits for consumer financing selectively for banks based on a uniform criteria whereby banks with experience, stronger risk management controls and track record will be able to expand this business. Commercial banks barely provided $1 billion for mortgage markets. The microfinance industry reaches only 770 households and agriculture and SME financing reaches to 300,000 borrowers each.

A number of development initiatives are underway to support banking sector to enhance its outreach. A strategy for microfinance industry is in the offing which advocates up scaling the outreach to 3 million people or more over next five or so years by allowing flexibility to microfinance institutions to commercialize their business and remove any distortions that stand in the way, while looking for partnership with well experienced international microfinance institutions to transfer the requisite approaches and modalities that have worked well in other environments. At the same time, work is underway to promote mobile banking which ought to help expand outreach of financial services.

In the SME sector, banks are now allowed cash flow based lending and several business development initiatives are underway. In agriculture, pilot programs are underway at federal and provincial levels to develop land records and titling to ensure that an effective collateral registry system evolves. In housing, banks are being encouraged to provide housing finance; however, banks fund long term housing loans through short term demand and time liabilities that in turn pose an asset liability mismatch on their books. Therefore, in order to mitigate asset liability mismatches, besides provision of fixed rate mortgages, deliberations are underway for establishment of mortgage refinance company in Pakistan.

Work is also underway to privatize outstanding financial institutions engaged in development financing business such as the SME Bank, Industrial Development Bank of Pakistan, House Building Finance Corporation and Zarai Tarakiati Bank Limited.

SBP has established a dedicated Development Finance Group to help improve the enabling environment for development financing and coordinate intervention and initiatives which could enhance outreach, while developing capacities across the board in banking sector and also providing specialized training in some sector areas.

Given the financial sector's dependence on the banking sector, as evident from the low bond market to GDP ratio, efforts are underway to enable the development of alternate sources of long term funding. Among others, an Infrastructure Finance Taskforce is now deliberating the possibility of supporting establishment of long term infrastructure lending institutions and equipping them with the desired project appraisal and risk management capacities.

There is scope for enhancement of efficiency in financial intermediation which should augur well for deepening and sustainability of financial sector. Trends of over 16 years reveal that Pakistan's interest rate structure has been quite volatile and unstable. After a period of exceptionally high interest rates, which were a manifestation of the public sector banks' inefficiencies, misallocation of credit and reckless lending accompanied by large defaults, Pakistan's lending rate fell but the real lending rate was kept so low that, despite low inflation over 2000-2004, it virtually turned negative.

Aside from volatility in interest rate, Pakistan's banking system over 1990s maintained high spreads. Subsequently, low interest rates pursued by central bank coupled with enhanced competition helped narrow spreads to 5.39% by December 2004. However, a reversal in trends was notable as spreads rose again to 7.4% by the end of November 2006 with commercial banks re-pricing their loans in line with the upward adjustment in SBP repo rate (policy rate) from 7.5% in April 05 to 9.5% in July 06 in the wake of growing inflationary pressures, without a concomitant rise in deposit rates.

Banking spread will eventually be aligned as competition deepens both for deposit and loan products. Fall in cost/income ratios coupled with sizeable balances in savings or short term deposit accounts (with less than 6-months maturity) or transactional accounts – which offer low returns below the inflation rate – should facilitate decline in spreads. However, a factor to consider here is the high administrative expense to total expense ratio because of rising remuneration of banking professionals and high operating costs.

SBP is keen to evolve a more stable and positive real interest environment over longer run and as a starting point has incentivized banks, through a combination of measures, to change the maturity mismatches on their balance sheets**. On one hand, SBP has used differential and concessional cash reserve requirement (half of the level applicable to deposits below 6 months) for term deposits above 6 months. On the other hand, SBP is using moral suasion to encourage banks to offer different products which offer better returns to depositors.** Improved efficiency in financial intermediation process and a shift to long dated deposits will augur well for sustainability of banking system. The latter should also help reduce the inherent asset-liability mismatches as the proportion of longer maturity deposits rises and encourages banks to lend long.

Efforts to strengthen risk management through effective implementation of prudential regulations, financial infrastructure and technology and internal controls within commercial banks should further augment sustainability of banking system. To consolidate and strengthen the risk management capacities of banking sector, SBP and banks have taken a number of initiatives. In line with the MCR, banks are to fully comply with the enhanced requirements by 2009. Banks are maintaining high CAR ratios (see para. 18). Moreover, improved credit risk management and strong vigilance has helped keep NPLs at manageable levels.

Over the last few years, about half of all bank branches are online with their respective head offices, providing management with real-time information. Besides overall improved service delivery, banks have actively pursued Debit and Credit Cards business in urban centres. E-banking is mandatory for banks to enhance interconnectivity of ATM switches in order to fully exploit ATM network of all the banks. SBP issued *Guidelines on IT Security* and started on-site IT inspections to ensure whether banks were adequately managing the risks associated with online banking. In SBP's on-site inspection, the quality of internal controls play a prominent role in determining the over all rating of the bank. The *Internal Control Guidelines* issued by SBP provide a minimum set of standards banks have to adhere to in this regard. While the level of sophistication varies from bank to bank, internal control systems have yet to be fully in place.

In coming years, commercial banks would continue to develop their infrastructure, technology and human resource capacities to adopt and implement Basel-II in a phased manner. Banks are required to adopt Standardized Approach for credit risk and Basic Indicator/Standardized Approach for operational risk from 1st January 2008. Subject to development of their in house systems, they would switch over to advanced approaches from 1st January 2010. In line with the Pillar 3 (Market Discipline) of Basel Accord II framework, SBP has revised the format of annual accounts to improve disclosure requirements. Further development of online management information system would enable banks to maximize benefit of eCIB (Credit Information Bureau), operationalized in 2006.

SBP is now in the process of introducing a Real-Time Gross Settlement (RTGS) system[5] for large value payments in the inter-bank market. Banks holding accounts at SBP would be able to operate their accounts in real time from their own premises. RTGS will help overcome the liquidity and settlement risks as banks would be able to settle their transactions affecting their accounts at SBP (e.g. inter-bank lending/borrowing) immediately after the terms of the transaction have been agreed and executed between the banks. A *Payment Systems and Electronic Funds Transfer Act 2006* after its passage by the Parliament will lay down legal framework for online banking.

With 81% of banking assets now in private hands, the government guarantee or backing of the deposits of NCBs has been withdrawn. The implied government policy of rescuing the failing banks at the expense of taxpayers' funds has now given way to a banking supervision approach based on international best practices. SBP has instituted an all-embracing framework viz. Institutional Risk Assessment Framework to further strengthen the existing supervisory mechanism and to mitigate the variety of risks banks are exposed to. The framework envisages a collaborative and seamless supervisory focus amongst various supervisory departments within SBP to ensure cohesive and proactive monitoring of risks within banks and DFIs. The framework, being highly technology driven, provides for the timely flow of information and enables SBP to institute more efficient and effective banking supervision and continuous monitoring both on the part of SBP and institution themselves, integrating off-site surveillance, on-site examination and current market information.

The new dynamics, however, pose a challenge and SBP will need to work on developing appropriate safety net for depositors, especially small depositors, without creating the problem of moral hazard.

Concurrently, the Board of Directors as well as top management of a bank should be held liable for their mismanagement and poor decisions. In this connection, SBP has now for sometime enhanced banking surveillance which, among others, involves conducting regular stress testing to measure system wide sensitivity to different risks including credit risks, market risks, liquidity risks and operational risks. Now banks are to be encouraged to estimate their risks to capital, liquidity crisis at the earliest stage, execute prompt corrective action in order to curb the problem at the onset, and settle depositors' claims in a timely manner, in cases where the corrective actions result in liquidation/restructuring of the banks.

Regulatory measures are now in place to curb practices of **anti-money laundering as well as terrorist financing.** These measures make SBP compliant with the recommendations of international bodies to prevent these high risk activities. There exists a comprehensive set of regulations on Know-Your-Customer (KYC), Customer due Diligence, Suspicious Transactions Reporting and correspondent banking has been put in place in line with the recommendations of the Financial Action Task Force. All financial institutions (FIs) have to confirm the true identity of every prospective customer and verify the documents obtained from new customers/account holders. All suspicious transactions are to be reported by banks to SBP and, after due analysis, such cases are handed over to NAB or other relevant authorities for further action. The capital base of exchange companies has been strengthened and they are subject to KYC and record keeping requirements with appropriate reporting to SBP. All such companies are now subject to both off- and on-site inspections and any violations by banks or exchange companies make them liable to penalties.

Lastly, but most importantly, effective implementation of corporate governance is the key for sustainability of banking sector. Pakistan has an elaborate corporate governance framework. The key objective of the framework is to ensure that the owners and managers of a bank are fully committed and have sufficient capacity to operate the bank prudently. The Banking Companies Ordinance 1962, the primary legislation governing banks, lays down several governance requirements. It includes the rules for appointment/dismissal of directors, disclosure of share ownership, dividend policy, appointment of external auditors etc. Further instructions in these areas are provided through Prudential Regulations issued by SBP. Most critical in this context are the exposure limits (see Box below), guidance provided on the role and responsibilities of the Board of directors, and fit and proper test criteria for Chief Executive Officers, Board members and key executives. This criteria is in addition to the minimum qualification requirements.

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[5] To facilitate this process a complete on-line, real time banking solution Globus is under implementation which will provide a strong back end system for SBP's banking operations.

SBP has maintained a fairly elaborate prudential regulatory framework consistent with BIS standards. Regulations define instructions for all types of financing and prescribe specific exposure limits depending on the nature of risks involved. Most critical for containing the risks are the following requirements:

(i) Bar on stock brokers, money changers, etc. from becoming part of the management and Boards of banks;

(ii) For individual single borrower, exposure cannot exceed 30% of FIs' equity (subject to a maximum 20% fund exposure) and exposure to a group cannot exceed 50% of FIs' equity (subject to 35% fund exposure). FIs' exposure shall not exceed 10 times the borrower's equity, fund based exposure shall not exceed 4 times the equity, current ratio of borrower shall not be lower than 1:1 and subordinated loans have been allowed to count towards equity of borrowers;

(iii) Unsecured/clean exposure against single facility has been restricted to Rs500,000 but aggregate exposure of clean lending is limited to equity base of FIs;

(iv) Investment in shares of a company cannot exceed 5% of the FI's paid up capital or 10% of capital of investee company, whichever is lower. Furthermore, total investments in shares shall not exceed 20% of banks' equity – strategic investment is excluded from the 20% aggregate exposure limit and there is a holding period of 5 years;

(v) Contingent liabilities cannot exceed 10 times the equity of FIs;

(vi) FIs have been barred from taking exposure in their own shares/other financial instruments or the shares/instruments issued by borrowing entity or its subsidiary. Banks cannot take exposure on any person against the security of shares of any commercial bank/FI in excess of 5% of paid up capital of the share issuing bank/FI. Banks cannot hold shares in any company whether for pledge or as a mortgagee or an absolute owner, exceeding 30% of the paid up capital of the company or of their capital, whichever is less;

(vii) Guidelines on internal controls are an integral part of guidelines for risk management systems and underscore transparency and disclosure requirements to minimize the hazards of asymmetrical information and adverse selection; and

(viii) Standard provisioning requirements are in place.

Listed FIs are also required to comply with the Securities and Exchange Commission of Pakistan's (SECP's) Code of Corporate Governance for Listed Companies; although the banking law and SBP's directives override it wherever there is a discrepant stipulation. SBP has issued a Handbook on Corporate Governance for Banks/DFIs containing international best practices and is involved in awareness building through conferences and regular interaction with the banking professionals, including partnership with the Pakistan Institute of Corporate Governance, which was established with SBP as a founding member**.**

The efforts of SBP and banking industry have yielded results in bringing about a positive change in the corporate governance practices of banks. Banks are now managed and run by better cadre of professionals and stakeholders now play an active role and take a keen interest in the affairs of banks. The Boards meet regularly and participate in both setting strategic direction for their institutions and providing desired oversight. Managements at majority of banks are equipped with professional competence and high degree of integrity. The increasingly intense competition among banks has resulted in improved and swift decision-making processes. The outside pressures have been marginalized. Financial reporting standards mirror international best practices, resulting in enhanced disclosure and transparency. In compliance with the elaborate corporate governance framework of the regulators, banks have displayed high level of eagerness to up-grade their systems.

A quick glance at the corporate governance practices adopted by banks brings to fore the following major areas where banks have shown increased, albeit slow, compliance with the existing codes and standards:

- Banks seek prior clearance from SBP for the appointment of directors and CEOs;
- Banks follow the fit & proper test criteria for the appointment of key executives who should not be holding an office in another financial institution;
- The scope of the Board's policies has been enhanced to cover a broad range of areas such as internal audit and control, risk management, human resources, credit, investments, etc.;
- Boards now include experienced non-executive directors;
- Boards meet more frequently;
- Banks record detailed minutes of the Board meetings;
- Boards constitute specialized committees with well-defined objectives, authorities and tenure, comprising of non-executive directors to review different critical functions;
- Banks ensure that executive directors are not more than 25% of the total directors on the Board;
- Banks ensure that their cross shareholding in other financial institutions does not exceed more than 5%;
- Directors of the same family do not get representation of more than 25% of the total directors on the Board;
- Auditors are appointed from the SBP's approved panel and they are rotated at an appropriate interval; and
- Banks publish and circulate on quarterly basis unaudited financial statements of the banks along with the directors' review.

Improvement in corporate governance has helped impart a high degree of financial stability. The balance sheet of the banking system has expanded at a fast pace. Since December 31, 2002 till December 31, 2005, the balance sheet has recorded a growth of 64.5%, which in all respect is quite significant. Deposits of the banking system registered unprecedented growth of 69% since 2002. Profits of the banking system scaled new heights. Return on assets (after tax) increased to 1.9% in 2005 (and further increased to 2.1% by Sep 2006) from 0.1% in 2002. Credit activities got a tremendous boost as banks responded zealously to meet the sharp rise in demand for credit. Loan portfolio of the banking system got doubled in the last three years. Unlike the past trends, the credit growth was fairly diversified. This led to substantial increase in the exposure of the banking system to new emerging sectors like consumer, agriculture and SMEs sectors.

Greater compliance with the corporate governance standards has helped keep NPLs to low levels and improve the management performance. As of December 2005, the key management performance indicators of the banking system confirm the impact of strengthened corporate governance and risk management practices within banks. For example:

- Intermediation cost has fallen to 2.7% as compared with 3.4% in 2000.
- Average earnings per share have increased to Rs5.7 from Rs3.2 in 2003.
- Deposits per employee rose to Rs30.2 million from Rs14.2 million in 2000.
- Assets per employee increased to Rs39 million from Rs19.1 million in 2000.

Conclusion

Pakistan, like the rest of Asia, is growing fast and the rise in per capita income, emergence of middle income group and relative wealth increases are together bringing with them new demands for retail banking industry. The transformation of Pakistan's banking sector, given the success in developing a stronger and robust system, offers some interesting perspectives and lessons for banking sector reform. The sector now faces interesting emerging challenges and risks that are not uncommon in financial systems in post reform period.

Going forward, Pakistan's financial sector strategy for next decade or so will aim at addressing the emerging challenges while laying the foundation for a deeper and efficient financial system which is competitive and financially inclusive. Banks are now aggressive and recognize that having cleaned up their loan portfolios and balance sheets, they need to re-position themselves to take advantage of the boosting economy. Over the next few years, commercial banks will have to focus on product innovations and diversifying their reach to infrastructure, housing, SME and microfinance industry while exploring and reaching out to new and under-banked regions. The investors and the industry are seeking better investment and financing alternatives and solutions, with demand for private debt, asset based and mortgage based securities, credit derivatives and hedge products etc. now emerging from different segments of economy and population. Banks will need to poise themselves to meet these demands for continued growth.