Shamshad Akhtar: Financial sector – ten-year vision and strategy

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the inauguration of the Development Finance Conference on "Expanding Frontiers of Financial Access in Pakistan", organised by State Bank on the eve of 60th Anniversary of the State Bank of Pakistan, Karachi, 1 July 2008.

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Pakistan's financial system grew significantly in the last few years. At present, total financial assets have reached $175 billion (110% of GDP). The banking system constitutes 95% of the total assets of financial institutions and bank shares constitute 40% of the stock market capitalization. Among different segments of financial markets, banking sector has gained dynamism, profitability, respectability and strength. Deposit base rose to $60 billion and advances to $47 billion. Supported by growing financial intermediation process, banks aggregate profitability rose to $1.8 billion. Recapitalization and prudent lending has lowered net non-performing loans (NPLs) to below one percent of assets. Banks capitalization and quality of assets have helped raise the risk weighted capital adequacy ratio to 13.2 percent.

These achievements are impressive, however:

(i) A large segment of population and geography is still under served from the existing financial markets and this gap will grow as Pakistan's population rises further.

(ii) The financial system has to gear itself to meet the growing requirements of the economy in particular infrastructure which conservatively requires almost $150 billion over next few years;

(iii) New types of risks have emerged as banks acquired different types of nonbank financial (NBF) institutions including investment finance, brokerage, asset management and insurance companies etc. Some of these have been merged into the banks while others remain as subsidiaries. Banks are beginning to cross-sell different financial products through their branch networks. This is a market driven development but does pose systemic risks and supervisory challenges. Some banks have also acquired strategic and non strategic stakes in nonfinancial companies. These create a different set of risks that will need to be thought through and dealt with carefully.

(iv) Financial sector needs to be diversified as bulk of the country's financing requirements is currently met by the banks. While market capitalization of stock market has increased significantly, new issuance of capital is small. Similarly, the debt markets constitute largely of government securities, while the corporate paper market is limited.

(v) Finally, within regional context Pakistan's financial system despite its growth is still small. For instance, the financial system of other Asian emerging financial market countries twice or three times larger in relative terms and the Gulf States have now geared themselves into regional financial hubs.

Keeping in view these considerations, the State Bank of Pakistan's (SBP) is now launching a ten year Financial Sector Strategy. This strategy has been developed based on (i) a comprehensive assessment and evaluation of the banking system that helps draw key lessons; (ii) Pakistan's forward looking economic development strategy and vision; and (iii) learning from the emerging changes in global and regional financial architecture and financial advancement and innovation. This paper aims to capture the objectives and broad elements of the financial sector strategy which will be finalized and adopted by the third quarter of the 2008 after consultation with stakeholders. The scope of the paper is confined principally to reforms of banking sector and regulatory architecture which would require some principal changes or new legislation.

The objective of the financial sector strategy will be to broaden and deepen the financial system to help Pakistan:

(i) Achieve higher and sustainable economic growth,

(ii) Develop a dynamic, robust and stronger system,

(iii) Mobilize the domestic and foreign resources for private investment (which has to be the key driver of the economy), and

(iv) Deepen financial penetration for poor and underserved regions.

Prerequisite for financial sector growth is, however, macroeconomic and political stability and augmentation of the enabling policy environment in the real sector. Assuming these preconditions are restored, the ten year strategy will

(i) Stimulate growth in financial assets to 165% of GDP, growth in deposit base by 13% to reach $217 billion, and advances to allow private sector credit/GDP ratio to rise from 27% to 42%;

(ii) Be financially inclusive supporting the small savers and meeting the requirements of small borrowers in agriculture, housing, small and medium enterprises (SME) and microfinance sectors by raising financial penetration ratio through enabling policy environment and outreach expansion (coverage of per bank branch to improve from 19,000 to 15,000 persons).

(iii) Developing financial infrastructure and automation to enhance the coverage of automated teller machines (ATMs) to 10,000; and

(iv) Reduce the systemic risks of the financial system by developing an adequate safety net for the small depositors and the central bank's lender of last resort functions as well as a framework for dealing with failing banks.

To achieve these goals, SBP is in process of putting together a comprehensive reform program. SBP has developed and has full ownership of this reform agenda and received technical assistance from the International Monetary Fund, the Asian Development Bank and the DFID of United Kingdom to draw from international experience and expertise.

Central bank governance

Principal driving factor for the formulation and implementation reform is the autonomy and competence of the organization. Over the years, emerging evidence has confirmed the significant benefits of central bank autonomy (not just *de jure* autonomy but *de facto* autonomy too) for macroeconomic performance as central banks play a primary role in price stability, while also ensuring financial stability. This role has been supported by assigning requisite powers to central banks not only in monetary policy formulation, conduct and implementation but in effective enforcement of fiscal discipline. This has been achieved in several jurisdictions without any real additional costs or sacrifices in terms of output volatility or reduced economic growth. Further, central banks in number of jurisdictions have performed the role of regulator of the full or part of the financial system. The recent financial market turmoil has also brought under scrutiny the models and governance structures of central banks/financial regulators, while bringing to forefront the risks of leaving nonbank financial (NBF) sector virtually unattended. In absence of proper regulatory and supervisory oversight, the NBF sector's overleveraging of the financial systems has exposed the global financial system to multiple risks. As defaults emerged the financial institutions lacked ability to service obligations. This episode has generated unprecedented liquidity crisis and bank losses whose undervaluation/closures/liquidation impacted the financial markets at large.

Rescue operations and economy wide and household losses have not only impacted advanced countries but taken a toll on global financial system and send warning signals on need for change in financial regulatory architecture and its landscape. These attributes of central banks helps cushion the impact of political cycles on economic cycles.

SBP over the years has acquired not only the required autonomy to steer the monetary policy and financial stability mandates, but has regulated and supervised well the banking sector reforms. Notwithstanding, SBP set up under the State Bank of Pakistan Act, 1956 has been amended occasionally to strengthen its powers and mandate but now it needs to be modernized in line with the international best practices. The key issues with SBP Act are that (i) it contains outdated provisions that have lost their validity in light of the administrative and structural changes at the economy level; (ii) governance structure of central bank which over the years has undoubtedly served well the interest of autonomy and accountability of central bank but does still contain provisions which undermine the functioning of central bank, (iii) if price stability is to be upheld, in line with the mandate adopted by other central banks, than provisions pertaining to the monetary and fiscal coordination need to be re-examined to ensure proper enforcement of fiscal discipline through more explicit restriction on central bank borrowings, (v) it ought to now include appropriate provision for the financial stability defining explicitly mandate of central bank in financial safety net, bank exit and lender of last resort functions and (iv) it includes provisions which ought not to be in primary legislation but in supportive regulations etc.

In addition to modernizing the SBP Act, as a part of financial sector reforms central bank has reviewed the supportive laws such as the Banking Companies Ordinance, 1962 and other principal laws. In parallel, SBP has been working on a host of new laws to develop adequate financial safety nets such as the Deposit Protection Scheme (to be discussed later in this paper) and Consumer Protection and financial crimes law.

The sections below further outline the major areas of thrust of the financial sector reforms, but do not as yet cover the full reform agenda.

Financial Inclusion Program

In Pakistan the level of financial exclusion is quite steep: only 17% of the population (30 million) has bank accounts and less than 4% (5.5 million) are borrowers. Moreover only 25% of the total bank deposits and 17% of the total borrowers are from rural areas. In value terms their shares are even smaller, 10% and 7% of the total value of deposits and advances, respectively. Limited access to services is captured by the low level of branch penetration, especially in rural areas and this has held back the growth of savings and impacted credit distribution system.

To address issues of access, SBP has established a Development Finance Group which has developed a comprehensive Financial Inclusion Program (FIP) that aims to promote access to development finance for all small and underserved markets. In Pakistan context there is need to encourage shift in banks' focus away from large companies to smaller companies and the household sector. Most credit to the enterprise sector goes to manufacturing, which receives a disproportionately large share of bank credit compared with this sector's contribution to GDP (20%). Aggregate data for all credit by borrower size shows an extremely skewed distribution: 22,000 or 0.4% of all 5.2 million banks' borrowers account for 65% of all bank credit—and the remaining 5+ million borrowers for the remaining one third. At the very top there is even more concentration; the largest 50 borrowers account for 37%[1] of all credit outstanding. Given that the manufacturing sector is the predominant recipient of credit, it is safe to assume that most of the large borrowers are concentrated in that sector.

1 As of 31st March, 2008 of all banks/DFIs.

The FIP, to be supported by DFID and other donors, is quite broad based and will help enhance the outreach. To start off, SBP and Pakistan Microfinance Network (PFM) has developed a multi-faceted microfinance strategy to triple the number of microfinance (MF) beneficiaries from 1 million to 3 million by 2010 and then to 10 million. To support this program, SBP has encouraged commercialization of microfinance industry so that it is financially and socially sustainable. Some of the specific actions being launched to facilitate this involves encouraging:

(i) Microfinance institutions (MFIs) to develop commercially viable operations that are financially and socially sustainable operations and transform them into MFB to provide holistic services. Tax holiday for five years has been provided to MFIs once they transform themselves into full-fledged microfinance banks (MFBs).

(ii) Development of partnership between commercial banks and MF providers and the post office (PO) network and MF providers. (POs already manage over 4 million savings accounts, mainly small accounts below Rs 10,000, through more than 12,000 branches.) There is scope for the PO and MF providers to join forces with the latter acting as intermediaries for funds from the PO, especially as many MF providers are constrained in their operations by limited funding.

(iii) Flexible regulatory regime for MFBs to allow innovation and organic growth without compromising prudential objectives. Limits for MFBs (and MFIs) will be adjusted at least in line with inflation and a two-tier regime is to be considered under which MFBs (and MFIs) with track record of prudent governance, risk management and financial success could be given more room to operate. This includes capital adequacy requirements, which will be reviewed so as not to put MFBs (and MFIs) in a competitive position substantially worse than that of banks.

(iv) Mobile phone-based banking services which is a cost effective way of bringing financial services even to the most remote areas of the country. This is an option with enormous potential as there already are almost two times as many mobile phone owners (some 80 million) than there are depositors. Mobile phone services reach almost every part of the country and would be an extremely cheap way for banks and other financial institutions to extend their reach.

(v) Development of domestic and international MFI partnership.

(vi) Financial literacy and customer awareness program.

In parallel, SBP has been promoting Islamic Banks (IBs) to appeal to the population which has thus far excluded itself for faith reasons. A separate Islamic Finance Strategy paper has been developed which projects that given the growth rate in IBs businesses, Islamic Finance is expected to constitute almost 12% of the Pakistan financial system in next five years or so. To encourage sound growth SBP has laid out an elaborate prudential regulatory and supervisory framework which conforms to the International Islamic Financial Service Board's (IFSB) framework in whose development Pakistan has played a key role. To ensure proper due diligence of the IF development SBP has constituted Shariah Advisory Board which approves broad policy and regulatory framework and new products etc. SBP is working to develop proper liquidity management framework and instruments to allow the IBs progress in a prudent and sound manner.

SME sector faces a host of both demand and supply side constraints impeding delivery. On demand side, lack of planning and entrepreneurial skills and problems with SME policy framework remain a major hindrance, while on supply side banks perceive financing these entities as high risk in absence of credit history and collateral. Notwithstanding the growth in the SME financing has been significant and its share in total outstanding advances is close to 14.5% and the number of borrowers in the sector is around 185,000. In line with international best practice, SBP plans to promote SME financing through supportive mechanisms. This would involve help in designing specific products, and developing credit scoring system for

SME finance and SME financial reporting system. In addition, banks are being encouraged to facilitate program based lending – in which banks establish general criteria for meeting the specific financing requirements of businesses – and cash flow based lending rather than collateral based lending. Work is underway to develop an appropriate credit enhancement mechanism which will facilitate bank lending to the sector. Also, SBP is exploring with industry possibility of development of venture capital funds focusing on SME promotion and offering training to commercial bankers on SME lending methodology and approaches.

Agriculture lending has received a significant boost with the banks meeting the target of Rs200 billion set for 2007/2008. Outstanding agriculture advances account for 6% of total advances. However, the current flow of credit meets only 45% of the agriculture credit requirements. SBP strategy for agriculture credit focuses on doubling the number of borrowers from 2 million to 4 million and meeting 75-80% of the agriculture credit requirements. SBP has encouraged a revolving credit scheme for three years – under which farmers can borrow for one year and can continue to borrow without providing documentation each year; guidelines have been issued lending for livestock, fisheries and horticulture subsectors and programs are being launched for dairy sector. In addition, a small farmer financing scheme has been promoted based on group based lending and a crop loan insurance scheme has been structured which is now being offered by some insurance companies. Work has been completed on promoting agriculture Islamic finance and also providing capacity building both to farmers and bankers in regional languages.

Finally, to promote rural areas, SBP has mandated banks to establish 20% of their new branches in rural areas. As competition for deposits grows and lending is backed by adequate margins, banks will find their rural operations to be more attractive. Innovative products and methods of selling them will also increase banks' reach and may change the "brick-and-mortar" nature of branch operations.

Strengthen consumer protection and financial education

Over time competition backed by financial literacy and awareness will impose the right pressure on banks to upgrade their customer services. SBP on its part is focusing on effective compliance with customer service regulations and following it up with proper enforcement to motivate banks to render good service and deal fairly with customers. To supplement and reinforce this, SBP plans to:

(i) Introduce a Consumer Protection Bill, in line with international best practices, which would among others provide guidance on issues of transparency, confidentiality, availability of statements, account servicing, protection against fraud, unfair contracts and lending practices, methods of debt collection, arbitrary penalties, etc. Supported by the legislation an appropriate dispute settlement mechanism will be established. Currently consumer protection is codified in SBP regulations but this will have to be also reviewed and updated in line with the new legislation.

(ii) Encourage Pakistan Banks' Association (PBA) to adopt a Banking Code to commit banks to fairness, disclosure and ethical standards.

(iii) Strengthen the newly established Consumer Protection Department of SBP to monitor compliance with such new laws, regulations and codes.

(iv) Introduce a depositor protection scheme to protect small depositors.

(v) Transform and strengthen the role and functions of Banking Ombudsman, which will remain an independent body from the regulators, to be better aligned with the above developments.

(vi) A long-term campaign to enhance financial literacy will be launched in rural and urban areas both by the commercial banks and SBP with the support of the IBP, NIBAF and PBA.

Consolidate and strengthen the banking sector

Further consolidation is necessary to ensure presence of stronger and well capitalized banks that can support diverse financial services and client requirements, while adequately managing risks. Even though the number of conventional commercial banks has declined from 41 to 29 through mergers and acquisitions and closures, there remain some banks with lagging performance. As the most attractive mergers already have been consummated, the pace of additional mergers requires SBP to further enhance the banks' minimum capital requirement (MCR). Moratorium for issuance of new licenses, extended now to Islamic banks too,[2] will remain – exceptions, if any, will require new banks to comply with $300 million capital requirements. Meanwhile all existing banks will be provided with a time frame to comply with the new MCR. Outside the ambit of moratorium will be MFBs but licensing for these will henceforth be at the national and provincial levels. New institutional arrangements such as introduction of credit unions that aim to serve the lower tier markets will be examined favorably.

In the banking sector, specialized government-owned banks have only made limited contribution in their niche markets. They have out-served their purpose and/or their dismal performance has impacted the SBP balance sheet (requiring regular provisioning for the losses). Compensating their losses is not an option given the fiscal stress. In view of this, proper resolution program is being worked out for these institutions. For instance: SME bank is being privatized, the House Building Finance Corporation (HBFC) will be restructured and privatized and the Zarai Taraqiati Bank Ltd. (ZTBL), a highly strategic case, needs to be restructured financially and operationally. The Industrial Development Bank has now been incorporated as a public company and will be available for sale. Privatization agenda should also be extended to insurance sector as this sector is quite critical for Pakistan's overall financial sector development.

Strengthen competition and efficiency

Competition drives a market-based financial system that helps bring about efficiencies and innovations by encouraging price discovery and formation process. In Pakistan, banks with substantive market power and access to low cost funds by virtue of their age old captive clients have ended up distorting price mechanism as they are principal price setters. As a result, real returns have been negative for the bulk of deposits, which has deterred effective fund mobilization and distorted the yield curve and pricing for loans and advances.

To assess the degree of competition in financial markets, SBP examines market structure indicators (such as the number of institutions) or concentration (Herfindahl or other indexes) as well as the performance measures such as bank margins or profitability – though it has to be acknowledged that these variables are influenced by multiple factors ranging from macroeconomic conditions to bank specific factors such as scale of operations and risk preferences etc.

To enhance competitiveness, SBP will primarily focus on continuing to broaden and deepen financial system further. Notwithstanding, efforts are under way to (i) review the actual behavior and conduct of banks related to structure of banking industry and take the required actions, (ii) encourage contestability by allowing entry and (iii) promote development of NBF intermediation to improve bank competition, . Furthermore, competition in banking system is likely to grow as demand for advances results in need for higher deposit mobilization which would then alter the pricing for both advances and deposits.

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2 Islamic banking constituting over 4% of banking assets, are encountering competition from within and from conventional banks and we need to nurture and solidify their performance.

Taking advance action, SBP has sought to remove structural distortions that have impeded competition. A case in point is the minimum deposit rate of 5% on all PLS savings product as banks had for quite some time enjoyed ample access to a pool of excessively cheap savings deposits. In addition, SBP regulations require greater transparency and disclosure in interest rates and rate setting. As market matures, competition will encourage better alignment of interest rates both on deposits and advances. Large corporate borrowers that have largely dependent thus far on banks, may over time find it more attractive raise financing from debt markets. In other countries such financing is typically cheaper than bank borrowing.

Strengthen prudential regulation and supervision

SBP has a broad set of prudential regulations that aim to strengthen risk management, internal controls and corporate governance in banks, while providing effective guidance for promotion of development finance and consumer related matters. The regulatory framework for banks is now quite complete, although it needs constant updating and upgrading to conform to evolving international best practices. Some challenges remain: (i) loan concentration, (ii) emergence of financial conglomerates and their supervision, and (iii) implementation of the Basel II regime.

Given high concentration of credit to the manufacturing sector, there is need to re-examine the regulation relating to exposures of large company/borrowers and related companies. High exposure has developed as banks and companies have been reluctant to go to seek alternate sources of financing and instead seek relaxation of SBP prudential regulations to borrow from banking system. Excessive exposure poses a threat to broader financial stability, while deterring growth in nonbank finance sector. Stricter limitations on bank exposures to large companies would drive those companies to raise capital from debt and/or equity markets. This would support financial sector and risk diversification and contribute to financial stability.

In developing prudential regulatory framework SBP will draw on the debate between the *Rules versus Principle based regulatory regime*. The former takes a legalistic approach in attempting to codify all prudential requirements into either primary law or regulations. This approach is common in Spanish speaking countries as well as the United States. While this approach provides certainty to the industry, it limits the flexibility of the supervisor to adapt to changing circumstances and experience. Thus it puts a high premium on thinking through every possible practical variation and also on having near perfect legal drafting. The problem with this approach is that financial regulation is more of an art than a science. Many of the rules that are introduced for prudential purposes need continuing modification and refinements based on experience. The danger of relying too heavily on detailed rule books/regulations is that the principle gets lost in the details. There is also a danger that the industry becomes unduly focused on avoiding the wording of the rules rather than the intent.

The principles-based approach attempts to limit hard-coded law and regulations to broad statements of principle. For example, the law might identify the need for banks to implement sound risk management frameworks. However, rather than trying to identify every feature of such a system, the principles-based approach allows the supervisor to develop its framework and its own understanding of best practice in line with the principles.

Given the pros and cons of two approaches, SBP will try to strike a balance between these two philosophies. The industry is still evolving and, as such, needs some guidance in the form of detailed rules. At the same time, the need to adapt quickly to changing circumstances and to learn from experience means that we need to retain flexibility around the detail that supports our principles.

Basel II implementation

SBP has initiated the implementation of the new Basel II minimum capital adequacy requirements. The Standardized Approach to credit risk and the Basic Indicator Approach to operational risk became effective at the beginning of 2008 after running the new regime in parallel with the old one last year (2007). Banks have made major advances in implementation of the new framework, though many are facing challenges in areas like integrated risk management policy, collateral management and the limited availability of credit ratings for counterparts. Almost one half of banks' on-balance sheet exposures require external credit ratings but only one sixth of those exposures have ratings. Of those that have been rated, most are banks, while only a small portion of corporate exposures are rated.

The policy issue for SBP is how fast to allow or require implementation of the more advanced approaches. Given the dearth of external ratings, banks will reap the full benefit of the new Basel II regime only when they can apply the advance approaches based on internal credit ratings. For this they need further improvements in their risk management systems. To push the reforms, SBP has made it mandatory for banks to carry out internal risk ratings though banks will be provided lead time for implementation.

The application of the basic Basel II approaches is not likely to result in any major change in banks' capital adequacy ratios (CARs). The impact studies done so far indicate that lower capital requirements against credit risk are offset by the new capital charge against operational risk, when compared against the previous Basel I regime. Only by moving to the advanced approaches can banks expect to lower their CARs.

Financial conglomerates

Commercial banks are de facto moving into conglomerate modes by venturing into other sectors. Some banks have acquired or merged NBF institutions such as investment finance, brokerage, asset management and insurance companies into the banks, while others remain as subsidiaries. Conglomerates have become the norm, as banks broaden their product offerings and seek cross-selling opportunities. Presently, 5 banks (and one DFI) own shares in insurance companies, 12 banks have interests in asset management companies and mutual funds, and many are involved in other areas like leasing, financial advisory and brokerage services, *modaraba* management and foreign exchange.

Financial conglomerates present a major challenge for the SBP. It is generally acknowledged that financial conglomeration makes good business sense, and that these developments should be regulated but not stifled by regulation. The main challenges that financial conglomerates pose for regulators are:

- First, unless there is strict implementation of sound banking practices, there is a danger that a bank can become a cheap source of finance to the other members of a group without proper recognition and management of the risks involved.
- Second, failures elsewhere in the group can expose the bank to contagion risk.
- Third, especially where the conglomerate group includes commercial businesses, there is a risk that the bank depositors end up carrying the residual risk for non-financial businesses.

Regulators address these concerns through consolidated supervision which places a supervisory net around all members of the group. The primary intention is to prevent an otherwise sound bank from being impaired by association. As a part of supervisory reform agenda, SBP will be moving towards consolidated supervision system in compliance with Basle Core Principles. To allow for this appropriate structural change in financial sector regulatory architecture would be required and legislated.

Regulatory architecture

The emergence of financial conglomerates has had an impact on the shape of regulatory architectures around the world. Internationally there has been a marked trend towards regulatory amalgamation and, within that trend, towards creation of a single or minimum two agencies with responsibility for all regulation within the financial sector. The reason most commonly cited for this trend is the need to better cope with the regulation of financial conglomerates.

Our current architecture in Pakistan is not well suited for consolidated supervision. Some members of financial conglomerates are under-regulated and no agency has power to regulate financial groups as a whole. At the centre of the case for reform in this area is the need for the SBP to regulate and supervise banking groups on a consolidated basis and to apply prudential norms to all aspects of the business of groups that include banks.

This can be achieved in Pakistan context best by ensuring that all deposit and lending institutions are under oversight of SBP and the responsibility of lead supervisor for consolidated supervision be entrusted fully to SBP. The basic rationale for this proposal is to protect depositors and public liability from the contagion that can arise from financial conglomeration. This case is strengthened by the role that SBP plays in financial system stability and the independence and skill base it has to carry out this function effectively.

Financial safety net framework

Depositor protection scheme. Aside from yield, safety of depositors is one criterion for enhancing deposit mobilization. Since private banks, which form the bulk of the financial system, are outside the Banks' (Nationalization) Act, 1974 SBP is developing a blue print for a limited deposit protection scheme (DPS) to protect small depositors. DPS increases depositor confidence in all banks and comforts small savers and helps the competitive position of small private banks in relation to large banks or government owned banks, which typically are viewed as safe and/or "too big to fail" (TBTF). DPS reduces the probability of open bank runs, which can be damaging to confidence in banks more generally and lead to contagion in other banks. The protection of deposits under a limited DPS typically would be strictly confined to small depositors which constitute majority of the depositors but represent only a small proportion of total deposits in value terms.

A DPS typically establishes a Depositor Protection Fund (DPF) to facilitate depositor payouts funded by the initial capital contribution, premium payments from banks and its own investment income. The premium charged can be fixed across the board or risk based for each bank. Managing expectations associated with DPS is critical as it does not prevent all bank runs and systemic crises but it can be a helpful tool in managing a systemic crisis. The SBP has advanced plans for introducing a DPS in Pakistan and will soon be circulating a concept paper and supportive legislation for stakeholder consultation.

Lender of last resort*.* A principal role of SBP is to maintain confidence in the banking system in times of systemic illiquidity. In light of this, internally SBP needs to define clearly Lender of Last Resort (LOLR) functions and the supportive liquidity arrangements. Currently SBP provides liquidity for solvent banks facing temporary liquidity problems using different instruments, like repos, access the discount window, or using other monetary policy instruments like outright securities purchases (OMOs or directed) or changes in the cash reserve ratio (CRR). Since SBP has a strong banking surveillance mechanism as well as regular banking inspection, the probability of banks having solvency problems is low but one cannot rule out such cases. Banks do have high exposures in loans and shares to certain companies and economic groups – often related parties – and liquidity and solvency issues could emerge despite high vigilance. In view of this, SBP plans to develop a policy framework and guidelines for its LOLR functions.

Exit framework. A strong legal framework for bank exit is already provided for in the draft amended Banking Companies Ordinance. Under this SBP would have strong powers to intervene, reorganize or close unviable or failing banks. SBP has experience of handling and intervening in problem banks and their subsequent liquidation or managed mergers. SBP will further develop a suitable range of resolution options to deal with TBTF banks.

In parallel, there is need to develop a Prompt Corrective Action (PCA) regime that obliges SBP to take specific corrective actions once certain trigger ratios are reached. The typical PCA regime is based on CARs and if the CAR falls to below the regulatory minimum CAR certain prescribed actions are triggered.

Development of Core Financial Infrastructure. Host of initiatives are under implementation or to be launched.

a) *Retail payment system:* SBP is launching today the 1st of July 2008 the Pakistan Real Time Gross Settlement (RTGS) system for wholesale transactions. In addition, work has started for modernization of the retail payments and settlement system which will encourage electronic and mobile phone based transactions, while taking due consideration of privacy and security matters and the development of an appropriate legal framework.

b) *Credit Information Bureau:* The SBP's electronic Credit Information Bureau (eCIB) has already helped credit risk management in all financial institutions. With up-to-date (almost real-time) data and coverage of almost 5 million consumer and commercial borrowers, it provides financial institutions, both large and small, an invaluable risk management tool. The data includes not only outstanding amounts but also repayment histories and some non-financial information. The comprehensive coverage of corporate borrowers down to very small consumer finance amounts provides a unique statistical basis for credit scoring techniques and other methodologies. SBP will further develop operational software for borrower analysis and credit scoring which will help in credit analysis of banks.

c) *Credit rating agencies:* Corporate ratings are needed for the standardized approach of Basel II implementation as well as for the development of a private debt securities market and for listing of companies on the stock exchange. There are two rating agencies who have rated a few companies, as there is little need and few incentives for companies to subject themselves to external scrutiny. The incentive framework for the services provided by private rating agencies needs to be analyzed with a view towards identifying measures and incentives that will result in more company ratings. That would also help facilitate private listings of private debt securities.

d) *Land and property registries:* Land and property titles are available in urban but not in rural areas. Improved land titling systems in rural areas could be seen as a necessary underpinning for an improved credit extension process, by allowing collateralized lending for the agriculture, SME and housing sectors. Security of title is essential. SBP is exploring ways to facilitate pilot studies and efforts to develop off the shelf systems and make it affordable for local and provincial governments to introduce new registries and systems over the medium term.

e) *The judicial system:* An efficient financial system requires legal certainty and enforceability of contracts. The present court system needs to be further equipped to deal with financial transactions and disputes. This would require a long-term program to train judges in commercial and financial law and perhaps to establish more specialized courts to deal with financial matters.

Conclusion

Drawing up the financial sector strategy for next ten years the paper has outlined the vision, objectives and strategy for financial sector. This paper concentrates largely on reforms of banking sector and central bank –essentially focusing on its role as regulator. Driving this reform is the country's overall development program which being ambitious requires resources for both the public and private sector. Pakistan's financial markets need to grow at a faster pace to not only meet the domestic requirements but to be able to position itself to receive the foreign inflows that will be critical to meeting our infrastructure and industry financing requirements. Financial sector broadening and deepening is critical to ensure the profitability and sustainability of banks, while ensuring that our citizens have access to development finance to change their lives. It is essential to structure and put in place financial safety nets with supportive legislation on a timely basis for banking sector to grow in a sound and efficient manner, while managing properly its systemic risks. Empowering and gearing the primary regulator will be key to keeping on track and effectively implementing the reform agenda.

In conclusion it is important to highlight that besides banking sector reforms, the broadening and deepening of financial markets requires equal emphasis on development of securities and debt markets along with the insurance and pension reforms which have lagged behind the banking sector reforms. Adhering to macroeconomic stability and developing an enabling environment for real sector, both at the federal and provincial level, and a functioning judicial system would be key to keeping the necessary momentum for financial sector reforms.